CHAPTER I

CONCEPTUAL FRAMEWORK OF FOREIGN DIRECT INVESTMENT

It is now a widely recognised fact that the developing countries are marred with the scarcity of the capital in their economy. India being traditionally an agricultural country with symptoms of over population historically looming large, the economy has largely been relegated to the mere subsistence level. Economic uncertainties, labour and market exploitations have always thwarted designs of organised capital investments until recently. In view of the changing planning perspectives and government priorities since the 1970s the investment scenario witnessed a new dawn. Growth took place through the 1980s and new financial and investment imperatives progressively consolidated all through the 1990s. Resultantly, the bolstered dynamism and diversification in the Indian economy is increasingly attracting the investment from foreign investors, particularly from the United States of America. Attraction and assimilation of foreign direct investment is generally acknowledged as a driving force for the economic growth of a developing country like India. If we hold a historical perspective we notice that the foreign investment has generated profound
impact on the economy of the developing world, on the social structure of countries and even the land use pattern and the industrial scenario of nations. In the process of the flow of foreign trade and investment two or more economies are introduced to each other to harness the possibilities of further economic and market interactions, leading to basic structural changes in their economic systems.

Due to the behooved trend of developing economies there is a lack of sufficient capital, technology and managerial skill required to utilise the resource potentials and to create one. The increasing realisation of the development dynamics and survival challenges, prompt the developing countries to grow at a faster rate while insufficient capital and obsolete technology are the stumbling hindrances in the growth and development process. It is under these circumstances that the harness and harvest of foreign investment is of paramount importance in supporting the process of growth and development of the drawing country.

ROLE OF FOREIGN DIRECT INVESTMENT:

It is often being debated as to what should be the share and role of foreign direct investment (FDI) in the economic planning of the country. Infact, it is to be probed as to whether FDI
complements trade or substitutes the trade of the countries mutually engaged in foreign direct investment.

'A good number of authors are of the opinion that F.D.I. is a substitute of foreign trade in the investing country. Regularly increasing outflow of funds of foreign investment projects, is like a substitution of commodity export by selling the projects which will inevitably lead to the reduction in employment opportunities at home. It is for this reason, the labour unions object to direct foreign investment which ultimately results in the export of employment from investing country to the host country. The main concern of such unions is that workers are not able to move freely among different countries and, therefore, employment opportunities and welfare have to be considered within the framework of a national economy.

Another point is that, if a particular nation raises import tariffs other countries start trying to penetrate the protective barriers through FDI rather than promote export operations in the country, since without barriers, the same goods would have been exported. For instance, many of the entrepreneurs of America rush to EEC to invest just to get behind its common tariff wall even if the growth of their domestic economy is slowed down.
In addition to it, it is a widely known fact that many of the surplus countries urge the scarcity countries to eliminate limitations on the inflow of direct investment and simultaneously also hope to increase exports and make requests to such countries to abolish quota restriction and tariffs etc. It means that the foreign country would like to increase direct investment as well as exports of the same products. The two situations appear incongruent with each other. This may be attributed to the lack of an integrated theory of trade and investment.

A perusal on the role of FDI might reveal that its primary objective is to promote attempts for extending free trade all over the world. The objective of free trade is that, each country, on the premise that neither labour force nor capital is transferred internationally, promotes international division of labour along the line of comparative costs. It suggests that the principles of trade reveal how each country can develop in the international economy. Foreign direct investment should then complement the lack of capital or management skills of the host country. Foreign direct investment invigorates the other factors of production such as labour, resources and management to boost up the cheap production which was not possible previously because of the lack of assimilating conditions. The role of FDI, as it promotes the
structural adjustments, is to establish harmonious trade all over the world.

To evaluate the positive role of foreign direct investment, scholars of financial administration have been trying to justify and support the activities of the multinational corporations from the point of view of the growth of an enterprise. The inadequacies of their view result from a considerable disregard to policy implications inferred from the international economic theories. The theory of international division of labour tends to assure that while one country takes advantage of specialised production and export of one commodity, it provides the opportunity to its counterpart economy to produce and export another commodity for its own advantage, despite the differences in size, stage of development and level of demand that might exist between the two economies. Thus, the theory invokes a sound basis for the interdependence and prosperity of trading economies. Therefore, the driving force of the multinational corporations should also be reconsidered in the theory of international division of labour.

In addition to it, the foreign investment is a pre-requisite for promoting free trade, which means to establish in the host country a new industry with a potential to produce at low cost.
One should view at the relationship between the direct foreign investment and comparative cost. Foreign direct investment is usually released from a comparatively surplus industry in the investing country to find its way into the industry with overt or potential advantage in the host country and will harmoniously promote an upgrading of industrial structure on both sides and thus speed up the expansion of trade between the respective nations.

DATA BASE AND RESEARCH METHODOLOGY

The nature, scope and scale of research determines whether it would largely employ the primary data or the secondary data. Since the present study is on the national scale and its nature is of international financial, technological and managerial cooperation, the information base of the study ought to be the secondary data sources. The study entails collection, classification and processing of the secondary data obtained from diverse sources. The published and unpublished records, Census data, Reserve Bank of India reports, SIA Newsletters and their monthly and annual reports were the major data sources. In addition to it the publications of Ministry of Commerce and Industry, other government reports, Clippings of the National Dailies, Reputed National and International Journals, Magazines and the authentic
Books were made use of in information building, conceptual frame and examining and analysing the trends, problems and prospects of foreign direct investment in India.

Simple statistical methods were used in the ordering, classification and processing of the data. Tabular, graphic and cartographic methods have been employed to depict the FDI distribution, growth, variations and trends. Both the deductive and inductive methods were harnessed in the analysis of data and drawing the inferences. Annual as well as periodic differentials between the FDI Approvals and the Actual Inflows were statistically computed and their patterns were ascertained.

CHIEF CHARACTERISTICS AND OBJECTIVES OF FDI:

* In FDI there is no immediate burden on the host country to pay interest.

* Another advantage of FDI is that the repatriation of profits is done / obligatory after the venture is fully established and starts earning reasonable profits.

* FDI brings have the latest technology and know-how.

* Besides technology, FDI brings in advanced business
management expertise as well as modern manufacturing culture.

* FDI companies also emphasize upon the cost and quality control.

* Formidable FDI companies such as MNCs and TNCs bring with them their invaluable knowledge and experience to ward off the industrial hick-ups in the host country.

* The major objective of India's efforts to boost FDI is that it tends to reduce the economic dependence on foreign aid as well as the high interest rate commercial borrowings.

* FDI usually opens up new export markets for the host country.

* FDI companies import plant equipments, raw materials and spare parts in the host country at foreign exchange neutral terms.

* In FDI the currency risk is borne by the foreign investor companies.
* As there is a tax holiday to some FDI companies there is a corresponding and compensatory holiday on repatriation of profits by these companies for some years.

THE CONCEPT OF MULTINATIONAL CORPORATIONS:

Multinational corporations do not merely bear a commercial connotation. The term "multinational corporations" (MNCs) is generally used to designate any business corporation in which ownership, management production and marketing extend over several national jurisdictions. The term appears to be a misnomer in the sense that these corporations are seldom multinational in either ownership or control. However, it is the one in general usage. There exist other technical definitions in general consideration. An MNC is essentially a corporation of the developed country that invests in other countries including the developing countries for a variety of reasons, e.g., to have access to a foreign market, to secure foreign sources of supply, and to have the benefit of lower cost of production or lower taxes etc. There are also a number of American and foreign corporations which invest in other countries especially in places like Brazil, Hong Kong, Taiwan and Mexico in order to cut costs, the
destination of the goods produced such "offshore production" usually returns to the American markets.

Some general characteristics of MNC's may be as follows: At first, they make direct investments in a foreign country. In contrast to portfolio investment, which involves the purchase of non-controlling equities in a firm or debt instrumentalities of any kind. Direct investment implies the establishment of a foreign branch or subsidiary or the takeover of a foreign firm. The main motive behind portfolio investment is largely to have financial participation though managerial control continues to rest with the borrower, and the liabilities incurred by debt borrowing can be liquidated through repayment. The purpose behind direct investment and the possession of foreign branches or subsidiaries, on the other hand, is primarily the acquisition of managerial control over a production unit in a foreign country. Foreign investments are aimed at, to establish a permanent source of income or supply in the foreign economy as a result of it, there is an increasing economic and political relationship due to the lasting and significant character of foreign direct investment.

Another important aspect of the present study is that the MNC's are usually characterised by a parent American firm and
a bunch of subsidiaries or branches also wholly or partly owned by U.S. corporations in several countries. There is a common pool of managerial, financial and technical resources, and crucially important is, the parent body which operates the whole in terms of a coordinated global strategy. Purchasing, production, marketing, research and so forth, are organised and managed by the parent organisation in order to achieve its long term goal of corporate growth.

It has been seen that the American investment has been accomplished by the flow of corporate management. Management, capital and technology have gone as a package to foreign lands in search of labour, and resources as well as the market.

INCENTIVES FOR FOREIGN DIRECT INVESTMENT:

One can basically see three factors which motivate the flow of foreign direct investment. These are explained as follows:

1. Natural Resource Appraisal:

Natural resource oriented investment is genuinely acknowledged as trade oriented or trade generating investment. The investing country desires to increase imports of its
comparatively disadvantageously produced or domestically unavailable products. It has been noted that integrated production and marketing are monopolised or oligopolised by big multinationals in oil, cooper and other resource goods thus leaving smaller benefits to those countries which are endowed with natural resource base.

2. Human Resource Inventory:

Human resource assessment is pertaining to work force. Labour oriented investment is a sort of trade oriented. As wages in the developed investing countries become higher and higher year by year because of increase in capital flaw. It becomes profitable and feasible for the advanced countries to contract their own traditional labour intensive industries and transfer the location of production to low wage countries where cheaper labour is available. Hence, corresponding to a dynamic change in comparative advantage, such foreign investments assist the reorganisation of the international division of labour and promote the growth of trade between labour scarcity and labour surplus countries. It should be noted that such foreign direct investments may transfer either traditional labour intensive industries which are well standardised, or new goods which utilised cheap labour
3. Market Environment:

Market oriented investment is generally sub-divided into two categories. Although direct foreign investment induced by the trade barriers in the host country is trade oriented but in a slightly different way. In this situation, heavier tariffs on final products result into the substitution of exports of final products for the export of parts and components, intermediate materials, machinery, equipments and technology necessary to the production of final goods from the investing country. Such a foreign direct investment meets the recipient country's interest in promoting import substitution activity, which is not necessarily intended to be comparative in the international market and therefore results in some wastage of resources because of the degree of protection provided to the final goods produced. But if the import substitution industry grows successfully towards export orientation, then foreign direct investment of this type culminates with labour oriented investment. Hence, there is no essential difference between labour oriented and trade barrier induced investment except in the circumstances when one aims at the worldwide markets and the other is confined to protected domestic
There is another type of market oriented investment which may be referred to as oligopolistic foreign direct investment. In recent times, this is generally found in American investment in new manufacturing product industries and it is anti-trade oriented.

**SHORT TERM Vs. LONG TERM FOREIGN INVESTMENT:**

International capital movements are conventionally divided into short and long term capital mobility on the basis of their dwell period.

**SHORT TERM CAPITAL MOBILITY:**

It is the duration and influence which differentiates the short term capital movements. Short term investments can be defined to include all such investments which have a maturity of less than one year. All investments in stocks or equity assets which have no specific maturity date may also be included under this head and will be interpreted as a tool to finance balance of payment deficit in the current accounts.

The difference in the interest rates between home and foreign countries and the domestic financial market and the
foreign financial organisation are the stimuli to such short term capital movements. One can further illustrate it with the example that when the S.B.I. purchases a documentary exchange bill accepted by a U.S.A. importer, it means that the bank has made a short term investment that yields interest at a rate marked at Washington stock market. If the interest rate in Washington is higher than that in India, this is a profitable transaction for the S.B.I. which will attract short term capital movement.

Another factor influencing the rate of short term investment is the exchange rate fluctuation. S.B.I. reckons its profits and losses in rupee terms which is inevitably affected with the exchange rate fluctuation. If the appreciation of dollar is expected the discounting of the above said bill at Washington will be postponed and if the depreciation is forecasted it will be done at the earliest. This procedure is adopted to harness the dividends at right time.

Short term investments normally flow from a low to a high interest rate country. A country can obtain the short term investment flows it requires to offset the deficits in other accounts by manipulating its interest rate. When a country increases its rate of interest, investment flows from foreign
country take place and the investment accounts turn in its favour, this undermine the necessity for improving its trade balance. At the same measure, the interest rate hike reduces domestic investments and exerts downward pressures on wage rates and employment. This promotes exports and reduces imports. All these effects vary from one economy to the other, depending on the conditions of liquidity preference and employment. These effects are influenced by the interest rate policy pursued by the central banks in order to achieve internal and external balances, and on the open market practices to supplement the policy.

LONG TERM CAPITAL MANOEUVRES:

One of the most important factors closely related to the economic development is international long term capital movement. The capital movements can be further divided into: (i) direct investment such as plant and buildings or sales bases abroad, and (ii) indirect investment like portfolio investments which subscribe to foreign stock or bonds.

In fact there is a difference between the international capital movements and the international movements of capital goods such as machinery, raw materials and the likes. Capital is an agent to
control or to have command over commodities and services of the factors of production. Foreign borrowings do increase a country's capacity to import capital goods. However, it does not necessarily imply that the country will import them from a leading country or even from other countries. The decision making as to which commodities are to be imported from which particular country from the borrowed capital is likely to be influenced by the differences in comparative costs in the world market with reference to the commodity costs in the host country.¹

It has been observed that the long-term international capital movements have three effects on the international economy. These are known as Liquidity Effect, Production Effect and the Recessive Liquidity Effect. The first effect of international loan is on the diffusion of international business activities this is generally acknowledged as the liquidity effect.

1. **Liquidity Effect**:

By means of international lending, investment in the borrowing country tends to increase. This in turn leads to increase

in the country's national income by a multiplier\textsuperscript{2} process and enhances its imports. The increase in imports of the borrowing country implicitly results into a correspondingly increased exports of the lending country as well as of other countries increases, at the same time imports and exports of the borrowing country as well. Through this process international lending stimulates international economic activity. In the mean time the increase in imports of the borrowing as well as other countries from the lending country makes the real transfer of capital in the form of commodities a feasible proposition.

2. Production Effect:

Another effect of international investments is the production effect. With the increased availability of capital in the borrowing country the production efficiency of the industry enhances. This promotes the living standard of the country as a whole which is the basic gain from improved production efficiency engineered by the capital drive.

3. Reserve Liquidity Effect:

Yet another effect of such investments on the international

economic activities is the reserve liquidity effect. This is the outcome of a process of repatriation of interest and the principal. It has the opposite effect of the initial investment process in which debt servicing leads to a capital outflow from borrowing countries. One can also visualize that if the continued international investments are suddenly suspended or the principal is suddenly repatriated, the production expansion plan will be interrupted and the internal as well as the external equilibria of the borrowing country is likely to collapse.

DIRECT AND INDIRECT INVESTMENTS:

There are a number of forms of major 'indirect investment' such as new flotations (new issues of national loan and bonds and debenture) sale and purchase of existing bonds and stocks (portfolio investment), and medium term loans upto five years and long term lending by financial intermediaries. Long term indirect investment is generally characterised as a means of profitable asset management from stand point of individual investors. In this regard, inter-governmental long term lending (such as economic aid) is different in nature, though it could also be considered as a form of long-term capital movement due to its similar effects.

As against this, 'direct investment' is a class of capital
movement which targets mainly at the control over management and profits of the enterprise in a foreign country. One can say that it includes the ownership of the firm by capital participation and the management authority by means of: (a) the acquisition of the stocks of the existing foreign firms to participate in the management of the firms concerned on take-over of the existing firms themselves, (b) the establishment of a new subsidiary abroad or participation in a joint venture through stock holdings, and (c) the acquisition of real assets for the purpose of business enterprise.

It could be pointed out that even if, the form of foreign investment is not a purchase of stocks but a long-term lending, it is included in a direct investment if the element of management participation accompanies it. The distinction should be made that the acquisition of stocks of a firm is included in portfolio (indirect) investment when it is done solely for dividend or capital gains, while minority (less than 50 percent) stock acquisition is included in direct investment category if it is made for the management participation alone.

THEORIES OF FOREIGN DIRECT INVESTMENT:

Theories of FDI assert that the basis for such investment
lies in the Transaction Cost of Transferring Technical and other knowledge and market imperfections needless to say that in a world of perfect market. The Multinational Enterprises (MNEs) would not exist and there would be no FDI.

According to the Hymer-Kindleberger theory (Kindleberger 1969) the foreign owned firms would make an investment in the host country only if it possesses some compensating advantage which allows it to compete on equal terms with indigenous firms. This is, however, not a sufficient condition for FDI since the firm has the option of licensing the advantage (technology) to an indigenous producer or exporting the product to the host country clearly. Certain other conditions have to be satisfied for FDI to apprise three such conditions are:

a) The advantage is internally transferable (it can be exploited by a subsidiary of the parent firm without any additional cost to the parent firm or to the subsidiaries already exploiting it).

b) It is more profitable for the foreign owned firm to exploit the advantage itself than to license it to an indigenous producer (because of imperfections in the market for
knowledge and heavy firm to firm transfer costs of the advantage) and

c) Exporting the product to the host country is not possible or unprofitable due to tariff or transfer cost barriers.

A more general theory of TNCs traces their emergence to internationalisation of markets (Buckley and Casson 1991) the theory is based on three simple postulates.

(1) Firms maximise profits in a world of imperfect markets.

(2) When markets in intermediate products are imperfect there is an incentive to bypass them by creating internal markets (within the firm) and

(3) Internalisation of markets across national boundaries generates Multinational Enterprises (MNEs) it is argued that the location strategy of a vertically integrated firm is determined mainly by barriers to trade and regional incentives to internalise, the firm will be multinational whenever these factors make it optimal to locate different stages of production in different countries. Another production of this theory is that unless either transfer costs
are very low returns to scale at the plant level are high or the comparative advantage of one location is very significant.

The international acquisition and exploitation of knowledge will normally involve international production through a worldwide network of basically similar plants. Following this theory one can see an important difference between the MNEs operating in the early part of this century and those which emerged in the latter part of the century. It is argued that prior to the second world war multinationality was a by-product of the internalisation of intermediate product markets in a multi-stage production process and in the post-war period it is a by-product of internalisation of markets in knowledge.

The two theories discussed above seek to explain FDI without making a distinction with regard to the country of origin. Kojima has argued that there is an inherent difference between FDI originating in the West and that in Japan (Kojima 1978).

He has developed a theoretical framework which integrates trade theory with FDI. This framework makes it possible for him to contrast Japanese type foreign investment with American type.
The theoretical framework brings out that the American type FDI eliminates the basis for trade in the Japanese case. On the other hand the host country's production frontier expands in such a direction that the industries having comparative advantage, expand while those having disadvantage contract thus enhancing the basis for trade. It is argued that Japanese FDI represents a search for location specific inputs to complement the skills developed by Japanese enterprises and this makes it different from the FDI originating in the West.

It should be pointed out here that Kojima's theory was developed first in the early 1960s and 1970s when most of the host countries in Asia adopted the import substitution industrialisation policy with the inflow of foreign investment. One of the core arguments of Kojima theory is that Japanese type FDI would upgrade the industrial structures of both Japan and the host country or play the role of initiator and tutor in the industrialisation of less developed countries (Kojima 1978:15-18). Lots of Japanese small and medium firms in the host countries were expected to provide production and technological linkages with local firms thus the theory presents the triad (triple) effect of the Japanese type FDI. Investment trade and industrial
restructuring with mutual benefit. The triad effect can be seen in the textiles industry typically but not so much in the automobiles and electrical appliances industries which contributed to upgrade local industry to some extent (it is still at a low level) but much lesser in the exports of these manufacturers. Surprise of Japanese FDI to Asian countries in the later half of 1980s showed different features from previous ones. The investment rush forced Japanese firms to either bring group vendor firms to the host countries or to start a new transaction in the host country with non-group Japanese vendor firms.

This was for the quick setting up of new manufacturing lines that kept to quality and timely delivery of goods for exports of the same volume / standard as that of Japan to the US and other developed countries in other words. The new investing firms are more self-contained (Ishigami 1996). Thus, although new investment from Japan in the late 1980s helped to increase the host countries exports considerably it contributed little in terms of industrial restructuring / upgradation of local supporting (vendor) industries. Indeed, the recent Asian Economic Crisis tells us that the fundamental weakness in these countries is that of their own industrial structure which lacks a strong basis of local
supporting industry. It is clear from the above that the features of Japanese FDI on which Kojima built his theory have changed fundamentals since the 1980s thus questions can be raised on the applicability of Kojima theory to Japanese FDI in recent years.

Dunning's electric theory of international production (Dunning 1988) explained both the ways in which overseas markets are surveyed by enterprises of different nationalities and the industrial and geographical composition of such activities. According to this theory a firm makes a direct investment in a foreign country if the following three conditions are satisfied.

(1) It possesses some ownership advantages vis-a-vis firms of other nationalities in serving particular markets.

(2) It is more beneficial for the firm to use the advantages itself than to sell or lease them to foreign firms, and

(3) It is profitable for the enterprises to utilise these advantages in conjunction with the least factor inputs outside the home country. The greater the ownership advantage of the enterprise. The more the incentive to exploit these themselves, the more the economies of production and marketing favour a foreign location. the greater is the
inducement for FDI.

The electric theory suggests that all forms of international production can be explained with reference to the above conditions and the location specific or country-specific advantages have an important bearing on FDI. Such advantages of particular host countries make FDI in them preferable to not only other potential host countries but also to domestic investment. It needs to be recognised further that an important determinant of FDI is the ability of the firm to generate ownership advantages which are best exploited by the firm in a foreign rather than in a domestic location. In this way the electric theory is able to provide an explanation for differences in the industrial pattern of outward FDI of different industrialised countries. While the electric theory provides a good explanation for the decision of firms to invest abroad it seems to us that the theory does not cover the competitive FDI induced by trade restrictions when a country imposes restrictions on imports of a particular industrial product. There is obviously inducement to multinational firms of the industry to invest in that country if one or two firms invest the other must also do so to counter competition and ensure their market share even if it returns. Particularly for late entrants some
FDI in the US and Europe are of his variety. Multinationals may enter a market today even if it is not profitable to do so because they foresee future growth and want to have the first entrants advantage.

Broadly speaking there are two approaches of foreign direct investment. (i) Micro-economic approach or theories of firm on direct foreign investment, and (ii) Macro-economic approach or the theories of the different countries on direct foreign investment. However, some of the macro-economic theories and their scope and effects are examined as under.

**A. MACRO-ECONOMIC APPROACH:**

Some of the macro-economic approaches are illustrated as follows:

1. **The Mac Dougall-Kemp Model:**

G.D.A. Mac Dougall attempted a macro-economic analysis of the effects of international capital movement or foreign investment which was subsequently elaborated by Murray C. Kemp. This has opened a route towards understanding a macro-economic approach to the problem at hand.

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When capital as an economic drive moves freely between the countries of the world, marginal productivities of capital are equalised internationally; efficiency in the availability of world resources is enhanced. The output of the world increases, thus augmenting welfare of individual countries concerned.

If there was a world composed of an investing country and a host country. Prior to international capital movement takes place, the marginal productivity of capital in the investing, surplus country is lower than that of the host country since capital is relatively abundant in the former. The law of diminishing marginal productivity is assumed for capital. At the same time it is assumed that within each country perfect competition prevails and the price of capital is determined equal to the marginal productivity of capital in the exchange relations.

Figure 1.1 shows that \( A_1 \) is the origin of the investing country and \( A_2 \) is that of the host country. The amount of capital is measured on the horizontal axis \( A_1Q \) which is the capital in the investing country and \( A_2Q \) that of host country. The sum of the two \( A_1A_2 \) is then the total capital endowment of the world. Marginal productivities of capital are measured on the vertical axis. The line \( MN \) is the marginal productivity curve of the
Figure 1.1: The MacDougall-Kemp Model

[Diagram showing the MacDougall-Kemp Model with axes labeled 'Marginal Product of Capital in Investing Company' and 'Marginal Product of Capital in Host Company', with points labeled P, S, Q, and T.]
investing country which depicts the diminishing marginal productivity of capital, which is concurrent to the demand curve for capital in that country. The line mn is the similar curve for the host country. Before international capital movement takes place, the investing country produces $A_1$ MTQ of output by $A_1Q$ of capital in combination with the given amount of labour, and the host country produces $A_2$ MUQ of output. It is easiest to understand the model if we assume that both countries produce the same product. The price of capital is equal to marginal productivity of capital which is QT in the investing country. This is lower than QU in the host country, and capital flows from the former to the later country to a point where marginal productivities of capital in the two countries are equated. Thus SQ, of capital moves from the investing country to the host country and the marginal productivity of capital becomes equalised as $SP = A_1$, $E = A_2$ between the two countries representing the model.

In consequence of capital movement, the output is now $A_1$ MPS in the investing country and $P_2$ MPS in the host country compared with the sum of the output of both countries before international capital movement ($A_1$ MTQ + $A_2$ MUQ), total world output increases by the triangle PUT. The model depicts that the
total output of the world increases by the free international movement of capital. One can argue and debate on the gain for the investing country decreases by SPTQ by foreign investment. However, this does not mean a decrease in its national income. As a turn to foreign investment, the investing country receives a sum equal to the marginal productivity of capital (= the price of capital) tunes the amount of capital invested abroad (SPWQ). So long as the income from foreign investment is greater than the loss of output (in the present case, by PWT), the investing country enjoys a greater national income than before the foreign direct investment. Similarly, the host country enjoys a net increase of national income. PWV. Part of the increase of output (QUPS) is set aside for payment to the investing country (by QWPS). Thus as the result of liberalisation of international capital movements, the output of the world as a whole increases and the gain is shared by both the investing and the host countries.

2. The Theory of Taxation on Foreign Investment Returns:

This famous Mac Dougall-Kemp theory has depicted the gain from investments. The authors also commented on the distribution of that gain among groups in both investing and host countries. From the point of view of a government, there exist taxing systems
which allocate a large amount of the gains to the country which initiated the tax. This is acknowledged as the 'theory of optimal taxation'. In place of allowing the investment to the point where total joint gains are maximised, a country can restrict investment and can still experience gains.

It can be exemplified that a host country can impose tax on the profits of foreign owned capital. On the other hand, the investing country can tax the returns from foreign investment after the tax in the host country is deducted. The investing country might impose a tax on the returns to domestic investment also. Investors in that country have to decide whether they should invest domestically or abroad by campaigning the after tax returns are equilibrated in their favour.

Now we examine that figure-1.2 holds similarity with figure-1.1, except that the necessary addition is made to explain the problem of optimal taxation on foreign investment. As it has been noted earlier. SQ of foreign investment will be made by the investing country in the host country under free international capital movement. Let us assume that the host country imposes

a tax on capital inflow at the rate of HG / HF. a line (not shown in the figure) can be drawn that would indicate marginal productivity of capital after tax; it shall be lower than the line mn by the tax rate, and intersects with the line MN at G. Thus, the amount of capital movement decreases from SQ to FQ in optimum taxation model.

The total output by foreign investment is the area QUHF from the stand point of the host country, of which the country pays abroad the area QJGF. instead of QWVG under free capital movement. It means that its national income increases by the area "a" (JWVG), goes to the government and then is returned to the people. On the other hand, national output decreases by the areas FHPS as compared with the case of free international capital movement. Out of this, the area FVPS was paid abroad under free capital movement. The area b. of VHP, is the decrease in output. National income of the host country is, therefore, greater under the restriction by tax than under the situation of free capital movement.

It can be understood by another interpretation that, the area "a" is the part which represents the reduction of the burden of interest (and dividends) to be paid abroad to the amount FQ of
foreign capital. Therefore, this gain is due to the decrease in the international returns to capital from QW to QJ as the result of the restriction of capital imports. The area b represents the reduction of income of the host country which is caused by the decrease of output because of the decline in the amount of capital inflow. Now it is clear from figure-1.2 that the gain is greater than the loss when the restriction of capital imports is very limited, whilst the loss exceeds the gain and the level of national income decreases when the restriction is very severe. One can estimate that somewhere in between the two there must be an 'optimal tax rate' which maximises the country's national income and determines the optimal amount of capital import. In case a country can influence the rate of return to international capital by restricting capital imports will gain by restricting capital inflow, than by allowing for free capital movement in the international market.

A similar reasoning holds good in the case of taxation by the investing country on outgoing capital. It is beneficial to the investing country to restrict capital exports by imposing tax on the returns to foreign investment when the restriction influences the return level.
Figure 1.2: The MacDougall-Kemp Model, optimum Taxation on Foreign Investment
3. The Uzawa-Hamada Thesis:

Uzawa-Hamada presented an appealing hypothesis. They hold that when by the levy of tariffs, the later will undertake direct foreign investment in the former, setting up a factory in the host economy behind its tariffs wall. It was shown originally by H. Uzawa and elaborated by K. Hamada, that, in such a case, there would be a loss to both the income and welfare of the host country.

B. MICRO-ECONOMIC APPROACH:

There are a number of micro-economic approaches. Four major micro-economic approaches are discussed as follows:

(i) Business Administration Approach
(ii) Industrial Organisation Approach
(iii) Product Cycle Approach
(iv) Catching-up Product Cycle Approach

1. Business Administration Approach:

It is the primary theory of F.D.I. which concentrates on the growth of the firm. The business administration approach was first

of all taken up to negotiate with the problem of direct foreign investment and still remains as one of the most influential. It holds the activities of direct foreign investment as a natural consequence of the growth of the firm. It is interesting to examine the process in which an Indian firm begins overseas activity to become a multinational firm. The decision making of the firm transforms from the traditional domestic market to a world market orientation. Its organisation undergoes changes. Primarily, with the process of strengthening its exports section. Secondly, with the independence of the international business section. Thirdly, with the establishment of a foreign subsidiary, and finally with the global control of subsidiaries. As a result of it, the firm faces new problems such as negotiation with foreign governments, the handling of foreign currencies and other assets, dealing with foreign labourers, arbitration of international conflicts, and so on. Such kind of problems are never encountered in the domestic market of a firm.

It means that the business administration approach seeks to give guidelines to the firm with reference to the type of management which would best confront the problems listed above.

It is more a source of counselling to the management of multinational corporations than an explanation of foreign investment. This approach is, therefore, theoretically confined to the analysis of one commodity produced by one firm even though the firm practically produces many products. It is based on the principles of absolute competition which justifies the stable growth of the firm.

2. Industrial Organisation Approach:

It was around 1960s that the economic analysis of direct foreign investment began in its earnest. The studies on economic analysis explained the U.S. type of foreign direct investment as a natural consequence of the growth and expansion of oligopolistic firms. In Stephen Hymer's view, direct foreign investment is typical of an oligopolistic firm, which has some sort of superiority and is endeavoring for control in an imperfect market in order to maximise profits. In the opinion of Richard E. Caves, newest products tend to be oligopolistic in their nature because of the product and the development differentiation. Refinement and sale of underground resources such as oil are suited to vertical

integration, which strengthens the oligopoly.

This theory suggests that the firms venture into direct foreign investments because of their oligopolistic character and that their investment and operation abroad enables them to survive by strengthening and expanding oligopolistic systems. The two theories discussed so far neatly characterise the U.S. type of direct foreign investments in commercial relations.

3. **Product Cycle Approach**:

Still another approach related to the oligopolistic theories is Vernon's product cycle theory. The special feature of theory lies in the combination of three stages of a commercial system: (a) innovation, (b) growth, and (c) maturing of a new product with the research and development. Further, the theory predicts where a new product (or innovative technology) is most likely to be harnessed. In the initial stage, the design of the product undergoes several changes. Hence, its production is technologically unstable and the market does not get familiar with the product. Its sales do not grow rapidly and demand for the product remains subject to price-inelastic conditions.

In the second or the growth stage, sales of the product increase, as large scale production and bulk sales methods are introduced. Meanwhile, entries in the industry increase and competition intensifies amongst producers. Demand becomes price-elastic so that the sales of each firm becomes more responsive to price conditions. Under these circumstances, the realisation of economies of scale and the managerial ability of the firm play important role in its growth.

Lastly, when the mature stage js arrived at, the product becomes standardised and its production technologically attains stability. Instead of the decisive role played by research and development activities or managerial skills at the innovative and growth stages, unskilled and semi-skilled labour becomes important considerations. Ultimately, through foreign investment the production location tends to shift to the low-stage, developing countries. The cost of marketing the exports of products from these countries may be low as compared to other commodities, since the commodity is already standardised. It is interesting to probe that at what stage in a product cycle and for what reasons is direct foreign investment preferably undertaken? Now products brought out in the United States first enjoy a monopolistic position. Export increases when mass production is introduced and
the cost is simultaneously reduced. Sometimes uncertainties to this export position arise and exports decrease. The uncertainties arise due to tariffs in the importing countries, import quotas, increase duplicate domestic production in the importing countries and more importantly the entrance of other foreign competitors into the import market. Thus direct foreign investment is a monopolistic defence of the market and could be made more successfully before the mature stage in the marketing of a product.

4. Catching-up Product Cycle Approach:

The catching-up product cycle approach was identified by Dr. Akamatsu, Professor Emeritus of Hitotrubashi University, Japan. He originally called it 'the wild geese-flying pattern' of industrial development in developing countries. As it is shown in figure 1.3, the time series Curve for imports of a particular product is followed by that of domestic production and later on by that of exports. Professor A. Kamatsu, suggested that a pattern like 'wild geese flying in orderly ranks forming an inverse English alphabet "V" is just as airplanes flying in demonstration.9

In order to drive home the point the concern of Vernon and others was to explain how a new product is invented and manufactured on a large scale in the leading industrial countries. In a developing or catching-up country, the product cycle starts with the imports of the new product with superior quality. The imports increase substantially and satisfy the country's aggregate demand. As and when the increase demand approaches the domestic production threshold, domestic production becomes economical.  

A learning process follows and is assisted by importing technological know-how and by direct foreign investment. The expansion of production then grooms the economies of scale, increase in productivity, improvement in quality and reduction in the costs. This involves an important substitution process in the product cycle.

Another important aspect is that as domestic costs reach the international competitive cost level, foreign markets are developed, the scale of production is extended further and costs are reduced again. Hence, the expansion of exports which is enabled by the growth of domestic demand in its turn provides a stimulus to individual development. To sum up it may be

appropriate to call such successive development of imports, domestic production and exports the catching-up product cycle. It is crucial to bear in mind that such a product cycle takes place only for standardised products, than new products, and in the developing rather than in the developed economies.

It is clear from the above mentioned theories of foreign direct investment, that the business administration approach and growth of the firm approach alongwith the macro-economic approach (the Mac-Dougall-Kempt model, the theory of optimum taxation on foreign investment, and the Uzawa-Hamada thesis) are basically one commodity analysis and hence instigate, partial equilibrium analysis. As a matter of fact, they can not be acknowledged to be true macro-economic theories. All of them are based on the principles of absolute competition and a profit maximisation by the capital. It is, therefore, imperative and important to tie these approaches together with a two commodity and general equilibrium approach. This approach will be based on the international division of labour, and will emphasise comparative cost considerations, and thus will be able to comprehensively analyse both foreign direct investment and international trade systems. This chapter is continued with the next
chapter of the thesis which deals with the US strategy of foreign direct investment.