CHAPTER - 2

FDI: A CONCEPTUAL FRAMEWORK
CHAPTER - 2

FDI: A CONCEPTUAL FRAMEWORK

2.1. INTRODUCTION

The introduction of FDI has been a subject matter of typical interest in the realm of academic discussion and study in the present increasingly interdependent, open and competitive world. Different people have different perceptions and approaches to understand the concept of FDI. There has been hardly any country in the world which has not depended upon foreign capital during the course of its economic development and all countries of the world especially developing ones are vying each other to attract foreign capital to boost the domestic rates of investment and also to acquire new technology and managerial skills. Thus, foreign resources are craved for filling the saving-investment gap\(^1\) and foreign-exchange gap\(^2\).

Now-a-days depending on external aid (from foreign countries and international institutions) is on a declining trend because generally the aid is tied besides distorting the allocation of resources in a country. Export of goods and services do contribute to foreign resources but it is not enough to meet the total demand for the foreign resources. Hence, global finance through FDI has become a reality for the new millennium. Foreign capital into a country can come in a number of forms like FDI, FPI, ECBs, FCs, loans from international institutions like

---

1 Bhat, T. (1982); "Foreign Investment in Export Industries with Particular Reference to Sri Lanka"; Foreign Trade Review, Vol. XVI, No.4, Jan-March.
IMF and WB etc. Among all the above forms, FDI have for long been the most prominent source as it is instrumental creating assets in an economy.

Before proceeding to examine different dimensions of FDI and study its impact on Indian economy, the researcher finds it important to distinguish between two confusing terms like FDI and Portfolio Investment (PI). FDI is generally thought as outcome of mutual interest of multinational firms and host countries. It is defined as a form of long-term international capital movement, made for the purpose of productive activity and accompanied by the intention of managerial control or participation in the management of a foreign firm. The essence of FDI is the transmission of a package of capital, managerial, skill and technical knowledge to the host country. As per IMF definition, ‘FDI’ is an investment made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor. The investor’s purpose being to have an effective voice in the management of the enterprise. A direct investment typically takes the form of a foreign firm starting a subsidiary or taking over control of an existing firm in the country in question. It is the direct type of investment, which is associated with MNCs because most of the FDI is transferred through firms and remains outside of the ordinary functioning of markets.

It is noteworthy to note that FDI should not be confused with PI because PI does not seek management control, but is motivated by profit. PI occurs when individual investors invest, mostly through stockbrokers, in stock of foreign companies in foreign land in search of profitable opportunities.

3 IMF (1977); "Balance of Payments Manual"; Washington, DC.
According to the fifth edition of BOPs Manual (IMF, 1993), 'FDI' refers to an investment made to acquire lasting interest in enterprise operating outside of the investor's and purpose is to gain an effective voice in the management of the enterprise. The foreign entity or group of associated entities that makes the investment is termed as 'Direct Investor'. The unincorporated or incorporated enterprise, a branch or subsidiary in which direct investment is made is referred to as 'Direct Investment Enterprise'. Some degree of equity ownership is almost always considered to be associated with an effective voice is management of an enterprise. This manual further suggests a threshold of 10 per cent of equity ownership to qualify an investor as a foreign direct investor. Since the main feature of FDI taken to be the lasting interest of a direct investor in an enterprise, only capital that is provided by the direct investor either directly or through other enterprise related to the investor should be classified as FDI.

According to the OECD definition (OECD, 1996), 'A direct enterprise is an incorporated or unincorporated enterprise in which a single foreign investor either owns 10% or more of the ordinary shares or voting power of an enterprise (unless he can be proven that the 10% ownership does not allow the investor an effective voice in the management) or own less than 10% of the ordinary shares or voting powers of an enterprise, yet still maintains an effective voice in the management'. An effective voice in management only implies that direct investors are able to influence the management of an enterprise and does not imply that they have absolute control.

FDI is further defined on a qualitative and quantitative basis. 'Qualitatively', it is about ownership and control. FDI is done by companies with the intent of having sufficient ownership to ensure a
partial or total say on a lasting basis in the management of a corporate entity located in a foreign country. In other words, a company based in the home country has at least a meaningful long-term voice in shaping output, production and marketing strategies, constructing corporate budgets, selecting senior managers, dealing with labour relations and approving new product development in a company incorporated and doing business in the host country. FDI is about long-term, perhaps permanent relationship that could have a significant financial impact (good or bad) on the foreign company making the investment. It involves relatively large transfers of capital that cannot easily be reversed. While 'quantitatively' i.e. universally accepted definition of FDI is ownership of at least 10 per cent of common (voting) stock of a business enterprise operating in a country other that the one in which the investing company is headquartered.

From the above discussion, it is clear that many definitions have been given by different economists, scholars, official and non-official agencies. But, here it is pertinent to make use of official definition offered by official agencies like RBI, IMF, World Bank, OECD, etc.

Now, in order to understand the concept of FDI in a simple manner, it is imperative here to give an outline about the various components of FDI.

These components are as follows:

- Equity Capital,
- Re-invested Earnings,
- Other Capital (mainly intra-company loans)

Here, 'equity capital' is understood as the foreign direct investor's net purchases of the shares and loans of an enterprise in a
country other than its own. ‘Reinvested earnings’ mean the part of an affiliates earnings accruing to the foreign investor that is re-invested in that enterprise. ‘Other capital’ includes short or long-term loans from parent firms to affiliate enterprise (or vice-versa) including trade credits, bonds and money market instruments, financial leases and financial derivatives.

In case of India, the actual FDI inflow is recorded under five broad heads. These are:

i. RBI’s automatic approval route for equity holding up to 51%;

ii. FIPB’s discretionary approval route for larger projects with equity holding greater than 51%;

iii. Acquisition of shares route (since 1996);

iv. RBI’s NRI schemes and

v. ECBs Route (ADRs/GDRs).

The earlier Indian definition of FDI differed from that of the IMF as well as that of the UNCTAD’s WIR, IMF’s definition includes ECBs. Ideally, FDI inflows should get reflected in capital formation, formation of new firms a factories, increase in foreign equity holding in existing firms and M & As of existing firms and factors.4

Since 2000, a new method of compilation of the FDI statistics has been adopted to make it comparable internationally. In this regard, RBI formed Technical Monitoring Group on FDI and in its first action taken report on June 2003, identified the following fourteen items under three different heads required to be included in FDI statistics to make it comparable globally:

FDI: A Conceptual Framework

A. Equity Capital:
   i. Equity in unincorporated and entities;
   ii. Non-cash acquisitions against technology transfer, plant and machinery, goodwill, business development and similar considerations;
   iii. Control premium;
   iv. Non-competition fee;

B. Reinvested Earnings:
   v. Reinvested earnings of incorporated entities;
   vi. Reinvested earnings of unincorporated entities;
   vii. Reinvested earnings of indirectly held direct investment enterprise;

C. Other Capital:
   viii. Short-term and long-term borrowings;
   ix. Trade credit;
   x. Supplies credit;
   xi. Financial Leasing;
   xii. Financial Derivatives;
   xiii. Debt securities;
   xiv. Land and buildings;

The OECD has recommended a procedure for calculating FDI flows which is calculated as the sum of the four components like retained earnings, equity capital, intra company loans and intra-company borrowings.
Retained earnings are profits generated and kept by the overseas enterprise. These are classified as FDI despite there is no cross-broader transfer of capital as the investor has the choice of either taking the retained earnings made by the overseas enterprise to their home country or by reinvesting them back into the enterprise.5

Among all types of capital inflows, FDI has been the most prominent source of international financing which has been instrumental in creating assets in an economy. The advocates of increased volumes of FDI argue that in terms of foreign investment, it is the direct investment that should be actively sought for and doors should be thrown wide open to FDI. FDI brings huge advantages with little or no downside.6

FDI is perceived superior to other types of capital inflows because of some specific reasons that are listed below:

- FDI inflows are less volatile and easier to sustain at times of crisis in comparison to portfolio investors and foreign lenders because foreign direct investor typically have a longer-term perspective when making investment in a country.

- FDI is most prominently used for productive purposes while debt inflows may finance consumption rather than investment in the host country.

- FDI is expected to have relatively strong positive effects on economic growth of the host country because besides providing

---

5 The retained earning of overseas enterprise are called as reinvested earnings since the earnings are being reinvested back into the overseas enterprise.
FDI: A Conceptual Framework

capital, it offers access to internationally available technology, capital goods, raw materials, technical know-how etc.

A recent UN report has revealed that FDI flows are less volatile than portfolio flows. To quote, “FDI flows to developing and transition economies in 1998 declined by about 5 per cent from the peak in 1997, a modest reduction in relation to the effects on other capital flows of the spread of the Asian financial crisis to global proportions. FDI flows are generally much less volatile than portfolio flows. The decline was made in all regions, even in the Asian economies most affected by the financial crisis”.

The risk-sharing properties of FDI are undisputed. This suggests that FDI is the appropriate form of external financing for developing countries. Moreover, the volatility of FDI remained exceptionally low in 1990s, when several emerging economies were hit by financial crises. FDI is widely considered an essential element for achieving sustainable development. Even former critics of TNCs (e.g. UNCTAD) expect FDI to provide a stronger stimulus to income growth in host countries than other types of capital inflows. Especially, after the recent financial crises in Asia and Latin America, developing countries are strongly advised to rely primarily on FDI, in order to supplement national savings by capital inflows and promote economic development.

Foreign investment, particularly FDI has significant advantages over external loans and other forms of financing the resource gap. Generally, the repayment of FDI is cheaper in comparison to loans and commercial borrowings. For Instance, FDI takes the form of repatriation of a certain percentage of earnings in the form of dividend of an enterprise only when it reaches at the stage of commercial profitability.

---

7 OECD (1997); “Model Double Taxation Convention on Income and Capital”.
Particularly, it happens normally after five to seven years of establishment of the concern. By the time, foreign investment has already been unpacked and its various components like capital, technical know-how, management, marketing skill, etc. have been absorbed. That is why, in certain cases, FDI is considered to be much less expensive and much more productive than commercial borrowings where repayment starts normally from the second year, further which is at very high rate of interest. In addition, the type of technology imported through FDI is likely to be up-to-date technology, as the foreigners would have interest in follow up action since their financial stock is involved.

In addition to technology, FDI is accompanied by management expertise in manufacturing and quality culture, all in a single package. FDI can open up export markets because of the marketing expertise, global contacts and outlets of the parent firms. In the case of FDI, the risk of fluctuations in the value of currency is also borne by the foreign investor. The sequencing and prior generation of resources by a JV can usually reduce the strain of higher inflow of foreign exchange over time.

Thus, it can be said that there is a growing global realization that it is much better to rely on foreign equity investment, rather than on external commercial loans and foreign portfolio investment, especially when major structural changes are being introduced in the economy.

2.2. DIFFERENT ROUTES FOR FDI FLOW

In India, FDI can be approved either through the automatic route or by the government:
2.2.1. Automatic Route

Companies proposing foreign investment under the automatic route do not require any government approval; provided the proposed foreign equity is within the specified ceiling and the requisite documents are filed with the RBI within 30 days of the receipt of funds. The automatic route encompasses all proposals where the proposed items of manufacture/activity does not require an industrial an industrial license and is not reserved for the SSS.

The automatic approval route of the RBI was introduced to facilitate more FDI inflows. However, during the post-policy period, the actual investment flows through the automatic route of the RBI against total FDI flows has been quite insignificant. While FDI flows through the automatic route of the RBI against total FDI flows has been quite insignificant. While FDI flows through the automatic route accounted for 15.18 percent of the total FDI inflows in 1993-94, its share has declined since then and was only 8.68 percent in 1998-99. This is partly due to the fact the crucial areas like electronics, services and minerals are left out of the automatic approval route. Another limitation has been the ceiling of 51 percent on foreign equity holding. An increasing number of proposals were cleared through the FIPB route while the automatic approval route has been declining in the relative importance since 1994.

Under the existing FDI policy, FDI up to 100% is allowed under the automatic route in most sectors/ activities, except few where sectoral equity/entry route restrictions have been retained. FDI under the automatic route does not require any approval and only involves intimation to the RBI within 30 days of inward remittances and/or issue
of shares to non-residents. As a result, FDI approval statistics do not reflect the investment intentions of foreign investors.

2.2.2. Foreign Investment Promotion Board

The FIPB is especially empowered to engage in purposive negotiation and also consider proposals which are totally free from predetermined parameters on procedures. Industry Secretary is the Chairman of FIPB. The Finance Secretary, Commerce Secretary and Secretary (Economic Relations), Ministry of External Affairs are the other members of the FIPB.

The approach of FIPB is liberal for all sectors and all types of proposals. The totality of package proposed is examined and approved on merits within a period of thirty days. RBI has granted general permission under FERA (now FEMA) in respect of proposals approved by the Government. Indian companies get foreign investment approval through FIPB for the purpose of receiving inward remittance and issue of shares to the foreign investors. Such companies are, however, required to notify the regional office concerned of the RBI of receipt of inward remittances within 30 days of such receipt and to file the required document with the concerned regional offices of the RBI within 30 days after issue of shares to the foreign investors.

2.3. FOREIGN INVESTMENT PROMOTION COUNCIL

The Government has recently constituted a FIPC in the Ministry of Industry. It has been set up to have more target-oriented approach towards FDI promotion. Its functions are to identify the sector/project within the country requiring FDI and target specific regions/countries of the world from where FDI will be brought through.
2.4. FOREIGN INVESTMENT IMPLEMENTATION AUTHORITY

The FIIA was established in the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry in 1999 to facilitate quick translation of FDI approvals into implementation, by helping the foreign investors in obtaining necessary clearances, sorting out their operational problems and meeting with various government agencies to find solutions to their problems. FIIA conducts regular interactions with investors of specific regions or countries. In the meetings of FIIA, apart from GOI, senior officials from state governments also participate.

2.5. FDI: THEORIES AND DETERMINANTS

Under this section, first of all different FDI theories are discussed in detail and then general and specific determinants of FDI in India are examined. The purpose of this topic is to review these theories and outline their contribution to the overall understanding of the process of FDI in a country.

Till now, a number of competing and complementary theories have been proposed to explain the nature, causes and possible socio-economic consequences of the rapid growth of FDI. The extensive internationalization of activities of US corporation like Coco-Cola, Dupont, General Electric, General Motors, IBM, and Xerox provided academicians and analysts in the US and Europe with the empirical basis for identifying explanatory variables of FDI decisions and behavior patterns. It was at that time that western scholars began to devise comprehensive theories for explaining the origin and causes of FDI as well as its impact on the economies of host and home countries.

As FDI increased in volume from the 1960s, there has emerged a corresponding economic literature on the theory of FDI. Before this
time, there was no stand-alone theory of FDI and the concept was treated in the same manner as international capital flows, which neglected many important features of FDI. The new theories were concerned with providing explanations to questions such as why FDI occurs, when it takes place and where it locates.

Theories and concepts of foreign Investment have been adjusted and constantly refined since the 1960s, but they have not yet been able to provide foolproof analytical tools to governments seeking to anticipate FDI Company’s behavior ex-ante and to effectively influence international movement of capital, technology and know-how. Certain paradigms, however, contain interesting findings, which can be of assistance in formulating and implementing strategic FDI policies for economic growth and industrial development. Broad empirical research also offers valuable insights into shifts of global FDI patterns and motivations of foreign investors in response to economic policies and incentives in host countries.

For the purpose of convenience in the analysis, FDI theories have been divided under two major heads.

➢ Theories assuming perfect Markets.

➢ Theories assuming imperfect markets.

2.5.1. THEORIES ASSUMING PERFECT MARKETS

These theories include:

- Differential rate of return approach,

- Portfolio diversification approach,

- Market size approach,
The differential ROR refers to the movement of capital from areas with low rates of return to areas with high returns. Until the 1960s, explanations of FDI were confined to this standard classical theory of capital movements. Thus, FDI was treated on the same lines as portfolio investment and was observed that FDI depends only on international differences in rates of interest and motivated by rates of return.

A strong contention regarding the validity of these studies was made by Aggarwal that these studies do not provide any strong evidence. The implicit assumption of a single rate of return across industries and the implication that bilateral FDI flows between two countries could not occur also made the hypothesis theoretically unconvincing.

The failure of differential ROR approach to satisfactorily explain the determinants of FDI flow forced to assess the amount of risk and expected return involved in number of projects. The amount of risk can be reduced to a great extent by diversifying investment into a number of countries at a time because ROR varies significantly in different countries. And this possibility has led to an alternative explanation of FDI, which revolved around the application of Markowitz and Tobin’s Portfolio Diversification theory. This approach contends that in making investment decisions MNEs consider not only the rate of return but the risk is also involved. Since returns to be earned in different foreign markets are unlikely to be correlated, the international diversification of an MNE’s investment portfolio could reduce the overall risk of the investor. Although this theory is an improvement over the differential ROR theory because of inclusion of risk factor but empirical studies have offered only weak support for this thesis.
FDI: A Conceptual Framework

This is not surprising when one considers the failure of the model to explain the observed differences between industries’ propensities to invest overseas and to account for the fact that many MNEs’ investment portfolios tend to be clustered in markets with highly correlated expected returns. Besides this, the problem of measuring expected profits and risk is critical point of this theory. The other shortcoming is that, it is not concerned about concentration of FDI in some specific industries than in others.

The market size approach, which has its roots in neoclassical investment theory, focuses on the role of both the absolute size of the host country’s market and its growth rate. The hypothesis states that there is a positive relation between the size of the market and the FDI. The larger the market, the more efficient the investor’s utilization of resources will consequently increase their potential to lower production cost through the exploitation of economies of scale. Aggarwal in 1980 in a survey on FDI determinants, found the size of the host country’s market to be one of the most factors influencing a country’s propensity to attract inward investment. Inspite of the lack sound theoretical back, the subsequent empirical literature has provided further support to the market size hypothesis.8

2.5.2. THEORIES ASSUMING IMPERFECT MARKETS

The neoclassical theory’s failure to explain and predict how, where and why FDI occurs and to highlight the social and economic consequences of FDI has led to the development of new explanations of international investment. Hymer (1976)9 was the first researcher who

---

pointed out that the structure of market and the specific characteristic of firm play an important role in explaining the FDI. Some of the major theories under this head include:

- Industrial Organization theory,
- Transaction Cost Approach,
- Eclectic theory of International Production,
- Product Cycle Theory,
- Oligopolistic Reaction theory,
- Currency Capitalization Approach,
- IDP Paradigm,

Micro economic theories are mainly theories of market structure imperfections. Hymer (1976)\textsuperscript{10} observed that market imperfections are the real cause of the existence of MNCs. The Industrial Organization Approach is based on the idea that due to structural market imperfections, some firms enjoy advantages vis-à-vis competitors. According to this theory, market structure and competitive conditions are important determinants of the types of firms, which engage in FDI. The theory uses firm specific advantages to explain MNC's international investment. These firm-specific advantages include patents, superior knowledge, product differentiation, expertise in organizational and management skills and access to overseas markets. The advantages that certain firms have over competitors in the home country can be extended into foreign markets through international direct investment. The industrial organization hypothesis has received some support in subsequent literature by Dunning (1974); Vaitsos

\textsuperscript{10} Ibid,
This theory was used by Graham and Krugman (1989) to explain the growing inflow of FDI in US post 1975. They argued that due to decline of US technological and management superiority, FDI increased manifolds over that period. This theory, however, is criticized on the ground that it fails to explain why firms need to engage in FDI to capitalize on the advantages when cheaper forms of expansion (for example; exporting) would allow them to compete equally and successfully in international markets.

The transaction cost or internationalization approach is developed to explain international production and FDI. One of the leading proponents of this approach is Buckley and Casson (1976). This theory suggests that FDI takes place as a result of firms replacing market transaction with formal transaction. Besides, this approach interprets the FDI activities of MNCs as a response to market imperfections, which causes increased transaction cost. Buckley and Casson present the MNEs as essentially an extension of the multi-plant firm. They further note that the operations of firms, especially large ones take the form not only for producing of services but activities such as marketing, training, R & D, management techniques and involvement with 'financial products' taking the form of either material products or knowledge and expertise. If the markets for intermediary products are imperfect then an incentive arises for the firm to

---

12 Cohen, B.I (1975); “Multinational Firms and Asian Exports”; New Haven and London Yale University Press.
13 Other authors on internationalization are harmonious like Mc Manus (1972) and Hennart (1977). As Hennat (2001) points out not all theories on internationalization are harmonious with each other, with Hennart's theory for example differing from that of Buckley and Casson.
FDI: A Conceptual Framework

internalize these, provided the benefits exceed the cost and when it occurs across national boundaries as MNE arises, FDI occurs.\(^\text{14}\)

This approach is treating markets and firms as the alternative modes of organizing production. This theory is also known as general theory of FDI. At theoretical level, the hypothesis received much support but because of its high degree of generality, no direct empirical tests have been conducted. In essence, the transaction cost theory or international theory is a model of private welfare maximization based on MNC's operations.

The Eclectic Paradigm is developed by Dunning (1981)\(^\text{15}\). This theory links together industrial organization approach, location theory and internationalization theory to explain FDI and international production activities. This paradigm of FDI states that a firm will directly invest in a foreign country only if it fulfills three conditions. First, it must have ownership specific assets which gives it an advantage over other firms and which are exclusive to the firm. Second, it must internalize these assets within the firm rather than through contracting or licensing. Third, there must be advantage in setting-up production in a particular foreign country rather than relying on exports.

Different type of Ownership (O), Locational (L) and Internationalization (I) factors (collectively known as OLI) are shown in figure - 2.1.

\(^{14}\) Market Imperfections that are believed to give incentives for utilization include time lags, discriminatory pricing, unstable bargaining situations and inequality of knowledge between buyers and sellers.

\(^{15}\) Dunning, J.H (1981); "International Production and Multinational Enterprises".
FDI: A Conceptual Framework

**Figure - 2.1**

Three conditions of the Electic Theory

<table>
<thead>
<tr>
<th>Ownership-Specific Advantages (Internal to enterprises of one Nationality)</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Size of the firm</td>
</tr>
<tr>
<td>▪ Technology and trade mark</td>
</tr>
<tr>
<td>▪ Management and organization systems</td>
</tr>
<tr>
<td>▪ Access to spare capacity</td>
</tr>
<tr>
<td>▪ Economies of joint supply</td>
</tr>
<tr>
<td>▪ Greater access to markets and knowledge</td>
</tr>
<tr>
<td>▪ International opportunities such as diversifying risk</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Location-Specific Advantages (Determining the location of production)</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Distribution of inputs and markets</td>
</tr>
<tr>
<td>▪ Costs of labour, material and transport costs between countries</td>
</tr>
<tr>
<td>▪ Government intervention and policies</td>
</tr>
<tr>
<td>▪ Commercial and legal infrastructure</td>
</tr>
<tr>
<td>▪ Language, culture and customs</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Internationalization-Specific Advantages (Overcoming market imperfections)</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Reduction in search, negotiation and monitoring costs</td>
</tr>
<tr>
<td>▪ Avoidance of property rights enforcement costs</td>
</tr>
<tr>
<td>▪ Engage in price discrimination</td>
</tr>
<tr>
<td>▪ Protection of product</td>
</tr>
<tr>
<td>▪ Avoidance of tariff</td>
</tr>
</tbody>
</table>

Source: Dunning (1981)

Dunning also tried to introduce some new consideration such as impact that different countries and industry characteristics have an each of the O, L and I advantage of FDI. He further stated that OLI advantages are not going to be same in all the countries and each advantage will be determined by the factors that are specific to

---

16 This theory has been amended and updated over the years but general framework is much the same.
FDI: A Conceptual Framework

individual countries. Links between OLI advantages and the country specific characteristics are summarized in table -2.1 below.

Table - 2.1

<table>
<thead>
<tr>
<th>Ownership-Specific Advantages</th>
<th>Country Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Size of firm</td>
<td>Large markets</td>
</tr>
<tr>
<td></td>
<td>Liberal attitudes to mergers</td>
</tr>
<tr>
<td>Technology and trade marks</td>
<td>Government support for innovation</td>
</tr>
<tr>
<td></td>
<td>Skilled workforce</td>
</tr>
<tr>
<td>Management and organizational systems</td>
<td>Supply of trained managers</td>
</tr>
<tr>
<td></td>
<td>Educational facilities</td>
</tr>
<tr>
<td>Product differentiation</td>
<td>High income countries</td>
</tr>
<tr>
<td></td>
<td>High-income countries.</td>
</tr>
<tr>
<td></td>
<td>Levels of advertising and Marketing</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Location-Specific Advantages</th>
<th>Country Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of labour and materials</td>
<td>Developed or developing country</td>
</tr>
<tr>
<td>Transport costs between countries</td>
<td>Distance between countries.</td>
</tr>
<tr>
<td>Government intervention and policies</td>
<td>Attitudes of government to FDI</td>
</tr>
<tr>
<td>Economies of scale</td>
<td>Size of markets</td>
</tr>
<tr>
<td>Psychic distance</td>
<td>Similarities of countries' languages and cultures</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Internationalization-Specific Advantages</th>
<th>Country Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Searching, negotiating, and monitoring costs. Avoid of enforcing property rights. Protection of products.</td>
<td>Greater levels of education and larger markets make knowledge type ownership-specific advantages more likely to occur.</td>
</tr>
</tbody>
</table>


Dunning used this hypothesis to evaluate Ownership and Locational aspects in describing the industrial pattern and sales of the US affiliates in 14 manufacturing industries in seven countries (Allen,
However, this theory fails to explain international differences in FDI by MNCs from countries with different cultural backgrounds and macro economic structures. Besides, it falls short of providing a framework for analysis of the micro-economic impact of the FDI in the host country.

The Product Cycle hypothesis is propounded by Vernon (1966). It makes an attempt to combine a three-stage theory of innovation, growth and maturity of a new product with R & D factor theory. This paradigm elaborates that an innovation may emerge as a developed country’s export, extend its life cycle by being produced in more favourable foreign locations during its maturity phase and ultimately once standardized, become a developing country’s export and developed country’s import. FDI, therefore, occurs when, as the product matures and competition becomes fierce, the innovator decides to shift production in developing countries because lower factor costs make this advantageous. This model was used basically to explain the expansion of US MNCs in Europe after World War-II. This theory looks at a dynamic process of FDI in terms of why, when and where it occurs. The main limitation of this hypothesis is that analysis done was only concerned with FDI by US. Vernon (1979) viewed that this theory is more relevant in case of FDI carried out by small firms in developing countries.

The Oligopolistic Reaction theory is given by Knickerbocker. In an empirical study of the international activities of 187 US multinationals during 1948-67, he discovered that in oligopolistic industries, market leaders who had ventured abroad were

automatically followed by rival companies from the home country. Thus, this hypothesis stated that FDI by one firm would lead to propagate the other firm to do the same in order to maintain their market share. An important implication of this hypothesis is that FDI by multinational firms is self limiting and due to increased concentration in home and other markets, the competition increases and this reduces the intensity of oligopolistic reaction. Graham (1978) slightly adjusted the model and used it to explain the investment behaviour of TNCs in the US, whose aim was to counter the strategies of the US rivals in Europe rather than outmanoeuvre their 'home' competitors. This theory has been criticized on the ground that it does not recognize FDI as one of the several methods of FI. Besides, this model does not explain the motivation for the initial investment by the market leader and it also neglects the role of medium-sized TNCs in modernizing industries in transition countries.

In 1970s Aliber suggested that weak-currency countries are likely to attract FDI due to the higher purchasing power and more efficient hedging capacity of investors operating from strong-currency countries. This work got serious attention only in late 1980s and early 1990s, when exchange rate was considered as a potential FDI determinant. Caves (1989) while examining inward investment flows into the USA from over a dozen different countries, found that the strength of a country’s currency relative to the US dollar was an important explanatory variable for that country’s direct investment in the U.S.A.

The basic notion of Investment Development Path (IDP) implies that the outward and inward FDI position of a country is directly

---

related and the level of its economic development in relation to the rest of the world. The IDP paradigm was formulated by Dunning in 1981. This paradigm suggests that countries pass through five main stages of development and they can be classified according to their propensity to be inward and/or outward direct investment.

A positive Net Outward Investment (NOI) position [as difference between inward and outward FDI stock] mean that the country has become a net outward investor and vice-versa in the case of a negative NOI position. The IDP suggests that companies tend to invest in markets with lower per capita GDP than their home countries at least until they reach the fifth stage.

Yu and Ito in 1988 observed in their study that FDI is propagated by behaviour of competitors related to host countries and firm related factors. Their research further illustrated that firms in oligopolistic industries consider their competitor's activities and make decision of FDI on the basis of economic factors.

Thus, from the above theoretical review of different FDI theories, it can be said that these theories yield a large variety of determinants of FDI at the firm, industry, economy, international levels. These theories include findings that can offer policy makers valuable tools for increasing FDI by anticipating TNCs behaviour, acting on fundamental decision making variables at corporate level and monitoring the FDI position of a national economy with respect to competitors' nations. Moreover, the policy implications of major FDI theories can be assessed that they can assist policy-makers in optimizing the entire FDI enhancement process, firm strategic planning to the analysis phase and implications including the use of appropriate policy instruments and efficiency control.
2.6. OTHER SPECIFIC DETERMINANTS OF FDI

As it is observed from fore mentioned discussion that most of theories on FDI only stress on the home country industry specific, firm specific and macro-economic factors. There are also certain other variable which could have considerable influence on FDI flows to understand the scale and direction of FDI flows, it is necessary to identify their major determinants.

One of the most important factors a company considers before undertaking FDI is minimizing investment risk. When a country has an unstable legal system (i.e. regulations change often), lacks appropriate laws and insufficiently enforces the ones it does have, then the risk increases. From the economical point of view, if the exchange rate is volatile and the country suffers macroeconomic instability (inflation), and from the political point of view, if the country suffers from political instability or social instability (e.g., high labour unrest and strikes), the risk of investing in this country is also increased.

Even a host country must possess certain locational advantages to attract FDI. And these may be host country’s push or full factors. The push factors explain the outward investment by different countries while the pull factors explain the uneven distribution of FDI among the recipient countries. It must be noted here that the relative importance of FDI determinants varies between different countries, between different types of FDI and between different periods of time. It has been universally observed that any type of international investment is made only after taking into consideration both economic and non-economic influences. Therefore, it is imperative to take into consideration both economic and non-economic determinants of international investment.
decisions. The general determinants of FDI (especially for developing economies like India) can be discussed in following paragraphs.

2.6.1. Market Size and its Characteristics

This is one of the major considerations while making investment location decision by foreign companies. Universally, big developing economies have attracted a major chunk of FDI worldwide because of large size of their markets. For example; China is attracting a massive amount of FDI since early 1980s. There is a positive influence of market size on the FDI inflows. The higher the GNP per capita, the better is the nation’s economic health and the better are the prospects for inflow of FDI. In addition, a high rate of inflation and larger deficit in BOP discourage FDI in a country and hence a negative relationship. Lall (1997)\(^{19}\) has given an elaborate list of determinants which are shown in table – 2.2.

The table lists three key determinants and factors associated with the extent and pattern of FDI in developing host countries. These are attracting of the economic conditions in host countries, the policy framework towards the private sector trade and industry and FDI and its implementation by host governments and the investment strategies of MNEs.

### Table - 2.2

Host Country Determinants of FDI

<table>
<thead>
<tr>
<th>Economic conditions</th>
<th>Markets</th>
<th>Size; income levels; urbanization; stability and growth prospects; access to regional markets; distribution and demand patterns.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Resources</td>
<td>Natural resources; location.</td>
</tr>
<tr>
<td></td>
<td>Competitiveness</td>
<td>Labour availability, cost, skills, trainability; managerial technical skills, access to inputs; physical infrastructure, supplier base; technology support.</td>
</tr>
<tr>
<td>Host country policies</td>
<td>Macro policies</td>
<td>Management of crucial macro variables; ease of remittance; access to foreign exchange.</td>
</tr>
<tr>
<td></td>
<td>Private sector</td>
<td>Promotion of private ownership; clear and stable policies; easy entry/exit policies; efficient financial markets; other support.</td>
</tr>
<tr>
<td></td>
<td>Trade and industry</td>
<td>Trade strategy; regional integration and access to markets; ownership controls; competition policies; support for SMEs.</td>
</tr>
<tr>
<td></td>
<td>FDI policies</td>
<td>Ease of entry; ownership, incentives; access to inputs; transparent and stable policies.</td>
</tr>
<tr>
<td>MNE strategies</td>
<td>Risk perception</td>
<td>Perceptions of country risk, based on political factors, macro management, labour markets, policy stability.</td>
</tr>
<tr>
<td></td>
<td>Location, sourcing, integration transfer</td>
<td>Company strategies on location, sourcing of products/inputs, integration of affiliates, strategic, alliances training, technology.</td>
</tr>
</tbody>
</table>
2.6.2. Political Stability

Direct investment decisions which are long term by nature are vulnerable to the prospects of political instability, especially if investment would be susceptible to major damage or interruption. A country in which there is political unrest or in which there is a threat of having investment nationalized without adequate compensation is more of a risk and therefore less attractive to invest in, than in a country offering political stability and a guarantee of property rights.\textsuperscript{20} Perceived political risk can greatly discourage foreign investment in a developing country like India as international investors may screen out some host countries as too risky at the preliminary stage of the decision making process, thus preventing the identification of investment opportunities in those countries. More recently Jaspersen, Aylward and Knox (2000)\textsuperscript{21} and Asiedu (2002)\textsuperscript{22} found no significant relationship between measures of political instability and FDI flows. This may be partly due to the fact that many nations now offer government-backed insurance policies to cover various types of FDI risks in politically unstable countries of the developing world. Risks insurable through these policies include the risk of appropriation of assets, war losses and losses stemming from the inability of repatriation of profits.

2.6.3. Economic Policies of the Host Country

Among the economic policies, industrial policy of the host country is one of the most important determinants of FDI. Liberal

\textsuperscript{20} Balasubramaniam, V.N (1989); “Incentives and Disincentives for FDI in Less Developed Countries”; Weltwirtschaftliches Archive, 120 (4), pp. 720-35.


\textsuperscript{22} Asiedu, E (2002); “On the Determinants of FDI to Developing Countries: Is Africa Different?“; World Development, 30: 107-19.
industrial policy which encourages private sector investment, M & As, conglomerates etc. increases FDI inflows. Clearly defined development plans, rules and regulations in economic policies give an edge to developing country to attract FDI. In addition to these, the government rules and regulations tend to increase or decrease FDI flows depending upon whether these are incentives or disincentives to FDI. FDI Incentive could take the form of tax exemptions, subsidies, grants, liberal banking and fiscal benefits, currency convertibility and unified and stable exchange rate. Likewise disincentives could take the form of slow processing, domestic content mania, export obligations, employment quotas, establishment of R & D facilities, appointment of host country nationals to senior managerial positions etc. But do these incentives play a significant role in determination of FDI? Overall, the evidence would seem to indicate that incentives have no major impact especially when they are established or perceived to be established, to compensate for continuing comparative disadvantages of the host country. As suggested by UNCTAD (1998), 'although government incentives may influence the choice of location within a country once the investment decision has been made, they are not to be regarded as an actual determinant of FDI'.

In addition to these, custom duties are often regarded as a major cause of investment. Export orientation and openness to trade have also received a considerable support in the empirical literature (Chakrabarti, 2001). It is interesting to point out the relevance of variables constitutes evidence inconsistent with the tariff jumping

23 Ragazzi, G (1976); “Theories of the Determinants of Direct Foreign Investment”; IMF Staff Papers, No. 20, pp.471-498.
FDI: Hypothesis, which views FDI as the result of MNEs' attempt to circumvent trade barriers. It should be noted here that as more and more countries liberalize import regimes, the tariff-jumping motive for FDI is bound to become less relevant. This argument is supported by the relatively recent evidence provided by Blonigen and Feenstra (1996)\textsuperscript{25}, who found trade barriers to have no significant impact on FDI.

2.6.4. Access to Basic Inputs including Cheap and Skilled Labour Force

Easy and sustained availability of raw materials for the manufacturing industry is an important factor in making the investment decision. If the raw material is available locally, the cost of production remains low. In many developing countries, especially India, have relatively low-wage rates as compared with developed countries and hence encourages developing ones to attract more FDI inflows. The availability of well-trained HRs may be a powerful incentive for investment especially in the manufacturing service sectors, which often require access to skilled labour and technical and managerial personnel. When the cost of labour is relatively insignificant, labour skills are expected to influence a country's propensity to attract FDI. However, due to measurement difficulties (much of which is of an indirect nature), the existing evidence is inconclusive.

2.6.5. Infrastructural Facilities

Highly developed infrastructure encourages FDI in a country. For example; due to the developed infrastructure, 70 per cent of the FDI is currently concentrated in developed world. The development of roads, rail transport, communication, electricity system etc. is vital for the

development of the industry. These factors are also responsible for attraction of FDI. The lack of such facilities in an economy hinders the inflow of FDI.

After looking into the above determinants, it is clear that no study has shown the clear cut importance of a particular and relative determinant in the FDI inflows. Overall, this lack of clear and conclusive pattern of results as to the relative importance of the determinants of FDI may be explained by a number of factors ranging from challenges associated with the collection of reliable data to differences in estimation and model specifications. Indeed, as shown by Chakrabarti’s (2001)26 Extreme-Bound Analysis Robustness Tests, estimates of the many controversial determinants of FDI ‘are highly sensitive to small alterations in the conditioning information set’ of FDI equations.

Against this backdrop, it not easy to formulate expectations of future trends on both the geography of FDI and possible shifts in the relative significance of variables determining the location of multinational activities. Some experts have argued that the process of globalization has already started to change the relative importance of traditional and non-traditional determinants. In a report by UNCTAD (1996)27 stated that ‘one of the most important traditional FDI determinants - the size of national markets, has decreased in importance. At the same time, cost differences between locations, the quality of infrastructure, the ease of doing business and the availability of skills have become more important.’

---

In a recent study by Noorbakhsh et al. (2001)28 partially support the view that non-traditional determinants, particularly labour skills and knowledge, are becoming increasingly more important as a result of globalization. Specifically, their results show that in the context of developing countries ‘the estimated coefficients of the variables used as proxies for human capital as well as their ‘t’ ratios increase in magnitude across the consecutive sample periods’. On the other hand, in his analysis of the impact of globalization-induced changes on the determinants of FDI in developing countries, Nunnenkamp (2002)29 argues that traditional market-related determinants are still dominant factors in shaping the geography of FDI, and that with the exception of the availability of local skills, non-traditional determinants such as labour costs and openness to trade have not become more important. Another study by Dunning (2002)30 points out that while in large developing countries traditional economic determinants such as cheap labour, natural resources and market size, remain important, in the more advanced industrialized countries ‘MNEs are increasingly seeking complementary knowledge intensive resources and capabilities, a supportive and transparent commercial, legal communications infrastructure, and government policies favourable to globalization, innovation and entrepreneurship’. He also suggested that the new globally integrated economic environment is likely to affect the geography of FDI in two main ways. First, by placing a higher premium on uncertainty and environmental risk, it may steer MNEs’ investments

29 P. Nunnenkamp (2002); “Determinants of FDI in Developing Countries: Has Globalization Changed the Rules of the Game”; Kiel Institute for World Economics, Kiel Working Papers, No 1122.
towards locations politically friendly towards their home country regimes. This, in turn, is likely to make socio-political instability more relevant as a determinant of FDI. Second, the increasing global integration of markets and competition is likely to force MNEs to improve their cost efficiency by relocating some of their plants in low cost locations. Under this scenario, the nature of investment flows from developed to developing countries may well shift from market seeking and resource-seeking FDI to more (vertical) efficiency-seeking FDI. It is pertinent to note that the driving forces for making any international investment may be different for different foreign investors. It may be:

- Market seeking Investment;
- Resource Seeking FDI;
- International business;
- Survival of the monopolistic position;
- Labor resource orientation;
- Demolition of Tariff wall;

Market seeking is the most important driving force behind FDI. It may be undertaken to sustain or protect existing markets or to exploit or promote new markets. Regarding the history of FDI in developing countries, various empirical studies have shown that the size and the growth of host country markets were among the most important FDI determinants. Traditionally, FDI was the only reasonable means to penetrate local markets in various developing countries. However, it is debatable now, whether this is still true with ongoing process of globalization. It is noteworthy here to point out that mostly the possible decline of market seeking FDI is largely restricted to FDI in manufacturing industries. On the other hand, this type of motive
received a major push by the opening up of services industries to FDI. The bulk of FDI in services, which accounts for a rising share in overall FDI, is market-seeking almost by definition, as most services are not tradable in the sense of cross border transaction.

Resource-seeking FDI is motivated by the availability of natural resources in host countries. This type of FDI was historically important and remains a relevant source of FDI in most of the developing countries. However; on a worldwide scale, the type of motive has not been very important one and has decreased significantly. For example, Allen (1973) found this motive to be significant for only 20% of the sample of projects surveyed in South Asian countries. Globalization essentially means that geographically dispersed manufacturing slicing up the value chain and the combination of market and resources through FDI and trade are becoming major characteristics of the world economy.

To grow internationally and to face competition from the other MNCs is the second most important motive for undertaking direct investment in developing countries especially in India. In sectors like telecommunications and computer software etc. there is tough competition in India with China, US and Germany making huge investments to grow internationally.

Survival of the monopolistic position motive of FDI confirms the view of the organic theory of investment, which states that the fundamental motive of corporation is survival. In order to survive in the world of oligopolistic competition, it is necessary to keep the

---

process of growth, which necessitates increasing share of an expanding market. Judd (1966)\textsuperscript{32} found out that FDI becomes necessary to achieve this objective. It is observed that there is high market concentration in food processing sector. The US and other European Countries investors, invest in this sector to maintain their monopolistic position in the international market.

Labour resource orientation of FDI states that the availability of cheap and skilled labour in developing countries especially in India gives international investors a good opportunity to invest overseas. Now-a-days developed countries including European ones are experiencing relatively high wages in their home countries. For example; availability of skilled and experienced software professionals makes our software industry much attractive to international investors.

Demolition of tariff wall is no longer considered an important motive behind FDI inflows. Actually this motive is to capture the export market lost due to tariffs imposed by a host country. However, it has been observed that majority of the Japanese firms reported it to be a significant attraction for their direct investment in India.

2.7. IMPACT OF FDI

Most of the economists in India are of the belief that it is absolutely essential for India to improve their investments in order to generate sustained economic growth that creates employment opportunities for the growing workforces in the years to come. They strongly recommend the government to undertake the financial investments in key physical and social infrastructure, as well as pursue structural economic reforms policies that attract large chunk of FDI in

\textsuperscript{32} Judd, Pock (1996); "US Production Abroad", Balance of Payment, New York.
order to reap the efficiency and productivity gains. The impact of FI on the development of developing economies is still a controversial issue. Empirical studies have shown both positive and negative impacts. There are also a number of studies undertaken to examine the role of FI in the development of developing country, ranging from its impact on the growth and distribution of national income to the economic desirability of technology brought-in by MNEs, its cultural and political impact. Over the years a number of studies have also shown that FDI may have a beneficial impact on developing host country [see among others Bosworth and Collins (1999); Feldstein (2000); Loungani and Razin (2001)]. These studies have shown that, as opposed to other sources of foreign capital, FDI in a developing country has been most important in providing access to foreign markets and tangible and intangible resources to the recipient country. These resources include capital, R & D, technology, human capital development through employee training, increased export earnings and organization and managerial practices.

There are many studies in the literature also which have estimated the impact of FDI inflows on domestic private investments. One of the panel data studies explored the role of FDI in financing gross fixed capital formation and its relation to other sources of financing. The results found that FDI is one of the important forms of financing sources for capital formation, with FDI having a substantially greater

---

35 Loungani, P. and A. Razin (2001); “How Beneficial is Foreign Direct Investment for Developing Countries”; Finance and Development, June.
impact than domestic credit and capital market financing, while such a relation was not found for state subsidies and for foreign credit. It was also found that FDI is a substitute for domestic credit while foreign credit is positively related to FDI, taking into account the economic environment. The study on transition economies by Krkosa (2001)37 show that capital formation is positively associated with FDI and acts as complimentary to domestic capital. In another study Ramirez (2001)38, presents theoretical and empirical linkage of complementarily hypothesis between the two for Latin American countries from 1981 – 2000. The major findings show that FDI and public investment spending have a positive and significant effect on private capital formation. Hecht et al. (2004)39 explored econometrically the interactions between domestic investment and various types of capital inflows for 64 countries for the period 1976 to 1997. The findings show a significant impact of the domestic investment on FDI inflows after controlling for other factors of these inflows. Nevertheless, in terms of impact on domestic investment, FDI inflows were ranked highest, above the other types of capital inflows. While Desai et al. (2005)40 unlike FDI inflows evaluated the impact of FDI outflows on domestic investments. They found that OECD countries with high rates of outbound FDI in the 1980s and 1990s exhibited lower domestic investment than other countries, which suggests that FDI and domestic investment are substitutes.

37 Krkosa, Libor (2001); “FDI Financing of Capital Formation in Central and Eastern Europe”; Working Paper No.67, EBRD.

FDI: A Conceptual Framework

In a single country time series empirical study, Hejazi and Pauly (2002)\textsuperscript{41} showed that higher net investment abroad is associated with a reduction in domestic capital formation, employment and production in Canada. Taking Korea as example for the period 1985 – 1999, Kim and Seo (2003)\textsuperscript{42} found that FDI has some positive effects on economic growth, but its effects seem to be insignificant. On the other hand, they found that economic growth is statistically significant and highly persistent effects on the future FDI inflows. The final outcome showed that FDI crowds out domestic investment in Korea. Titarenko (2006)\textsuperscript{43} analysed the theoretical and empirical issues of FDI effect on capital formation process for Latvia. The results showed the evidence of crowding out long-term effect of FDI on investment in Latvia. Exploring the effects of FDI inflows on domestic investments, exports, imports and GDP growth from 1980 to 1999, Xu and Wang (2007)\textsuperscript{44} found that inflow of FDI has stimulated domestic investment in Chinese economy. Changyuan (2007)\textsuperscript{45} studied the relationship between FDI inflows and economic growth for provincial level in China. The results are found to be insignificant. Through improving technical efficiency and ‘crowding in’ domestic investment, FDI produced positive effects on China’s economy. Finally, there are also other studies on impact of firm level FDI on domestic investments. The study of Lin and Chuang (2007)\textsuperscript{46}

\textsuperscript{41} Walid Hejazi & Peter Pauly (2002); “FDI and Domestic Capital Formation”; Working Paper No. 36, University of Toronto, Canada.
\textsuperscript{43} Deniss Titarenko (2006); “Influence of FDI on Domestic Investment Process in Latvia”; Transport and Telecommunication, Vol.7, No.1, pp.76-83.
\textsuperscript{44} Xu, Gang & Wang, Ruifang (2007); “The Effect of FDI on Domestic Capital Formation, Trade and Economic Growth in a Transition Economy: Evidence from China”; Global Economy Journal, (7) 2, pp.35-45.
\textsuperscript{46} Hui-lin Lin & Wen-Bin Chuang (2007); “FDI & Domestic Investment in Taiwan: An Endogeneous Switching Model”; The Developing Economies, No.4, pp.465-490.
examines the effect of the FDI decision on domestic investment in the case of Taiwanese manufacturing firms. The empirical results showed that FDI is found to have a positive influence on the domestic investment of the larger firms, while the influence is negative in the case of the smaller firms.

In view of the increasing need for additional foreign capital to achieve the MDGs by the year 2015, FDI is now becoming quite crucial for many developing countries. Vast literature on the determinants of FDI in developing countries clearly indicates the importance of infrastructure, skills, macroeconomic stability and sound institutions for attracting FDI flows. The basic presumption that is found in the literature, which is based on the principles of neoclassical economics, is that FDI raises income and social welfare in the host country unless the optimum conditions are significantly distorted by protection, monopoly and externalities. It should be kept in mind that MNCs operate in such a way as to maximize profits world wide and in the processes they shift resources to areas where returns are high and buy inputs were their prices are low (after all they are profit maximisers). On the surface, it would seem that this is some sort of efficiency that leads to an increase in world welfare. However; the problem is that MNCs exist and operate primarily because of market imperfections, which costs doubts by the validity of the conclusion that FDI leads to an increase in welfare. Thus, the impact of FDI on host country can be classified into:

- Economic Effect;
- Political Effect;
- Social Effect.

---

Further, the economic effects of FDI can be classified into: macro-effects, and macro-effects. The usual convention in analyzing the macro effects of FDI is to treat it as a rise in foreign borrowing. If there is unemployment and capital shortage (as it is typically the case in developing countries like India) such borrowing leads to a rise in output and income in the host country. FDI will, under these conditions, have beneficial effect on BOP but an indeterminate effect on terms of trade (depending on whether the impact of increased output falls on import substitutes or exports).

The micro-effects of FDI pertain to structural changes in the economic and industrial organization. In general, the micro effects pertain to individual firms and individual industries particularly those that are closely exposed to and associated with FDI.

In simple words, we can say that macro economic effect is connected with issues of domestic capital formation, BOPs and taking advantage of external markets for achieving faster growth, while the latter is connected with the issue of cost reduction, product quality improvement, making changes in industrial structure and developing global inter-firm linkages. The macro-economic effects of the investment made by one multi-multinational may be quite different from that of another multinational even if investments are made in the same industry just like the theories of FDI, there is significant overlapping in the discussion of these effects.

After a brief review of past studies on impact of FDI in a host country, it is now feasible to give a brief outline of the general economic effects of FDI under following paragraphs:
2.7.1. The Provision of Capital

The two-gap model illustrates that developing economies typically face the problem of increasing their savings to match their investment needs (that arises due to saving gap) and financing imports through export earning which arises due to foreign exchange gap [See, for example; McKinnon (1963)\(^{48}\)]. FDI contributes to filling these two gaps because MNCs have better access to financial markets. Besides this:

- FDI by a particular MNC in a particular project may encourage other MNCs to participate in the same project;
- Such an action may encourage the flow of official development aid from the investor’s home country;
- By offering locals attractive investment opportunities, FDI may mobilize domestic savings.

Therefore, it is arguable that the net impact of FDI on the quantum of capital flows to developing countries is usually positive because it leads to an increase in the flow of financial resources available for investment and therefore, can stimulate domestic investment through forward and backward linkages.

2.7.2. Up gradation of Technology

Technology transfer is identified by economic literature as perhaps the most important channel which foreign corporate presence may produce positive externalities in the host economy. MNE’s are the developed world’s most important source of corporate R & D activity. They generally possess a higher level of technology than is available in

FDI: A Conceptual Framework

developing countries, so they have the potential to generate considerable technological spillovers. However; whether and to what extent MNEs facilitate such spillovers varies according to content and sectors. If, at one extreme, foreign companies were wholly willing to diffuse certain technologies, than the host country would generally be able to acquire them via direct purchases or licensing agreements, rather than relying on the more indirect FDI route.

FDI brings with it technological knowledge while transferring machinery and equipment to developing countries and that is why diffusion of technology plays a central role in the process of economic development [see for example; Nelson and Phelps (1966)49; Jovanovic and Rob (1989)50; Segerstrom, (1991)51]. And, what benefits the local economy will be to reap from the investments depends, among other factors on the capabilities of the host country in regard to technology transfer and industrial restructuring.52 The transfer of technology has perhaps become the predominant issue around which discussion of MNCs and their dealings with the developing countries evolve. This is because technology is believed to be a vital source of economic growth, capital accumulation, trade, production etc. Particular problems in this respect take the form of how foreign technology is transferred to, and absorbed by the host country and how it affects this country’s economy. The indirect effects of FDI on development which arise from the diffusion of technology and other know-how are sometimes more

52 Goldar, B. and Ishigami, E. (1999); “Foreign Direct Investment in Asia”; Economic and Political Weekly, Review of Industry and Management, August 1.
important than the direct effects of FDI. Therefore, one should consider not only the actual transfer of technology but also the spread of better managerial practices and the contribution of FDI to an enhancing competition in host country markets.

2.7.3. Improvement in Export Competitiveness

FDI makes a positive impact on the host country's export performance by raising the level of efficiency and the standards of product quality. FDI may also contribute to export growth by facilitating access to the markets of industrialized countries.\(^{53}\) Besides this, FDI contributes directly where the foreign investment has been made with the specific intention of sourcing parts/components/final products form the host country to take advantage of low cost conditions. Increased export possibility contributes to the growth of host economies by relaxing demand side constraints on growth. In this regard, the empirical evidence available is mixed. Most empirical studies based on cross-sectional industry and firm level data indicate a positive relationship. For example, Lipsey and Weiss (1981, 1984)\(^{54}\) and Blomstrom et al. (1988)\(^{55}\) found a predominantly positive relationship. Pain and Wakelin (1998)\(^{56}\) considered a time series relationship between manufacturing exports and FDI for eleven OECD countries and found mixed results. Blorigen (1999)\(^{57}\) argues that most of the empirical


\(^{57}\) Blorigen, B. A (1999); “In Search of Substitution between Foreign Production and Exports”; NBER Working Paper, No. 7154.
FDI: A Conceptual Framework

studies of the relationship between trade and FDI indicate complementary relationship [for example; Belderbos and Sleuwaegen, (1998)58]. Finally, Amiti et al. (2000)59 explains why the evidence is mixed in terms of country characteristics, hence attributing the difference to whether FDI is horizontal or vertical.

2.7.4. Increase in Productivity

Many of the studies have supported the view that productivity is likely to rise and unit cost is likely to decline, if FDI is export-promoting and the products of the subsidiary are destined for the large world markets and the underlying conditions and policies allow the installation of plants designed to achieve the full economies of scale. On the other hand, if FDI is import-substituting and the size of the market is too small to allow the installation of the optimum plant size, then productive efficiency may not be achieved.

2.7.5. Creation of Employment Opportunities

There is a direct relation between investment and employment creation (as per general theory of Keynes, 1936). FDI can create employment opportunities in the modern sectors of the developing economies. In general, the employment effects of FDI may be summarized as follows:

- FDI is capable of raising employment directly by setting up new facilities or indirectly by stimulating employment in distribution.
- FDI can preserve employment by acquiring and restructuring ailing firms.

• However, FDI can reduce employment through disinvestments and the closure of production facilities.

There is also considerable divergence in views on employment effect of FDI. Further, Baldwin (1995)\textsuperscript{60} argues that FDI effects on employment can be taken into account only after these three issues are taken into consideration:

• The extent to which FDI substitutes for domestic investment.

• The extent to which FDI stimulates the exports of intermediate goods and capital goods and

• Whether FDI involves the construction of new plants or simply the acquisition of existing facilities.

2.7.6. Resilience Factor Benefit

FDI is considered less prone to crisis because direct investors typically have a stronger long-term perspective when engaging in a host country. During Latin American debt crisis of the 1980’s, global financial crisis, 1997-98 (in East Asian countries), Mexican crisis of 1994-95, FDI proved to be resilient and hence was stable during such crisis. In sharp contrast, other forms of private capital flow like the portfolio and debt flows were subject to large reversals during such crisis. And this is only due to this resilience, which had led many developing countries to favour FDI over other forms of capital flows to supplement national savings by capital inflows and promote economic development.

2.7.7. Consumers Benefit

Through FDI in the developing countries, consumers gain in the form of new products and qualitative products at reduced prices.

MNCs undertake production at large scale which gives economies of scale and hence reduce the per unit price of the products and services which ultimately benefits the consumers.

2.7.8. Contribution to Public Revenues

MNEs operating in a host country are taxed on the profits generated by such enterprises at specified rates. Therefore, FDI generates revenues for government. According to Industry Minsiter (ex) Mr. Murasoli Maran, “foreign investment is not considered only as a stock of capital but as something that provides modern technology, modern management practices, employment opportunities and a new market for products produced in India. Moreover, it is essential for an economy. We have a gap between our savings and investment rates. The gap can only be filled by FDI”.

Taking an overall view of major studies, it can be said that FDI is not an unmixed blessing. But governments in developing countries have to be very careful while deciding the magnitude, pattern and conditions of private foreign investment. Since 1960, the discussion on the advantages and disadvantages of FDI has started and is still enduring [Reuber etal, (1973)\textsuperscript{61}; Lal and Streeten, (1977)\textsuperscript{62}]. The capital flows to an industry in which an existing firm has monopoly power in the world market, an increase in output from the new competition lowers the price of the exportable, thus reducing the terms of trade and potentially lowering welfare in the host country.\textsuperscript{63} Possible adverse

\textsuperscript{62} Lall, S. and Streeten, P. (1997); “Foreign Investment, Transnationals and Developing Countries”; London, Macmillan.
\textsuperscript{63} Akkio, Hagiwara (2004); “Recent FDI Trends and Policies in Developing Asia”; Economic and Research Development, ADB.
implications of foreign investment that have been observed till now by various studies can be discussed in following paragraphs:

➢ When foreign investment is competitive with home investment, profits in domestic industries fall, leading to fall in domestic savings.

➢ Contribution of foreign firms to public revenue through corporate taxes is comparatively less in developing countries because of liberal tax concessions, investment allowances, disguised public subsidies and tariff protection provided by the host government.

➢ Foreign firms reinforce dualistic socio-economic structure and increase income inequalities. They create a small number of highly paid modern sector executives. They divert resources away from priority sectors to the manufacture of sophisticated products for the consumption of the local elite. As they are located in urban areas, they create imbalances between rural and urban opportunities, accelerating flow of rural population to urban areas.

➢ Foreign firms stimulate inappropriate consumption patterns through excessive advertising and monopolistic/oligopolistic market power. The products made by multinationals for the domestic market are not necessarily to be low in price and high in quality. Their technology is generally capital-intensive which does not suit the needs of a labour-surplus economy like India.

➢ Foreign firms are able to extract sizeable economic and political concessions from competing governments of developing
FDI: A Conceptual Framework

countries. Consequently, private profits of these companies may exceed social benefits.

➢ Foreign investments sometimes, have unfavorable effect on the BOP of a country because of the continuous drain of foreign exchange by way of royalties, dividends etc., is more than the investment made by the foreign concern. Foreign investors are very particular about profit repatriation facilities. FDI also tends to flow to the high profit area rather than to the priority sector.

➢ Foreign firms may influence political decisions in developing countries. In view of their large size and power, national sovereignty and control over economic policies may be jeopardized. In extreme cases, they (foreign firms) may bribe public officials at the highest levels to secure undue favours. Similarly, they may contribute to friendly political parties and subvert the political process of the host country.

➢ The technologies brought in by the foreign investor may not be adapted to the consumption needs, size of the domestic market, resource availabilities, stage of the development of the economy, etc.

➢ Through their power and flexibility, MNCs can evade or undermine economic autonomy and control, and their activities may be inimical to the national interest of particular countries.

➢ Foreign investors sometimes engage in unfair and unethical trade practices.

Besides above, one of the most limitations to utilize the foreign capital is the absorptive capacity of the country to utilize the foreign capital effectively. Lack of infrastructural facilities, technical know-how,
personnel, inputs, market, feasible projects, inefficiency or inadequacy of administrative machinery, etc., are important factors that affect the absorptive capacity. Sometimes 'strings' are attached to the official assistance—the recipient country may be pressurized to fall in line with the ideology or direction of the donor. Therefore, the key question before developing countries like India is how they can minimize possible negative effects and maximize positive effects of FDI through appropriate policies.