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# Effects of Direct Foreign Investment

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**There has been a considerable controversy in the Indian economic literature regarding the relative merits of direct foreign investment and official development assistance. No systematic study<sup>1</sup>, however, is available on the effects of direct foreign investment in India. Therefore this article discusses this subject for the period 1951–66.**

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Foreign investment has brought many benefits to India during the last century but it has also resulted in a lopsided stress on exports to the neglect of domestic needs. During the twentieth century, however, official encouragement led to the establishment of some basic and consumer-goods industries which partly corrected this imbalance. In fact the private sector has prospered during the first two five-year plans of India. Though the role of public sector has increased since the beginning of the third plan, yet in a mixed economy like that of India the private sector has to play a vital role in the economic development of the country. The attitude of the Indian Government towards foreign investors has always been favourable and sympathetic. One of the most serious complaints raised over the past few years has been the question of administrative delays and forbidding procedures in India, in the selection and approval of foreign investment applications. The decision of the Government of India to establish a foreign investment board and an Indian Investment Centre seems to be a major step forward in this direction. Also for guidance to the foreign investors, there are regional centres (branches) of the Indian Investment Centre (in Germany, UK and USA). There have been plans to open such centres in other countries, too.

Foreign capital in the form of direct foreign investment has played an important role in the economic development of many countries. A brief look at India's various development programmes shows that almost all such programmes have been financed with the help of foreign capital. It should perhaps be noted, however, that this characteristic of foreign capital in India is more an outcome of a reluctant compromise on the part of the Indian Government rather than a wholehearted welcome in principle. Over the period of fifteen years (1951–66), the

dependence of the Indian economy on foreign capital has greatly increased; India's external debt had increased from Rs. 320.3 mn in 1951 to Rs. 21,928 mn in 1965. The aggregate book value of total foreign business investments (FBI) in the private sector, representing this sector's external liabilities, increased from Rs. 2,646 mn in 1950–51 to Rs. 10,699 mn in 1965–66. At the end of this period such investments accounted for nearly one-fourth of total foreign liabilities of the country. A breakup of foreign investments in the private sector shows that direct foreign investment (DFI) increased from Rs. 2,111 mn in 1950–51 to Rs. 6,331 mn in 1965–66. Thus DFI accounted for about two-thirds of the total FBI and portfolio investment for the balance. The tempo of DFI was held down to some extent by the repatriation of funds especially by branches in the petroleum industry. However, since independence and particularly during the planning period, DFI in India has grown enormously in size.

Direct foreign investment in India is concentrated in a few important industries. Plantations, manufacturing and petroleum together account for more than three-fourths of the total DFI. We find that manufacturing attracted a large amount of DFI, as there has been a very large market for the products of this sector. It is rational to expect that foreign investors sought the most growing and profitable sectors like manufacturing. Petroleum came second on our list. The subsequent decline in DFI in petroleum may well be explained by the Indian Government's policy to encourage its own oil industry. The Indian Oil Company was registered in 1959 and by 1962 it had accomplished certain operations and foreign oil companies thus started winding up their operations and this sector became less important for new foreign investments after 1962.

Plantations have also been very attractive to foreign investors; tea being the most important. In the mid-fifties 80 p.c. of the acreage under tea plantations was under foreign (British) control. During 1955–66 slightly under one-tenth of the foreign controlled area changed hands, presumably to In-

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\* Economics Officer, Commonwealth Secretariat, London. Opinions expressed in this paper are of the author and do not necessarily reflect the views of the Secretariat.

<sup>1</sup> M. Kidron, *Foreign Investment in India*, Oxford University Press, 1965. This study has been considered an authoritative, pioneering work on foreign investments in India and we have supplemented Kidron's analysis and compared our conclusions with those of his study.

dian ownership leaving seven-tenths of total acreage under foreign control in the early sixties. Foreign investment in other plantation industries like coffee and rubber is perhaps less overwhelming but still considerable. The importance of DFI in mining showed a decline over the period as in this sector, too, the Government of India has been establishing its own plants. Mining machinery became primarily a state-run industry with the establishment of a plant for coal machinery at Durgapur in 1963. The share of DFI in the service industry has been more or less stable over the planning period. Thus the foreign dominated sectors have been manufacturing, plantations and petroleum over the period under consideration; petroleum becoming less and less important during the last years of the third five-year plan. This sectorwise dominance is well explained by rates of return in these different sectors of the economy.

Country-wise distribution indicates that the most important country has been the UK with its stake increasing as the UK investors have clearly been at an advantage because of their century-old trade relations with India. UK investors know the country and the market better than any other foreign investor. USA has also played an important role in this regard. Switzerland, West Germany, Japan, Canada, France, Italy and Sweden have also been increasing their investments in India especially after the second five-year plan period.

### High Profitability

What makes investments in India so attractive to the foreign investor is not only the absolute level of high profitability in India but also a favourable rate of return in India as compared to that in most other developed countries. This feature has been highlighted by several independent surveys made by the US Department of Commerce, the British Board of Trade and the Reserve Bank of India. The average rate of return on UK and US investments in India for the years 1958–62 was higher than average figures for all other countries and also higher than the average for domestic investments in UK and USA. The ratio of net income (post-tax) to net assets of UK investors in India during 1958–62 was 8.8 p.c. as against the world average of 7.9 p.c. and 7.8 p.c. in UK.

The Government has always welcomed DFI in high priority private sector industries which require imported plants and machinery and in which adequate capacity does not already exist. If a proposed foreign investment introduces a modern technique not being used already in India or if it earns and/or saves foreign exchange then such investments are very welcome. Such investments have the same standing as the domestic investments. In addition the Government offers the free-

dom to repatriate profits. India, in fact, offers enormous untapped resources with a well developed infrastructure, vast and low-cost manpower resources capable of being turned into skilled and technical labour. Along with this, India provided such a growing market that output may lag behind demand for a long period to come.

### Favourable Government Policy

The scope for all investments is defined by the strategy of economic growth as determined by the five-year plans. The flow of DFI will inevitably have to be along selected channels. The Government of India has to consider that India faces serious foreign exchange difficulties and that the inflow of private capital does not impose undue strains on the balance of payments of the country. All investments in India whether public or private, domestic or foreign have, therefore, to be governed by the industrial policy of the Government. The industrial policy has been modified in practice by the Government from time to time in the light of changes in the economic conditions and the needs of the economy.

The policy of the Indian Government has been to attract more and more foreign investments into those fields which India needs to develop on the basis of planned economic development. The Government has generally encouraged DFI but on a selective basis. The industrial policy resolution of 1948 recognised that participation of foreign capital would be of great value in rapid industrialisation of the country. However, it was necessary that the conditions under which foreign capital would participate in the Indian economy should be carefully regulated in the national interest. Thus, as a rule, the major interest in ownership and effective control would normally be in Indian hands.

During the first plan period (1951–56), which was a period of consolidation for the corporate sector rather than of development of new industries, foreign collaboration arrangements were approximately of the order of 50 approvals a year. During the second plan period (1956–61), the manufacturing sector made very rapid advances into various technology intensive fields producing capital goods, intermediate goods and more sophisticated consumer goods. Thus there were more and more technical collaboration arrangements and approvals. During 1959–66, the average annual number of approvals was more than 300.

One of the serious complaints raised over the past few years has been the question of administrative delays and forbidding procedures. Therefore in July 1968 the Government announced its decision to set up a foreign investment board which will be

responsible for all matters relating to DFI and collaboration arrangements. In order to ensure speedy disposal of applications, the board will provide specific guidelines for processing applications; and supervise the disposal of all applications. The Government has approved the following system:

- ☐ A foreign investment board having the sole power to consider all proposals for foreign investment where total investment does not exceed Rs. 20 mn.
- ☐ A sub-committee to consider all proposals where total investment is less than Rs. 10 mn.
- ☐ A government cabinet committee to consider all cases having total investment exceeding Rs. 20 mn.

Maximum time limit for deciding upon the applications was fixed at six months. Also, sectors have been clearly defined as follows: where foreign investment is to be permitted without technical know-how, where only technical collaboration is required, and where no foreign collaboration – financial or technical – is required.

### Effects of DFI – Conclusions

In a study<sup>2</sup> we tried to establish a relationship between direct foreign investment and economic development in India during the period (1951–1966) and assessed the effects of DFI on the latter. The effects of direct foreign investment are mainly assessed in relation to India's balance of payments and the transfer of technology to India. Direct foreign investment, because of its spread effects on technology and new skills, may have different effects on the structure of the economy and in turn on demand for foreign exchange resources than in the case of development assistance. In case of direct foreign investment, it is obvious that as soon as a foreign firm enters the recipient country, it adds to the foreign exchange resources by transferring capital to the host country's account. But at the same time the firm needs to import certain machinery and raw-materials from abroad which utilises part of the foreign exchange made available initially. Also foreign investment absorbs foreign exchange resources for payment of profits, dividends, royalties, technical fees and other investment-income payments. Further, some capital repatriation because of past investments may take place and absorb foreign exchange resources. Apart from these direct and obvious costs of foreign exchange due to direct foreign investment, it may further strain balance of payments if the pattern of investment is import creating.

Therefore, while considering the effects of direct foreign investment on balance of payments, in addition to some obvious effects such as the out-

flow of repatriated profits, dividend, capital, royalties and technical fees, etc., other indirect effects of dynamic nature through import-substitution and export-promotion should also be considered.

In the case of transfer of technology the foreign exchange costs of transfer and the local adaptation of transferred technology are important questions from the point of view of the recipient countries. We examined these problems as they are directly related to the mechanism of transfer and with the indigenous technology system. An attempt has, therefore, been made to assess the cost of technology transfer to India and the adaptation and/or diffusion of this transferred technology, with the help of whatever factual evidence was available.

### Real Impact Difficult to Measure

The determination of the real impact of direct foreign investment in India is difficult. Neither the uses to which direct foreign investment is applied (even though they may be identifiable) nor goods and services resulting from it can adequately measure the net contribution of direct foreign investment to the productive capacity and, thus, to the economic development of India. The difficulties involved in measuring the real impact of direct foreign investment are as follows:

- ☐ The real impact of direct foreign investment on the productive capacity it helps to create does not show only at the point where it is applied.
- ☐ If we confine our analysis only to the quantifiable effects of direct foreign investment which combine with non-direct foreign investment resources to create capacity, it may become difficult to separate the contribution of each set of resources.
- ☐ There may be more qualitative effects of direct foreign investment such as the spread of knowledge, diffusion of science and technology into the domestic economy, introduction of new tastes, etc. Though these effects of direct foreign investment are not quantifiable, they should nevertheless be considered while evaluating the effect of direct foreign investment on the development of the economy.

Our general impression about the Indian experience with foreign investment over the planning period is that despite the growth of India's foreign liabilities on private account, the private foreign investment played only a marginal, not a substantial, role in India's economic development. The growth of the foreign stake in India was mainly

<sup>2</sup> In this paper we have provided major conclusions of our analysis. For a detailed analysis please read author's paper "An Economic Analysis of the Effects of Direct Foreign Investment in the Development of the Indian Economy", Institute of Development Studies, Sussex University, Discussion Paper No. 11.

through the process of investment-in-kind and re-investment. Investment-in-kind, which accounted for a large part of fresh inflows, like import of machinery and equipment, resulted in uneconomic import of capital goods at "inflated prices" and it often raised the import-content of the projects. Since foreign firms transferred very little of funds in conventional foreign exchange, the alleviating effect of foreign investments on balance of payments was more apparent than real. In general, the investment income service payments, added to the fact that foreign capital in a sheltered market enjoyed high rates of return, raised foreign exchange outflows on current service payments and imposed a heavy burden on the balance of payments. The net position of the foreign exchange transaction of foreign investment in the manufacturing sector remained continuously unfavourable to India. Nor is there any evidence to suggest that there has been the "expected" diffusion of industrial know-how and skills. Although foreign investments did facilitate import of advanced technology, the terms and conditions of import restricted the choice, effective adaptation, assimilation and effective utilisation of the imported technology.

#### Balance of Payments Effect

First of all we looked at the balance of payments effect of foreign investments in India. We found that foreign firms have taken out more foreign exchange from India than they brought in directly. Our calculations for the period show that foreign firms have taken out approximately double the foreign exchange they brought in directly through foreign investment. Using figures, it was found that, on the whole, there have been approximately Rs. 3,800 mn worth of foreign exchange gains whereas there have been foreign exchange losses of roughly Rs. 7,740 mn over this period. The direct net contribution made by foreign investment was, thus, negative. Here our result is similar to that of Kidron's study. Referring to the cost of foreign investments in India during the period 1947-61, Kidron concluded that foreign investors on the whole have taken out nearly *three times* as much foreign exchange as they contributed directly. Kidron also presents a balance of payments for the foreign private investments over the same period<sup>3</sup> and comes out with a deficit of Rs. 4,710 mn. Kidron has used gross investment (foreign exchange gains), on the one side, and profits, royalties and fees, and capital repatriation (foreign exchange losses), on the other side, for this calculation. We have also calculated this direct cost in a similar way and our analysis supports Kidron's evaluation that net direct contribution to India's balance of payments turns out to be negative.

<sup>3</sup> M. Kidron, *Foreign Investment . . .*, loc. cit., p. 311.

Further, we have also provided an analysis of export earnings and import savings as indirect contribution of foreign investment to the balance of payments. In this regard we found that although there is no formal evidence, yet our analysis suggests that foreign investment has had a positive contributory indirect effect on India's balance of payments. In case of import substitution, there is no evidence to suggest that the contribution of domestic sales of foreign firms to the "import substituting output" is not higher than our critical value. Kidron has excluded from his calculations the net import savings and export earnings, although he estimated the increase in new manufactured exports by foreign business enterprises as of the order of Rs. 160 mn between 1950-51 to 1959-1960.<sup>4</sup>

#### Technology Transfer — Costly and Capital Intensive

Regarding the import of foreign technology, its adaptation or diffusion in the Indian economy and its cost of transfer, we arrived at the following conclusions. Although the foreign exchange costs of technology transfer in terms of royalties, technical fees, etc., are not easy to identify and measure we consider that the total foreign exchange outpayments represent in some measure the direct cost of technology transfer. An analysis of the incidence of direct cost by different mechanisms suggested that foreign investment in the form of subsidiaries was, perhaps, the costliest amongst the mechanisms of technology transfer. This cannot, however, be relied upon as foreign firms may use royalty payments to camouflage part of their profits. It is further noticed that in India very few foreign firms spent a reasonable share of their sales on research and development. This implies that there was no serious effort made by foreign firms to spread their technology to other sectors of the economy. We may, thus, conclude that the transfer of technology through foreign investment has been relatively expensive, on the one hand, and that there was no evidence to suggest that there were substantial diffusion effects of this technology transfer, on the other. In this connection also Kidron's conclusion seems to be similar to ours. He found that the technology imported has been too capital intensive in relation to India's labour supply and it has been too expensive for India. Further, the imported skills have not been transmitted into the economy perhaps because foreign firms failed to employ Indians at the higher levels.

The uneasy triangular relationship between the Indian Government and the domestic and foreign private sectors may be one of the causes of excessive and unsuitable imports of technology as Kidron points out. To start with, Indian capitalists

<sup>4</sup> M. Kidron, *Foreign Investment . . .*, loc. cit., p. 311.

were hostile to foreign enterprises and it was the Government which used foreign companies as a leverage against Indian capitalists. With time there has been an increasing collaboration between the Indian and foreign private sector, usually helped by the Government's insistence on foreign technical collaboration before issuing manufacturing licenses to Indian firms.

### Unholy Alliance?

Thus the trend in the Indian Government's policy towards foreign investment has been of increasing liberality and encouragement. This was further influenced, during the mid-fifties, by India's growing foreign exchange shortage and further accentuated by the Chinese invasion. Kidron's criticism of the Indian Government's policy towards foreign investment, no doubt, had a great deal of substance, yet he is perhaps a little too critical of what he considers to be the Government's excessive liberality and complacency towards foreign investment in India. No doubt that after 1955 there was increased collaboration between Indian and foreign private interests; it is perhaps too strong to regard it as "something of an unholy alliance between Indian and foreign capital aimed at restraining Indian state capitalism and government control and taxation", as Kidron does.

Kidron raises serious questions whether foreign investment has provided India with technological independence and whether India has saved foreign exchange resources as a result of foreign investment. The answer to these questions, perhaps, is no if we look at the direct effects of foreign investment on India's economic development. Foreign investment has been costly. Costs have been inflated in a number of ways: excessive "mark up" of prices of machinery and equipment, excessive charges for technical know-how, excessive capital imports due to unnecessary imports of marginal goods of low priority, very high rates of profits, undue tax incentives and tax concessions in terms of tax rebates and tax holidays, etc. Other worrying features have been: reluctance to transmit knowledge, skills, technical processes to the Indian economy and restrictions imposed on exports. Thus along with other factors, the Government's policy has not been completely satisfactory. However, one of Kidron's main conclusions is subject to criticism. Kidron, in general, seems to believe that India has lost control of its industrial sector to foreign investors. This is far from true. The Government of India makes the final decisions and in fact has turned down investors when the price seemed to have been too high, it has controlled the terms of entry and limited the entry into some well defined sectors. On the whole, Kidron has overstated

the drawbacks of foreign investment in India and has played down or even ignored some of its contributions to India's economic development.

Notwithstanding the costs and handicaps, foreign investment has enabled India to make a start on its development at a higher level of technology than possible, if India were to seek to develop on its own. Foreign investment thereby accelerated the growth processes and contributed to building up a large and diversified base of the Indian economy. Nevertheless, in order to make foreign investment more effective as a channel of capital and technology imports, a still closer screening of terms and conditions and a purposeful planning for the utilisation of foreign capital and technology are needed. Therefore, an active policy framework and clearly defined policy measures through an efficiently organised machinery for implementation, are highly important. The most important policy measures needed are:

*First:* Policy measures to reduce the direct foreign exchange costs through elimination of the inefficiencies observed in this channel of foreign investment. This can be achieved by

- ☐ rationalising the role of foreign capital and at the same time assimilating the necessary foreign technology,
- ☐ keeping foreign capital participation only through cash-investments, investment in kind should be discouraged,
- ☐ having a selective policy of not allowing import of foreign technology in certain fields where indigenous technology is available and can be developed in a short period,
- ☐ avoiding duplication in the import of technology and import for low priority goods,
- ☐ taking policy measures concerning the alternative methods of transfer of technology.

*Second:* The above measures will reduce the direct foreign exchange costs of foreign capital in the short run. Policies for a reduction of the balance of payments burden should be worked out in a rather wider perspective. Here policy measures concerning import substitution of products and processes are very important.

*Third:* There should be policy measures designed to coordinate the role of foreign investment with the development plans and further to increase "linkage type effects".

*Fourth:* At the organisational level there should be an efficient body to identify opportunities for supplying know-how and earmark areas for the import of capital and technology.