Forum for Global Knowledge Sharing (Knowledge Forum)
and
Centre for Policy Studies, IIT Bombay

Policy Brief on Foreign Direct Investments (FDI)

In recent years Knowledge Forum Annual Conferences have been having Sessions on FDI. Research papers presented in these sessions have been subsequently published in professional journals and edited volumes published by *Springer*. These are mainly read by scholars who are interested in this area. It is now felt that issues arising out of these studies and their policy implications needs to be made available to a wider audience and in particular to the policy makers. With this in mind Knowledge Forum organized a Seminar jointly with the Centre for Policy Studies, IIT Bombay, on February 24, 2018 at IIT Bombay.

For this purpose, we invited scholars who have been presenting research studies on FDI in the Knowledge Forum Conferences to present papers dealing with the main issues in this area and the policy imperatives based on their research and findings of other scholars. This Policy Brief is based on the papers presented, their deliberations in the Seminar and Keynote and Valedictory addresses. It is hoped that the Policy Brief will be useful to policy makers in formulating FDI policy.

I Crucial Role of Governance in Attracting FDI

- Several studies show the importance of governance variables. They consider the following governance variables: absence of corruption and bribary, rule of law, violence, regulatory burden and accountability. In addition good and effective governance is also reflected in the quality of physical infrastructure like roads, electricity availability, ports and transport. These studies show that tackling corruption and improving governace is more important than granting fiscal and tax concessions. In this context they point out that corruption is also a tax except that the amount collected does not go to the government.

- It is also well known that India ranks unfavourably with regard to ease of doing business in relation to our competers. Currently (2017) the Indian rank of 100 out of 190 countries is unfavourable compared to the ranks of Malaysia 23, Thailand 46, and Vietnam 82.

Fortunately, the Indian rank is adverse only with regard to items relating to registations like starting business, Indian rank 156, construction permit 181 and registring property 154. The common perception is that with regard to these items relating to registration the corruption levels are very high. It is not difficult to focus on these few irritants and reduce corruption on the registration process. Instead of a general attack on corruptions which may not bear fruits it woud be better to focus on few areas listed above that could bear fruit even in the short run.

- Outwards foreign direct investments (OFDI) depends on pull and push factors. The main pull factors for Indian investments abroad are the markets, technology spillovers by being present in a technologically developed country and ease of doing business in the foreign country. The push factor is mainly difficulties in doing business in India compared to ease of doing business in foreign countries. The unfavourable investment claimate in India compared to our Asian competitors has pushed several medium and large entrprises to setup manufacturing units in ASEAN countries and import those goods back to India. In recent years Indian OFDI to ASEAN countries have increased and Indian imports from several ASEAN countries have been several time of the exports. The way out of this problems is to substantially improve governance and remove corruption.

II Importance of the Manufacturing Sector

- Studies show that FDI in manufacturing sector mainly contributes to growth and FDI in other sectors do not. Furthermore, evidence indicates that FDI in nonfinancial services could harm growth and could even result in deindustrialisation. In this context in recent years the share of FDI in the Indian manufacturing sector has sharply declined. Most of FDI into India is in nonmanufacturing sectors and mainly from tax heavens. Policy should concentrate on reversing this trend.

III Technology and Efficiency Spillovers

- Countries welcome and give favourable treatment to multinational enterprises (MNE) mainly because of their entry and presence with superior technologies and management styles could have spillover effects on domestic firms. Spilliovers could be due to movement of labour frm MNEs to other firms, new atmosphere created in the respective industry and the interaction of the MNE with the component manufacturing firms. Spillovers are not technology purchases. Spillovers do not involve payments – they come free. However, not all domestic firms would benefit by MNE presence and spillovers. Studies show that firms that have R&D units and enjoy higher productivity levels benefit from spillovers. Other firms could become victioms of MNE entry. Policy must explicitely recognise this, namely, importance of in-house R&D and improving productivity. It should not uniformally favour and equate low and high R&D firms and likewise low and high productivity firms. Productivity factor should be explicitely introduced in Industrial and Trade Policy.

IV FDI and Exports

- Another important reason for welcoming MNEs is to promote exports. In this context, China benefited immensely by FDI and their MNE affiliates firms exported much more than others. However, the findings of several Indian studies show that MNE affiliates in India export less than the Indian firms. So far no study has revealed MNEs in India exporting more than their local counterparts.With regards to exports, Indian firms have done exceeding well in pharmaceuticals and IT software. It appears that MNEs invest in India mainly to benefit from the Indian market and not to export. They are not efficiency seeking investments but market seeking investments. Policies should target and aim at improving the business claimate to attract efficiency seeking investment.

V FDI in R&D

- India is an attractive destination for FDI in R&D. MNEs use India as a human resource hub for their global R&D activities. Research studies show that MNE R&D units are not integrated with the Indian manufacturing sector and do not aim at introducing new products and processes in India. In recent years R&D expenditures of foreign units have also come down. In line with other countries, in collecting information on R&D units, India should also collect information on new products created. It should list products that are considered new only for the enterprise, new for India and new for the world. Such information is available for China. This will help in evaluating the R&D units – both domestic and multinational, better.

VI FDI and Environmental Issues

- FDI can create environmental problems both in the short and long run. India must have clear cut environmental standards applicable to Indian firms and foreign MNEs. Market-based regulatory components are needed to ensure FDI promotes higher environmental quality and sustainable use of natural resources.

- There are several bottlenecks that a nation comes across while formulating environmental regulations for the manufacturing sector. Numerous arguments are made to demand for industrialization first and worry about environmental consequences later. However, with the adoption of Sustainable Development Goals under the Paris Declaration in 2015, OECD as well as developing countries are mandated to identify and switch over to sustainable development practices and report the same to the international community. Consensus is emerging to come out with clear policies for encouraging and supporting industries to switch over to environmentally benign practices. Adoption of global environmental standards should not be far-fetched for developing countries. Creation of rules with the same level playing field for domestic as well as foreign investors is the need of the hour. Such rules will reduce the scope for 'rent seeking' and thereby attract better investments.