

INTRODUCTION

CHAPTER I

INTRODUCTION

The structural transformation in the global economy in terms of changes in market orientation opened up a new paradigm in the treatment of private capital and capital accumulation in theoretical and empirical discussions. Private capital flows have the potential to provide essential financing for developing countries for economic growth. Discussions on foreign capital and growth originate from pre-classical views. Basically the issue of foreign capital originated from the mercantilist investment-trade mechanism which was enhanced through protection of domestic producers and making exports competitive. In spite of the rise in savings potentials in export-surplus countries, a large proportion of savings could not be invested due to poor investment opportunities. The classical political economists went beyond the intuitive thoughts of mercantilists and they focused on the causal relations of the economic phenomena. Gradually the neo-liberal policies had been effective since the 18th century. The neo-classical doctrine regarded the issue of capital mobility as the significant determinant of economic growth. The emerging capital mobility in terms of foreign direct investment (FDI) has led to the resurgence of neo-classical orthodoxy. International capital movements had been the main component of neo-classical growth theory and policy (Nurkse, 1953). With the advent of endogenous growth theories, FDI could be regarded as the recourse of new technology and high skilled labour. Consequently, FDI has been integrated into theories of economic growth as the “gains-from-FDI” approach (Krugman, 1998).

For the developing countries foreign capital plays a role of catalyst in the industrialization and economic development. It was not only confined to developing countries, the experiences of the world showed that every developed country has had the assistance of foreign finance to supplement its own meagre savings during the early stages of its development. England borrowed from Holland in the 17th and 18th centuries and in turn came to lend to almost every country in the world in the 19th and the 20th centuries. The U.S., now the richest in the world, borrowed heavily in the 19th century, and in turn became the major lender of the 20th century. Foreign capital flows are mutually beneficial to both the home country and host country (Rizwanullah and Mangalani, 2009). Foreign capital has significant role for every national economy regardless of its level of development. For the developed countries

it is necessary to support sustainable development. For the developing countries, it is used to increase the rate of investments to create conditions for more intensive economic growth.

FDI is considered to be the lifeblood of economic development especially for the developing and underdeveloped countries. FDI can immensely benefit the host country and it is perhaps because of this the governments of many countries around the world formulate several strategic policies that soothe the MNCs (Multinational Corporations) to enter into their provinces (Mishra, 2011). The rationale for increased efforts to attract more FDI stems from the belief that FDI has several positive effects, such as productivity gains, technology transfers, introduction of new processes, managerial skills and know-how in the domestic market, employee training, international production networks and access to markets (Bhat and Raj, 2007).

In the 1960s and 1970s many countries maintained a rather cautious, and sometimes an outright negative position with respect to FDI. In the 1980s, however the attitudes shifted radically towards a more welcoming policy stance (Gakhar, 2006). After the debt-crisis that hit the developing world in the early 1980s, the conventional wisdom was that it is unwise for countries to borrow so heavily from international banks or international bond markets, rather countries should try to attract non-debt-creating private capital inflows i.e., direct foreign investment (DFI). Since then private capital became the major source of external financing for developing countries. The last two decades of the 20th century witnessed a dramatic world-wide increase in FDI, accompanied by a marked change in the attitude of most developing countries towards inward FDI. Most countries now regard FDI as beneficial for their development efforts and compete with each other to attract FDI. FDI is the dominant form of private capital flow to developing countries accounting for about 70 per cent of private flows to developing countries as a whole (UNCTAD, 2011) and has become an important source of private external finance for developing countries.

FDI is one form of foreign investment characterized by a certain degree of influence and control over the assets in the host country. It is distinguished from the provision of cross-border bank loans and portfolio investment where there is no active involvement in the management of the enterprise. The Organisation for Economic Cooperation and Development's (OECDs) Benchmark definition states that a key characteristic of FDI is the presence of a 'lasting interest' in an enterprise,

consisting of a 'long-term relationship' and a 'significant degree of influence', and considers ownership of at least 10 per cent of the voting power to be evidence of such influence (Bhattacharyya and May, 2012).

FDI has three components, viz., equity capital, reinvested earnings and intra-company loans. Equity capital is the foreign direct investor's purchase of share of an enterprise in a country other than its own. Equity FDI is sub-divided into three components, viz., Greenfield investment, Mergers and Acquisition and Brownfield investment. Greenfield investment is a form of foreign direct investment where a parent company starts a new venture in a foreign country by constructing new operational facilities from the ground up. Greenfield investments occur when multinational corporations enter into developing countries to build new factories and/or stores. Mergers and Acquisitions (M&As) is dealing with the buying, selling, dividing and combining of different companies and similar entities that can help an enterprise grow rapidly in its sector. A related term to Greenfield investment which is becoming popular is Brownfield investment. When a company or government entity purchases or leases existing production facilities to launch a new production activity it means Brownfield investment. The purchasing of an existing production or business facility by companies or governmental agencies for the purpose of starting new product or service production activity is called as Brownfield investment. Reinvested earnings comprise the direct investors' share (in proportion to direct equity participation) of earnings not distributed as dividends by affiliates, or earnings not remitted to the direct investor. Such retained profits by affiliates are reinvested. Intra-company loans or intra-company debt transactions refer to short or long-term borrowing and lending of funds between direct investors (parent enterprises) and affiliate enterprises (Report of the Committee on Compilation of Foreign Direct Investment in India, 2003).

Multinational companies capitalize on foreign business opportunities by engaging in FDI, which is investment in real assets (such as land, buildings, or existing plants) in foreign countries. MNCs engage in joint ventures with foreign firms, acquire foreign firms, and form new foreign subsidiaries. It plays an important role in the long-term development of a country not only as a source of capital but also for enhancing competitiveness of the domestic economy through transfer of technology, strengthening infrastructure, raising productivity and generating new employment opportunities (Deutsche Bundesbank, 2003). FDI transmits a package

of capital, managerial skills and technical knowledge to the host country. It supplements domestic investment for achieving a higher level of economic growth and development. FDI stimulates employment generation in the host country because the establishment of foreign firms increases the demand for labour and the demand for intermediate goods and services from local suppliers. FDI triggers technology spillovers, assists human capital formation, contributes to international trade integration, and particularly exports, and helps create a more competitive business environment, enhances enterprise development, increases total factor productivity and more generally, improves the efficiency of resource use (Pawha, 2010). Further, domestic firms contemplating to enter the international market may require information and knowledge that may be costly to obtain. Foreign firms are an obvious source of such information, boost host country access to the world market and reduce the costs associated with targeting export market (Baskaran and Charlas, 2010).

The UNCTAD (1999) notes that transnational corporations (TNCs) can complement local development efforts by: (a) increasing financial resources for development; (b) boosting export competitiveness; (c) generating employment and strengthening the skills base; (d) protecting the environment and social responsibility; and (e) enhancing technological capabilities (transfer, diffusion and generation of technology). Many developing countries including India will need to be more effective in attracting FDI flows if they want to bridge the technological gap with high income countries, upgrade managerial skills, and develop their export markets.

India receives foreign capital in the form of: (i) direct foreign investments by MNCs which means acquisition of shares or other securities in an Indian company, (ii) indirect investments, known as 'portfolio' or 'renter' investment when foreign concerns/individuals subscribe to the shares and debentures of Indian companies; (iii) foreign collaborations between private Indian and foreign concerns, between Indian government and foreign concerns, between Indian and foreign governments; and (iv) public foreign capital, known as foreign aid or external assistance, in the form of grants and loans on bilateral basis from developed countries, and multilateral basis from the Aid India consortium, IBRD, IMF, ADB etc. (Mujtaba and Purushotam, 2009). However, capital flows in the form of FDI are usually preferred to other forms of external finance because these are non-debt creating, non-volatile and their return depends on the performance of the project financed by the investor. Unlike

borrowings from foreign sources which involve contractual obligations from day one, direct foreign investment does not involve any fixed charges. FDI implies an element of risk sharing between the capital owners and the capital importing countries that may make this type of capital flow more desirable than loans (Baskaran and Charlas, 2010). The role of the Multinational Enterprises (MNE) as a source of capital and technology has grown over time, as other sources of capital have become scarcer or more volatile and technical change has accelerated (Lall and Narula, 2004).

FDI in Indian Scenario

The Indian economic policy post-independence was influenced by the colonial experience and Nehru's exposure to Fabian socialism during his Cambridge years. It was a policy tended towards protectionism, with a strong emphasis on import substitution, industrialisation, state intervention in labour and financial markets, a large public sector and business regulation (Pawha, 2010). Compared to the most industrialising economies, India followed a fairly restrictive foreign private investment policy until 1991, relying more on bilateral and multilateral loans with long maturities. Inward FDI was perceived essentially as a means of acquiring industrial technology that was unavailable through licensing agreements and capital goods import. Technology imports were preferred to financial and technical collaborations. Even for technology licensing agreements, there were restrictions on the rates of royalty payment and technical fees. Development banks largely met the external financial needs for importing capital equipment. However, foreign investment was permitted in designated industries, subject to varying conditions on setting up joint ventures with domestic partners, local content clauses, export obligations, promotion of local research and development and so on. Such restrictive policy was believed to have retarded domestic technical capability as it was reflected in the poor quality of Indian goods. It also meant a loss of export opportunity of labour intensive manufactures (Nagaraj, 2003).

In 1991, the collapse of the Soviet Union, which was India's major trading partner, and the first Gulf War, which caused a spike in oil prices, triggered a major balance of payments crisis for India and India asked for a \$1.8 billion bailout loan from the International Monetary Fund, which, in turn, demanded reforms. The economic reforms of 1991 did away with the License Raj and ended many public monopolies, allowing automatic approval of FDI in many sectors (Pawha, 2010).

Pre-Liberalisation Period

Prior to 1991, the FDI policy framework in India was highly regulated. Kumar (1994) classified the FDI policy in India into four distinct phases. Phase one (1948-1967) was characterized by gradual liberalisation. This period was marked by a cautious approach concerning the foreign capital. Even though the policy makers were aware of importance of foreign capital, it was felt that foreign capitals need to be regulated in order to safeguard national interests. However, until 1956, there was no regulation on foreign capital. The Industrial Policy Resolution passed in 1956 emphasised reservation of certain industries to the public sector. The foreign exchange crisis in 1958-59 made the government to rethink its stand on foreign capital. The government tried to offer concessions in the form of tax incentives to foreign investors. The outcome was many MNCs started showing interest in investing in India.

Restrictive Phase (1968-79) was marked by the regulation of foreign capital and streamlining of procedures in the approval of foreign collaborations. During this period, a Foreign Investment Promotion Board (FIPB) was set up to monitor approval of foreign collaborations exceeding 40 per cent of equity. Three new enactments passed during this phase clearly underline the apathy of the policy makers to the foreign capital. The Monopolies and Restrictive Trade Practices Act (MRTP) of 1969 required the scrutiny of all projects involving large firms' capacity expansion. The Indian Patents Act of 1970 was an attempt to remove the monopolistic advantages enjoyed by the multinational corporations. The act was enacted with the intention of avoiding the crowding out of domestic firms. The Foreign Exchange Regulation Act (FERA) of 1973 required the dilution of all foreign equity to 40 percent. As a result, those multinational companies which refused to comply with the new regulation left the market.

Third Phase (1980-1990), witnessed easing of regulation on the foreign capital. Until the early 1980s the Indian economy was characterised by industrial licensing and controls along with import and exchange rate restrictions. This prevented competition and increased inefficiency in Indian industries (Ahluwalia, 1991). The Industrial Policy Resolution of 1980 and 1982 announced certain liberal policy rules like de-licensing of selected industries and exemption of foreign equity restriction on fully export-oriented units. Along with the adoption of liberal trade policies, government also took certain measures to allow the import of capital goods

and technology. A significant consequence of the policy regime during this period was the shift in the sectoral composition of FDI from plantations, minerals and petroleum to manufacturing sector. The manufacturing sector accounted for 85 percent of total stock of FDI by the end of 80s (Balasubramanyam and Mahambre, 2003).

Historically, India had followed an extremely careful and selective approach while formulating FDI policy in view of the governance of “import substitution strategy” of industrialisation. The regulatory framework was consolidated through the enactment of Foreign Exchange Regulation Act (FERA), 1973 wherein foreign equity holding in a joint venture was allowed only up to 40 percent. Subsequently, various exemptions were extended to foreign companies engaged in export-oriented businesses and high technology and high priority areas including allowing equity holdings of over 40 per cent. Moreover, drawing from successes of other country experiences in Asia, the government not only established special economic zones (SEZs) but also designed liberal policy and provided incentives for promoting FDI in these zones with a view to promote exports. The announcements of Industrial Policy (1980 and 1982) and Technology Policy (1983) provided for a liberal attitude towards foreign investments in terms of changes in policy directions. The policy was characterised by de-licensing of some of the industrial rules and promotion of Indian manufacturing exports as well as emphasising on modernisation of industries through liberalised imports of capital goods and technology. This was supported by trade liberalisation measures in the form of tariff reduction and shifting of large number of items from import licensing to Open General Licensing (OGL) (Sharma and Singh, 2013).

Post-Liberalisation Period

Since 1991, the regulatory environment in terms of foreign investment has been consistently eased to make it investor-friendly. There has been a sea of change in India’s approach to foreign investment from the early 1990s when it began structural economic reforms encompassing almost all the sectors of the economy. After mid-1990s, the political disturbances along with other economic problems viz., high rate of inflation, fiscal deficit and political instability gave rise to severe financial crisis in the Indian economy. The virtual stoppage of remittances from Indian workers in the Gulf countries and a sudden break out of Gulf war in January 1991 exacerbated the balance of payments crisis. The foreign exchange became so

scanty that, it was insufficient to pay even for one week imports. As a result the economic liberalisation process was introduced under Structural Adjustment Programme (SAP) with the support of IMF and the World Bank and this culminated into a series of economic reforms in 1991 (Akhtar, 2013). The policy makers realised that the solution was to adopt a liberal policy regime. The New Industrial Policy (NIP) resolution passed in 1991 abolished industrial licensing. NIP provided for automatic approval of FDI up to 51 per cent of equity in a list of 34 specified high priority, capital intensive, and high-technology industries. The prime motive of the policy-makers in the adoption of the NIP has been to attract foreign direct investment in various sectors.

A series of measures that were directed towards liberalising foreign investment included: (i) introduction of dual route of approval of FDI, Reserve Bank of India's (RBI) automatic route (do not require prior approval from the government) and government's approval (SIA/FIPB) route, (requiring prior approval from Foreign Investment Promotion Board). FDI is allowed under the automatic route without prior approval either of the Government or the RBI in all activities/sectors as specified in the consolidated FDI Policy, issued by the Government of India from time to time. FDI in activities not covered under the automatic route requires prior approval of the government which are considered by the Foreign Investment Promotion Board (FIPB), Department of Economic Affairs, Ministry of Finance; (ii) automatic permission for technology agreements in high priority industries and removal of restriction of FDI in low technology areas as well as liberalisation of technology imports; (iii) permission to Non-resident Indians (NRIs) and Overseas Corporate Bodies (OCBs) to invest up to 100 per cent in high priorities sectors; (iv) hike in the foreign equity participation limits to 51 per cent for existing companies and liberalisation of the use of foreign "brand name"; (v) signing the Convention of Multilateral Investment Guarantee Agency (MIGA) for protection of foreign investments; (vi) abolition of industrial licensing system except for 18 industries specified in the Annex-II of the statement, which includes those industries which manufactured, hazardous chemicals or of national concerns social well being and the environment concerns; and (vii) registration under MRTP Act was removed. These efforts were boosted by the enactment of Foreign Exchange Management Act (FEMA), 1999 (that replaced the Foreign Exchange Regulation Act (FERA), 1973) which was less stringent. Ceiling of 40 per cent foreign equity under FERA was done

away with. Foreign Investment Promotion Board (FIPB) was established and was authorised to provide a single window clearance for all project proposals regarded by it.

Besides these measures, in August 1999 the Government of India set up Foreign Investment Implementation Authority (FIIA) within the Ministry of Industry to facilitate quick translation of FDI approvals into implementation by providing a proactive one step after care service to foreign investor like helping them obtain necessary approvals and sorting their operational problems. FIIA is assisted by Fast Track Committee which was established in 30 Ministries/Departments of Government of India for monitoring and resolution of difficulties for sector specific projects. The steering committee on FDI was set up by the Planning Commission in August 2001 under the Chairmanship of N.K. Singh recommended that the ban on FDI in retail trade should not be lifted while for other sectors such as oil marketing, petroleum exploration, banking and financial services and real estates was raised to limit of 100 per cent (Akhtar, 2013). This along with the sequential financial sector reforms paved way for greater capital account liberalisation in India (Akhtar, 2013).

FDI has played a significant role in the growth and development of India since liberalisation. India has already marked its presence as one of the fastest growing economies of the world. It has been ranked among the top three attractive destinations for inbound investments. An investor-friendly FDI policy has been put in place, whereby FDI up to 100 per cent is permitted under the automatic route in most sectors/activities. In 2014, FDI policy has been further liberalised. FDI up to 49 per cent through the government route has been permitted in the defence industry. Higher FDI has also been allowed on a case-to-case basis. FDI up to 100 per cent through the automatic route has been permitted in construction, operation, and maintenance of identified railway transport infrastructure. Norms related to minimum land area, capitalisation, and repatriation of funds for FDI in construction development projects have been further liberalised. During April-November 2014-15, total FDI inflows (including equity inflows, reinvested earnings, and other capital) were US\$ 27.4 billion, while FDI equity inflows were US\$ 18.9 billion. Cumulative FDI inflows from April 2000 to November 2014 were US\$ 350.9 billion. Services, construction, telecommunications, computer software and hardware, drugs and pharmaceuticals, the automobile industry, chemicals, and power have attracted a proportionately high share of total inflows (Economic Survey, 2014 – 15, p. 96). The

top ten investing countries in terms of FDI equity inflows were Mauritius, Singapore, U.K., Japan, U.S.A, Netherlands, Cyprus, Germany, France and U.A.E. The top ten sectors attracting highest FDI equity inflows were services sector, construction development, telecommunications, computer software and hardware, drugs and pharmaceuticals, chemicals (other than fertilisers), automobile industry, power, metallurgical industries and hotel and tourism (Factsheet on FDI, 2014).

Inflow of FDI increases with the attractiveness of the country, due to various factors like large GDP and market potential, advanced know-how, skilled work force, low labour cost and wages, low taxation, lower environmental protection, favourable laws and public incentives and professional territorial marketing (Piana, 2005). India has a number of advantages to offer the potential foreign investors, viz., political stability, steady economic growth, a vast domestic market, a large pool of trained manpower, social and physical infrastructure, rapidly expanding capital market etc. Being the tenth largest economy in the world and fourth in terms of people's propensity to purchase, India has emerged as a potential player for FDI and NRI investments. India has a large reservoir of skilled labour available at competitive prices, large entrepreneurial base and diversified manufacturing structure that makes it easy to find partners for collaborations. Besides, India has a vast domestic market of 300 million strong middle-class population having substantial purchasing power and another 700 million people whose purchasing power is gradually improving. The country also has a huge network of technical and management institutions of international standard for development of excellent human resources. The country has a strong English language base for business correspondence (Baskaran and Charlas, 2010).

Spillovers from FDI

The contribution of FDI in economic progress of the host economies can be direct as well as indirect. FDI adds directly to employment, capital, exports, and new technology in the host country and local firms may also benefit from indirect means. These advantages or pecuniary benefits result in improved productivity of domestic firms which cannot be fully appropriated by foreign investors. These externalities are commonly known as spillovers (Mishra, 2011). There are two main channels through which these spillovers occur. They are horizontal spillovers and vertical spillovers.

The horizontal spillovers or intra-industry spillovers from FDI or spillovers happening in the same industry group as that of the foreign firms occur due to the

MNEs i.e., the MNEs with their superior technology might induce higher productive efficiency in domestic firms through increased competitive pressure or through demonstration effects. Competition from foreign companies may compel domestic firms to use their resources more efficiently or go in search for new or advanced technologies. The demonstration effects could be by the introduction of new know-how or new technologies, through workers trained in MNEs who take employment in local firms, or through imitation of MNE products and process (via reverse engineering) or managerial and organisational innovations. At the production level, the mere presence of MNEs exerts pressure on host country firms to scale up their production methods by creating their own in-house production techniques or importing foreign technology.

Vertical or inter-industry spillovers from FDI accrue via the supply chain. Vertical spillovers can be either from backward linkages or from forward linkages between domestic firms and foreign firms (MNE-affiliates). The productivity spillovers can take place if the local/domestic firms are able to improve their productivity as a result of their interactions (known as buyer-supplier linkages) with MNE-affiliates. Externalities generated from downstream multinationals to upstream local suppliers in the supply chain are known as spillovers due to backward linkages (also referred to as backward spillovers). The domestic firms in such supply chains may benefit when they are employed as suppliers or subcontractors to MNEs as this would help them to expand output and achieve economies of scale. Technology spillovers via backward linkages may take place through (i) direct knowledge transfer from foreign customers to local suppliers; (ii) higher requirements for product quality and on-time delivery introduced by multinationals, which provide incentives to domestic suppliers to up-grade their production management or technology; and (iii) multinational entry increasing demand for intermediate products, which allows local suppliers to reap the benefits of scale economies (Javorcik, 2004). Spillovers from forward linkages happen when domestic firms are customers to foreign firms in the local market (Joseph, 2007). Technology spillovers via forward linkages from foreign firms occur when foreign firms provide knowledge embodied in products, process, and technology to the domestic customers at the downstream industries, which help domestic firms boost up their productivity (Blomstrom and Kokko, 1998).

FDI has long been considered as an important channel for international diffusion of technology (Malik, 2015). The diffusion of technology by MNCs leads to

faster economic growth and it gives higher rates of productivity growth in the host country (Veeramani and Goldar, 2005). FDI is now recognised as an important source of industrial development in developing countries in view of the fact that it brings new intermediate goods, technology transfers and skills in the form of externalities and technology spillovers. Industries in the developing countries like India are now under pressure to speed up their production process in order to exist and face the competition in the global competitive market. Indian manufacturing has been stagnant at low levels, especially when compared with the East Asian successes (Economic Survey, 2014-15). The National Manufacturing Policy (NMP) ratified in 2011 aims at creating additional 100 million jobs in manufacturing sector by 2022. The government wants to achieve this without subsidies through fiscal incentives. The ambitious target set by the government cannot be achieved only by tapping savings from within the country; private sources have to take a lead, of which a major portion has to come from foreign sources (Assocham, 2012).

FDI and Manufacturing Sector

Multinational corporations undertake FDI in different sectors in the host country, such as agricultural, manufacturing, or financial sectors. Wang (2009) studying 12 Asian economies over the period of 1987 to 1997 showed that FDI in manufacturing sector had a significant and positive effect on economic growth in the host economies. Higher growth rate in the manufacturing sector results in higher growth rate in gross domestic product (Kilavuz and Topcu, 2012). FDI inflows in non-manufacturing sectors do not play a significant role in enhancing economic growth. Manufacturing and trade have been the engines of growth in the post-war period for most economies, especially in Asia. The Economic Survey of India 2014 – 15 recognised registered manufacturing as having the “potential for structural transformation”. However, it was observed that manufacturing productivity in India lags behind other nations. Manufacturing production and exports have been driving the rapid growth of many dynamic emerging economies. But India’s share in world manufacturing is only 1.8 per cent. This is in stark contrast to China whose share is 13.7 per cent of world manufacturing. The striking aspect of India’s growth has been the dynamism of the service sector, while, in contrast, manufacturing has been less robust. The lacklustre growth of manufacturing can also be traced to the low technological depth of the Indian manufacturing sector. The reasons for the decreasing share could be raw materials, lack of innovation and proficient workforce

of India (Nayak et.al., 2013). The primary sectors, principally agriculture, can provide jobs but not growth; the tertiary sector services like information technology can provide growth but not enough jobs: if both jobs and growth are to be provided, then foreign direct investment into the secondary sector (manufacturing) has to be encouraged. A renaissance in Indian manufacturing would accelerate employment generation, boost exports, strengthen the financial sector and attract substantial foreign capital inflows into the country.

It is generally accepted that the positive impact of FDI on growth is driven by FDI transferring assets relating to productivity improvement, or the spillover effect of FDI. Liu et.al., (2000), Haskel et.al., (2007), and Keller and Yeaple (2009) found that FDI spillovers positively affect the domestic firms' productivity. Pradhan (2008) argued that FDI promotes economic growth indirectly via productivity spillovers and export spillover effects. Spillover effect of FDI is considered more likely to occur in manufacturing sector than in other sectors and the empirical discussions of spillover effect are often based on FDI in manufacturing industries/sector. The growth in industrial manufacturing can be possible only through external demand with a high growth rate; that is, through export (Kilavuz and Topcu, 2012). Based on these arguments, it is important to examine the influence of FDI spillovers on the productivity and exports performance of Indian manufacturing firms i.e., whether the existence of foreign firms help the domestic firms to improve their productivity and does the foreign firms influence the export decision and export intensity of the indigenous firms; and if yes whether the low technology firms or the high technology firms get influenced more by the spillovers from FDI. Another important aspect to ascertain would be, whether the FDI spillovers occur through the minority-owned foreign firms or the majority owned foreign firms.

Research Gap

Many researchers attempted to study the horizontal and vertical spillovers from foreign firms. Large number of existing studies viz., Kokko et.al., (1996), Aitken and Harrison (1999), Fosfuri et.al., (2001), Konings (2001), Javorcik (2004), Mullen and Williams (2007), Parameswaran (2007), Haskel et.al., (2007), Halpern and Murakozy (2007), Reganati and Sica (2007), Javorcik and Spatareanu (2008), Liu (2008), Javorcik and Spatareanu (2009), Keller and Yeaple (2009) Pant and Mondal (2010) analysed the impact of FDI and FDI-linked spillovers on productivity. Wei and Liu (2006), Halpern and Murakozy (2007), Reganati and Sica (2007), Blalock and

Gertler (2008), Wang and Zhao (2008), Marcin (2008), Javorcik and Spatareanu (2009), Anwar and Nguyen (2010), Le and Pomfret (2011) and Gorodnichenko et.al., (2014) found that the vertical FDI spillovers positively affect the productivity of domestic firms. As far as horizontal FDI spillovers were concerned Marcin (2008) found that the local firms benefit from foreign presence in the same industry. However, Halpern and Murakozy (2007) and Reganati and Sica (2007) found no evidence of horizontal FDI spillovers and Le and Pomfret (2011) found the effect of the horizontal spillovers from foreign firms on the productivity of indigenous firms to be negative. The empirical literature, however, finds little conclusive evidence indicating that domestic firms in developing countries benefit from foreign presence in their industries (Haddad and Harrison, 1993; Aitken and Harrison, 1999; Djankov and Hoekman, 2000). Moreover, studies analysing the influence of spillovers from foreign firms on the productivity of Indian manufacturing firms is limited. Among the Indian studies Joseph (2007), Thakur and Burange (2014) and Malik (2015) found that vertical FDI spillovers positively affect the total factor productivity (TFP) of the Indian firms. However Sasidharan (2006), Sasidharan and Ramanathan (2007) and Mishra (2011) found that the effect of vertical FDI spillovers on the productivity of the host country firms to be negative. With regard to the effect of horizontal FDI spillovers on the productivity of indigenous firms Mishra (2011) found positive productivity spillovers through horizontal channels. However, Sasidharan (2006) found no significant horizontal spillovers and Thakur and Burange (2014) found negative horizontal FDI spillovers. The existing literature however, does not provide clear evidence on whether the horizontal or vertical FDI spillovers contribute to the productivity of indigenous firms.

Though there were many studies analysing the impact of horizontal and vertical FDI spillovers on the performance of domestic firms in the host country, few researchers tried to investigate the export spillovers from FDI and its impact on the export performance of indigenous firms. Greenaway et.al., (2004), Lemi (2004), Ruane and Sutherland (2005), Vuksic (2005), Zhang (2005), Buck et.al., (2007), Gu et.al., (2008), Sun (2010), Nguyen and Sun (2012), and Sun (2012) found that FDI exerted significant influence on the exporting behaviour of domestic firms. Considering vertical FDI spillovers and export performance of domestic firms Kneller and Pisu (2007) using British manufacturing firms found that the decision as to how much to export appeared to be influenced by the presence of foreign multinationals

in the same, upstream and downstream industries. Nguyen (2008) showed that horizontal and forward linkages to be the two main channels of export spillovers from FDI while domestic firms in Vietnam had no benefits from backward linkages to enter export markets as well as to increase the export value. Anwar and Nguyen (2011) showed that the presence of foreign firms in Vietnam, through horizontal and forward linkages, significantly affected the decisions of domestic firms to export as well as their export share. Chen et.al., (2013) examined the Chinese manufacturing firms and found that FDI has had a positive impact on the export value of domestic firms mainly through backward technology spillovers. Phillips and Ahmadi – Esfahani (2010) found that foreign ownership neither increases nor decreases the probability that a firm will be involved in exporting in Australia. Many studies have also focused on the export performance of domestic firms through horizontal linkages with foreign firms. Empirical studies viz., Kokko et.al., (2001), Alvarez and Lopez (2008) have found the impact of horizontal linkages on export performance to be positive and statistically significant which suggests that the presence of foreign firms promotes the export activities of domestic firms in the same sector. On the other hand, some studies like Aitken and Harrison (1999); Djankov and Hoekman (2000), Greenaway et.al., (2004) have found the impact of FDI spillovers on export performance to be zero or negative. Studies on export spillovers by the Indian researchers include Aggarwal (2002), Banga (2006), Joseph and Reddy (2009), Prasanna (2010), Kuntluru et.al.,(2012), Barua (2013) and Kemme et.al., (2014). Prasanna (2010), Barua (2013) and Kemme et.al., (2014) showed that FDI positively affected the exports of host country firms. However, Aggarwal (2002) and Joseph and Reddy (2009) could not find any evidence of a positive relationship between foreign equity share and export performance of firms. Kuntluru et.al., (2012) showed that foreign ownership had a negative impact on export performance. Hence there are persistent doubts about the influence of FDI spillovers on the export performance of domestic firms with regard to their decision to export and the intensity of exports. Also very few studies have analysed the impact of vertical spillovers on the export performance of the domestic firms. Therefore a study on the impact of vertical FDI spillovers (backward and forward linkages) on the export performance of the domestic firms is needed.

Studies are, however, focused mostly on unconditional technology spillovers from FDI. But the characteristics of domestic and foreign firm affect the occurrence

of technology spillovers from FDI. Some domestic firms are more technology intensive and some are less technology intensive, which ultimately provide different absorptive capacity to absorb the technology spillovers from the presence of MNEs (Girma et al., 2001; Girma and Gorg, 2002). Another aspect which is ignored by most of the studies is the structure of foreign ownership. It is believed that participation of a local shareholder in a foreign investment project reveals the multinational's proprietary technology and thus facilitates technology spillovers in the host country (Blomstrom and Sjöholm, 1999). Demelis and Louri (2002) found that the majority foreign ownership in affiliates was highly prone to technology spillovers than affiliates with minority foreign ownership. Javorcik and Spatareanu (2008) opine that affiliates with minority foreign ownership are more linked to domestic firms in upstream and downstream industries and thus facilitating technology spillovers in the host country. Hence the evidence is mixed. Thus, technology spillovers are not spontaneous from the presence of foreign firms in the host country; it depends on the technology content and structure of foreign ownership. These aspects were ignored by most of the studies. The current study aims to comprehend how the in-house technology differences among domestic firms affect the technology spillovers from FDI. Also the study examines how the structure of foreign ownership in affiliates affects the technology spillovers to domestic firms in the host country.

The current study contributes to the literature significantly in many ways. Firstly, among the Indian studies which studied FDI spillovers few studies attempted to investigate the impact of vertical FDI spillovers via backward and forward linkages on the productivity of Indian manufacturing sector (e.g., Pradhan, 2004; Joseph, 2007; Parameswaran, 2007; Mishra, 2011; Thakur and Burange, 2014) and a few studies analysed the impact of FDI inflows on the export performance of domestic firms (e.g., Aggarwal, 2002; Prasanna, 2010; Kuntluru et.al., 2012; Kemme et.al., 2014) and Joseph and Reddy (2009) analysed the export performance of domestic firms through buyer-supplier linkages with the MNEs. Most of the FDI spillover studies in India analysed the impact of FDI spillovers (horizontal and vertical) on the productivity of domestic firms ignoring its impact on the export performance of indigenous firms. A detailed systematic study on the impact of vertical FDI spillovers through the backward and forward linkages on the productivity and export performance of Indian manufacturing firms is limited. Secondly, in comparison to previous studies (e.g., Aggarwal, 2002; Banga, 2006; Joseph and Reddy, 2009;

Prasanna, 2010 and Kuntluru et.al., 2012), the present study considers more recent data for a relatively longer period of latest 13 years after a decade of globalisation. Further, unlike most of the studies the current study has divided the Indian manufacturing firms on the basis of technology intensity viz., low technology industry and high technology industry and has classified the foreign firms on the basis of structure of foreign ownership viz., majority-owned foreign firms and minority-owned foreign firms to analyse the influence of FDI spillovers on the productivity and export performance of Indian manufacturing firms.

Rationale for the Study

Capital formation and technological improvement are the engines of economic growth. In the developing countries, an acute shortage of domestic capital formation causes low per capita income and savings rate. Thus, to give a 'big push' to the economy and overcome the vicious circle of low capital formation and low growth, there is a need to supplement domestic resources with foreign capital to achieve the critical minimum investment (Verma and Arora, 2009). FDI induces economic growth and hence economic prosperity is always linked with massive FDI inflows in the economy (Pradhan, 2008). FDI is considered a vehicle transferring both tangible assets and intangible assets such as advanced technology, better managerial skills and innovative product designs. As a result, FDI is expected to promote host country's economic growth (Wang, 2009). Choe (2003), Balamurali and Bogahawatte (2004), Li and Liu (2005), Yasin et.al., (2009) and Abbas et.al., (2011) argued that FDI causes economic growth. Among Indian studies Dash and Sharma (2007), Verma and Arora (2009), Dhakal et.al., (2010), Sethi (2011), Ray (2012) and Saiyed (2012) revealed that FDI causes economic growth. The spillover effect has been identified as an important channel through which domestic firms benefit from FDI. Spillovers are also considered as an important conduit through which FDI promotes growth in a host country. Spillover benefits arise from foreign firms demonstrating new technologies, providing technological assistance to their local suppliers and customers, and training workers who may subsequently move to local firms. Local firms can also learn by watching. Moreover, the very presence of foreign-owned firms in an economy increases competition in the domestic market. The competitive pressure may spur local firms to operate more efficiently. Because foreign firms are not able to extract the full value of these gains, this effect is commonly referred to as the spillover effect (Kokko 1994). However, it is also argued

that foreign entry in the local market can steal demand from domestic firms causing them to cut production. If the competitive pressure from foreign firms is very high, there is a possibility of crowding out of domestic firms from the market. Moreover, the potential benefits are very limited for domestic firms if the host country's firms have poor absorptive capacity (Joseph, 2007).

The increased FDI flows have further stimulated intensive debate and research on the role of FDI on host economies. The spillover effect has been identified as an important benefit accruing to domestic firms. It is also considered an important mechanism through which FDI promotes growth in a host country. Realisation of this and other benefits from FDI has prompted governments to allow and encourage FDI inflows. There have been increasing flows of direct investment across national borders over the past few decades. These have stimulated intensive debate and research on the role of FDI on host economies. As a matter of fact, MNEs are considered to be owners of superior firm specific assets which may spill to the domestic firms through various channels. However, according to the available empirical evidence on the issue, there is no consensus regarding the positive benefits that FDI may bring into the host economy. The lack of consistency in the findings across studies may be attributed to several factors viz., the absorptive capacity of the domestic firms, the technology gap between foreign and local firms and the motivations for which MNEs invest in a specific host country (Gorg and Greenaway, 2004). Nevertheless, there is an important aspect that has not received proper investigation, i.e., whether MNEs activities have other indirect benefits on local firms such as exporting activities? Numerous studies report that exporters perform better than domestic market oriented firms. Mainly, it can be attributed to two issues: (i) in order to enter the foreign market, firms need to compensate for sunk costs involved in the exporting activity; and (ii) firms may also raise their productivity due to higher competition in foreign markets. Further, it may also be due to the fact that a sort of learning by exporting effect may occur while investing in foreign markets. Local firms may become aware of new products and processes and they may try to imitate the same. In the line of above discussion, the following research question remains: Does the presence of foreign firms help domestic firms to improve their productivity and export competitiveness through either horizontal or vertical spillovers? Hence the need for the current study arises.

Scope of the Study

India's strategy towards FDI in the post-liberalisation period has been to attract large amount of FDI by offering it freedom of entry and operation. FDI is now increasingly recognised as an important contributor to the economic performance and international competitiveness of the developing countries. FDI is seen as a means to supplement domestic investment for achieving a higher level of economic growth and development. FDI benefits domestic industry as well as the consumers by providing opportunities for technological upgradation, access to global managerial skills and practices, optimal utilisation of human and natural resources, making Indian industry internationally competitive, opening up of export markets, providing backward and forward linkages and access to international quality goods and services. FDI is considered as an important channel for international diffusion of technology. Owing to the public good characteristics, these technologies tend to spill over to domestic firms and thereby affecting the economic activities of the host country. These spillovers mainly accrue to firms in the manufacturing sector. However, India failed to attract the desired quantum of FDI into the manufacturing sector, the prime focus of 1991 policy shift. The manufacturing sector accounted for only about 30 per cent of the inflows during 2000-2012 and even these were concentrated in few industries (Rao et.al., 2014). Hence there is a need for policy change with regard to the FDI inflows into the manufacturing sector because FDI inflow into manufacturing sector is imperative to create more jobs and to shift the exports from the primary products to manufactured products. Moreover, export of high-technology intensive commodities from the developing nations is likely to increase the value of exports which paves way for narrowing the current account deficit. However, developing countries remain net importers of manufactured goods and imports of manufactured goods have continuously outpaced exports of such goods for developing countries, unlike developed countries. This is because the domestic firms in developing countries lack adequate technology to export high technology commodities. It is a well acknowledged fact that the foreign firms own superior technology when compared to the indigenous firms. Hence the existence of foreign firms helps the domestic firms to learn superior technology from them. Nevertheless, FDI inflows into India are still believed to crowd out the domestic firms in the manufacturing sector. Therefore before making any change in the policy with regard to FDI inflows into manufacturing sector, it is important to investigate whether

the spillovers from foreign firms really benefit the domestic firms in improving their productivity and export performance. Hence the current study investigated the impact of spillovers from FDI (both horizontal and vertical spillovers) on the productivity and export performance of Indian manufacturing firms by categorising them on the basis of technology intensity and by assessing the extent of spillovers from minority-owned foreign firms and majority-owned foreign firms i.e., structure of foreign ownership for the period 2000-01 to 2012-13.

Objectives

The specific objectives of the study are:

- To analyse the trends in FDI inflows in India since liberalisation period.
- To study the causal nexus between FDI and economic growth and observe the direction of causation.
- To identify the determinants of FDI in India.
- To examine the impact of vertical spillovers from the foreign firms on the productivity of Indian manufacturing firms.
- To analyse the influence of vertical spillovers on the export performance of Indian manufacturing firms.
- To offer suggestions to improve the productivity and export performance of Indian manufacturing firms through backward and forward FDI linkages.

Hypotheses

In the course of the study, the following hypotheses were examined:

- The FDI inflows into India increased substantially since the post liberalisation period.
- There is no causal nexus between FDI and economic growth.
- Gross domestic product, trade openness, exchange rate, current account deficit and government's spending on economic infrastructure determine the FDI inflows into India.
- There are positive backward and forward FDI spillovers from the foreign firms on the productivity of Indian manufacturing firms.
- The backward and forward FDI spillovers from the foreign firms have a positive influence on the export performance of the Indian manufacturing firms.

Implications of the study

Although the study relates to India, it has a broader appeal. This study on FDI spillovers and their impact on the productivity and export performance of the Indian manufacturing firms provides an opportunity to explore if the FDI inflows into the manufacturing sector is beneficial or not from the point of view of the developing countries. The results of the study could help other developing countries in taking appropriate steps to improve the absorptive capacity of the manufacturing industries and to fully realise the benefits from FDI spillovers. The analysis of the horizontal spillovers and vertical spillovers from FDI and its effect on the productivity and export performance of Indian manufacturing firms and the suggestions offered by the study, would help the policy-makers to evolve various incentive programmes to make the domestic firms invest in more research and development activities which enables them to contribute to the economic growth, by increasing their productivity and export performance through the quality of their supplies.