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ORIGINAL ARTICLE

# SPILLOVER OF FDI

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**Abstract:**

*The spillover effect has been identified as an important channel through which domestic firms benefit from foreign direct investment (FDI). It is also considered an important medium through which FDI promotes growth in a host country. Realization of this and other benefits arising from FDI has prompted government to encourage FDI inflow. The increased FDI flows have further stimulated intensive debate and research on the role of FDI on host economies. The purpose of the paper is to summarize the different spillover effects of FDI and to study the trends in FDI in different sector in India.*

**KEYWORDS:**

Foreign direct investment (FDI), host country, spillover.

## INTRODUCTION:

"FDI or Foreign Direct Investment is any form of investment that earns interest in enterprises which function outside of the domestic territory of the investor." A business relationship is required between the parent company and its foreign subsidiary for the investment to be an FDI. Foreign direct investment gives rise to new corporations, which are known as multinational corporations. Attitude of India towards FDI has changed over the years. In the 1950's at the time of independence, India feared and was suspicious towards allowing participation of foreign investment in the country. This attitude had been built up because of the previous happenings in which India had lost lot of its natural resources to the foreign investors. The Industrial policy of 1948 emphasized on the fact that private foreign investment would be allowed but it was necessary for every investor to see that they don't hamper the national interest of the country. During the 1970's most of the economist and policy makers thought that MNC'S would be detrimental to the host economies as they were thought to create monopoly situations. In the 1990's government attitude changed and it started encouraging FDI. "The government relaxed its policy concerning majority ownership in several cases and granted several tax concessions for foreign personnel."In the New Industrial Policy of 1991 there was substantial liberalization and doors for foreign investment in several industries had been opened. Regulations had moved from restrict and control FDI to promote and give guarantees to foreign investors. Government started giving tax evasions, exemptions from import duties, tax holidays and direct subsidies to promote FDI. In the development of the Indian economy foreign direct investment (FDI) has played an important and major role. The growth &development, which has taken place and a certain degree of financial stability that India has achieved, has been possible due to FDI. Today, India welcomes foreign investment in virtually all sectors except defense, railway transport and atomic energy."MNCs are allowed up to 100 percent ownership of their Indian subsidiary without government approval in sectors like road and port infrastructure, mining of gold and minerals, and pharmaceuticals. “As per the information produced by Department of Industrial Policy and Promotion (DIPP), the collective amount of FDI influx 1991 to 2009 stood at US$ 127.46 billion”.

## DIFFERENT TYPES OF SPILLOVERS OF FDI

There are many possible effects of FDI inflow on a host country. “Since it is generally assumed that investing firms will possess some technology superior to that of host country firms, higher-quality goods and services could be produced at either lower prices or in greater volume than previously available, resulting in higher consumer welfare. Another effect would be rise in the output levels of domestic firms as the inward investment adds to the capital stock of the host country. Today governments spend part of their budgets in attracting FDI, as they believe it will generate a positive effect on their country. Its quiet important for the host country to look at how the multinational companies are contributing to the country's economic growth and prosperity. The way of measuring the effect of FDI is by seeing the changes happening in the economy of the host country. Due to certain kind of behavior and operating style of the foreign subsidiary there are effects on the domestic firms. These kinds of effects are known as spillovers. Spillovers are basically unintentional effect generated by firm A on firm B as a result of an economic behavior by A.

In India the general kinds of spillovers that have taken place are:

1) Wage Spillover
2) Productivity & knowledge spillover
3) Export Spillover

## WAGE SPILLOVER

Wage spillover happens when the higher wages of MNC produce an effect on the wages of employees in domestic firms. It can be both negative and positive. Negative when with higher wages of MNC leads to decrease in the domestic firms wages.

The reason behind why a foreign firm would pay more wages than its competitors in the host country in this case India is because:

Foreign firm wants to reduce their labour turnover by paying premium to the workers.
Foreign firms always want to attract better skill workers so that they can have an advantage over their competitors.
They want to maintain good public relations with the host environment and the local government.
Sometimes with the pressure from the home country or country regulations foreign firms end up paying more.

In case of India we will see that the foreign-owned firms did acquire the domestic plants and also paid higher wages to the workers, but “the margins over the averages were far too small to account for the wage differential between domestically owned and foreign-owned plants.” So the wage spillover effect in India is equivalent to negligible.

## PRODUCTIVITY & KNOWLEGDE SPILLOVER

In general terms productivity indicates how efficient the production process is. It is basically how much output a firm produces given its inputs. It is generally assumed by the economists and is the fact that foreign firm or MNCs have higher productivity than the domestic firms especially in the case where the host country is developing. MNCs have been possible to produce much more than the domestic firms because of the availability of superior technology that they posses. It is mostly taken for granted that some of the technological knowledge spills over as superior technology possessed by the foreign firms comes to the host economy with the effect of huge direct investment. The superior efficiency of the foreign owned operations are the main benefits that the host country can enjoy.

Depending upon whether the effect of technology spillover is across or within industries technological spillovers can be horizontal spillover or vertical spillover. The horizontal spillovers are the intra-industry spillovers, which depend on demonstration effects and/or the extent of labor turnover. However, in the sectors where there is presence of strong patents these demonstration effects may not exist. Similarly, labor immobility limits spillover effects. On the other hand, inter-industry spillovers normally occur via vertical linkages of foreign companies. When foreign suppliers in the host country join in with the domestic companies through forward or backward linkages and start producing the same product then vertical spillover takes place.

The effect of advanced technology can be negative or positive. Mostly positive productivity spillover occurs when the domestic or locally based firms might increase their efficiency by copying the operations of the foreign owned firms, by transfer of knowledge through backward linkages with the domestic suppliers, by improving the skill and quality of the domestic labor or human force and by being forced to compete with the foreign firms to survive in the market domestic firms raise their capacity. Sometimes it may happen that with the increase of FDI the productivity of the domestic firms in the same industry i.e. horizontal spillover or in industries that are vertically connected may decrease, as the domestic industries might not be able to cope up the superior technology. One more reason that could lead to negative productivity spillover is with higher productivity and superior technologies MNCs erode the market share of the domestic companies by providing better quality goods at cheaper prices. With domestic companies producing comparatively lesser amount of products they are not able to reach economies of scale, which could help them to reduce the prices.

Domestic firms may benefit from the accelerated transmission of new technology if the foreign firms introduce new products and processes to the domestic market. To make a new product or process feasible substantial resources are required and for the economic growth of developing countries who are by and large scarce in human capital and financially starved the role of technology transfer really becomes important. It is very important factor to know that what the capabilities of domestic firms are. To know the absorptive capacity of the host country and their firms is of great importance as it is difficult to adopt, adapt and imitate what the foreign firms are doing. To train the human resource or to invest in R&D and in experimentation at the same level is very difficult. It's not easy to get the same kind of technology imported that the foreign firms are using as lot of legal work and money is required. "In India, government has an expressed foreign technology agreements in which Reserve Bank of India through automatic route within certain prescribed monetary limits related to Royalty, permits foreign technology agreements in all industries (Ministry of Industry and Commerce, Department of Industrial Policy and Promotion, Govt. of India, 2005)."

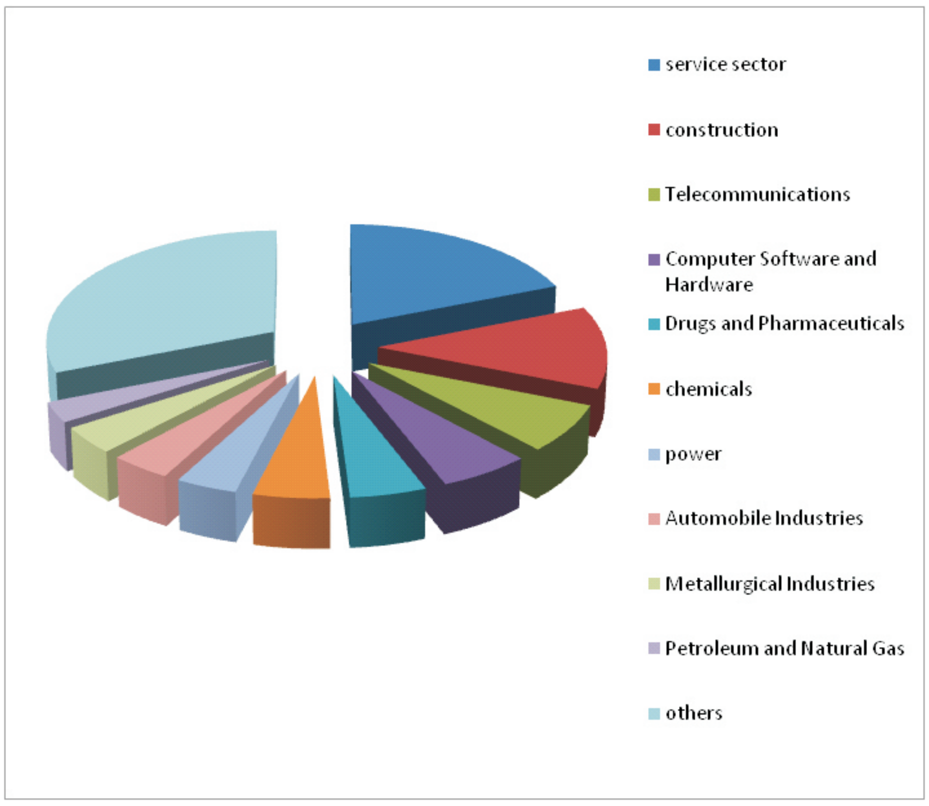
## EXPORT SPILLOVER

MNCs always have more average export than the local or domestic firms by having more exports they put pressure on the domestic players to export by which export spillover takes place. Sometimes in developing countries when the foreign players enter they start building up new industries by this they enjoy the benefits of reaping the most amount of profits and from the point of view of the host country there are new opportunities for the domestic players.

After looking at the general spillovers that an economy may face we will now be looking at spillovers that every sector or industry in India might be having. It is important to look at every sector in India to find out the spillovers as by just looking at the general spillovers we can't come to a conclusion that whether India had positive or negative spillovers as the margin of change that happened due to FDI is quiet small. So by looking at each sector we will be having exact ideas which sectors were affected positively and which were affected negatively. After analyzing the Sector wise inflow of FDI in India we found that maximum FDI has taken place in the service sector, which includes the telecommunication, information technology, travel and many others. The manufacturing sector is second in terms of inflow of FDI. In industries like pharmaceuticals, cement, automobile, metallurgical and electronics high volumes of FDI has take place. India is the leading country in Asia pacific region as far as IT Industry is concerned. The telecom industry with the growth rate of 45% is one of the fastest growing industries in India and this has happened due to the inflow of FDI in form of international players entering the market and transfer of advanced technologies. With inflow of FDI in Automobile Industry and increase in disposable income in India there has been huge growth in this industry over the past few years. The automobile sector has also benefited from the introduction of tailor made finance schemes, easy repayment schemes. With some of the Indian cement giants merging with major cement manufacturers in world such as Holcim, Heidelberg, and Italcementi the FDI inflow in the Cement Industry in India has increased. With the inflow of FDI in India the financial markets have become fast, transparent, and efficient. FDI inflow in terms of real estate investments has made India one of the most prime destinations and also had helped India in an exceptional growth of economic life. The increased FDI Inflows to Chemicals industry in India has helped in the growth and development of the sector. The quality of pharmaceuticals drugs and products has improved with the increase in FDI Inflows to Drugs and Pharmaceuticals industry in India. It has also has helped the industry in expansion, growth, and development. The transformation of India's busiest airports Mumbai and Delhi has taken place with the help of FDI in the Indian airport industry. Cities like Bangalore and Hyderabad have been facilitated with two new Greenfield airports.

In India it is found that the top 10 sectors out of total 62 (in which FDI inflows) attract almost 70% of the total FDI inflows based upon the data given by department of Industrial Policy and Promotion.

**Percentage of FDI Inflows in Different Sectors in India**




This table clearly indicates the FDI inflows in different sector for the period of April 2000 – August 2012. Most of the foreign countries were liked to invest their amount in service sector, Construction Industry, Telecommunications and Computer software and Hardware, because these sectors earn more profit compared to others.

"The service sector in India attracts the maximum FDI inflows amounting to 158252 dollars, followed by Construction amounting to 97028 dollars. These two sectors collectively attract more than thirty percent (30%) of the total FDI inflows in India." "Thus the sector wise inflows of FDI in India show a varying trend but acts as a catalyst for growth, quality maintenance and development of Indian Industries to a greater and larger extend. The technology transfer is also seen as one of the major change apart from increase in operational efficiency, managerial efficiency, employment opportunities and infrastructure development."

**FDI Inflows in Different Sectors in India**

| S.NO. | SECTOR | FDI Inflows 2000-2012 August in US $ | % |
|---|---|---|---|
| 01 | Services Sector | 158252 | 19 |
| 02 | Construction | 97028 | 12 |
| 03 | Telecommunications | 57188 | 7 |
| 04 | Computer Software and Hardware | 51149 | 6 |
| 05 | Drugs and Pharmaceuticals | 45440 | 5 |
| 06 | Chemicals | 39468 | 5 |
| 07 | Power | 34936 | 4 |
| 08 | Automobile Industries | 34201 | 4 |
| 09 | Metallurgical Industries | 30142 | 4 |
| 10 | Petroleum and Natural Gas | 24783 | 3 |

Source: DIPP, Federal Ministry of Commerce & Industry, Government of India

**FDI inflows in India (Amount US$ in Millions)**

| S.No. | Financial Year | Total FDI Inflow | % growth over previous year |
|---|---|---|---|
| 1 | 2004-2005 | 6051 | (+)40 |
| 2 | 2005-2006 | 8961 | (+)48 |
| 3 | 2006-2007 | 22826 | (+)146 |
| 4 | 2007-2008 | 34362 | (+)51 |
| 5 | 2008-2009 | 35168 | (+)02 |

Source: DIPP, Federal Ministry of Commerce & Industry, Government of India

The above table reveals the FDI inflows in India for the period of 2004-05 to 2008 -09. The inflows of FDI are increased year by year due to various reasons, such as Heavy Demand of Indian Consumers, Liberalized Government Policy, Communications facilities.

## CONCLUSION

As India has benefited from FDI the government should make policies that enhance the ability of a sector to attract foreign investments. The major spillovers of FDI to the domestic economy are the generation of additional output and employment. Upgrading the level of knowledge and technical expertise in the local economy is very important if India wants to negate the negative spillovers. We also found that there exist horizontal spillover effects from the activities of foreign firms to local firms. After analyzing the above results we found that foreign investment in a firm significantly and positively increases the firm's output and productivity. In contrast to this, the firms with no foreign investment (domestic firms) are found to be less productive in sectors with more foreign investment.

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