in brief...

# India's foreign investment policy: the impact on productivity

What kind of liberalisation policies can make a difference to firms' productivity? Research by **Arunish Chawla** explores this question in the context of India's economic liberalisation of the 1990s. He analyses the impact of foreign investment policy on the performance of Indian manufacturing firms over a 15-year period.

A particularly striking feature of India's foreign investment regime since the 1990s has been that it encourages the adoption of foreign technology by domestic firms while at the same time opening up these industry sectors to foreign investors. So liberalisation consists of two distinct components:

- Foreign direct investment (FDI), defined by the International Monetary Fund as a foreign firm taking at least a 10% stake in a domestic firm.
- Foreign technology agreements (FTA), more 'arm's-length' transactions in which a foreign firm enters into partnership with a domestic firm.

The relative importance of the two components can be gauged by the fact that in the post-reform period (between August 1991 and January 2005 in this study), the number of FDI projects approved by the Indian government was nearly 19,000 and the number of FTAs approved was just over 7,600.

Unlike in many East Asian countries, Indian policy-makers have resisted the temptation to offer subsidies to foreign investors (at least until very recently). Instead, they have pursued a two-pronged strategy of inviting FDI from foreign firms as well as encouraging FTAs by domestic firms.

Previous research has shown that increasing FDI leads to greater competition in industries where firms compete with each other at a single stage of the production process. The effect of increased competitive pressure is to lower the mark-ups that domestic firms are able to charge, thereby reducing their measured productivity.

This is typically not outweighed by any productivity benefits to domestic firms from observing and copying the techniques used by foreign firms – what are known as 'technology spillovers'. For firms in these industries to gain significantly from technology spillovers, they need to be technologically advanced or close to the 'technology frontier'.

India's liberalisation has been successful by its openness to both foreign investment and foreign technology

But in vertically integrated industries (where firms operate at more than one stage of the production process), previous research suggests that the effect of FDI on productivity is positive. This implies that both domestic and foreign firms benefit from technology spillovers.

Chawla's research finds that liberalisation of the foreign investment regime in India has significantly improved the performance of manufacturing firms. This is surprising as the sample mainly consists of firms that compete at a single stage of production. What seems to have happened is that the policy of encouraging FTAs has had an effect equivalent to technology spillovers, moving domestic firms closer to the technology frontier, albeit through different means.

Since the industries studied were simultaneously subjected to both FDI and FTA liberalisation, it is not easy to distinguish between the effects of two policies.
To do this, the research looks in detail at the motor vehicle industry. It finds that in this sector at least, the two elements of the foreign investment regime have been complementary in their positive impact on firms' productivity.

India's experiences are often compared with China's, and while the latter has attracted greater FDI inflows than the former since the early 1990s, India has attracted greater portfolio investment and the ratio of market capitalisation of its listed firms to GDP has been higher. What's more, Indian firms now invest so much abroad that FDI outflows almost match FDI inflows.

The fact that India's foreign investment liberalisation treats foreign technology and direct investment as inseparable is important here. Such a policy is bound to have effects beyond the simple enumeration of FDI inflow figures. At least one important implication of this policy is its positive effect on the productivity of manufacturing firms.

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