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# Investment Development Path Theory and the Case of India

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This study analyses India's economic development in the light of the country's foreign direct investment inflows and outflows, using the theoretical framework of the Investment Development Path (IDP) Theory. The study investigates whether the relationship between India's economic development and its foreign direct investment flows shows a specific pattern, similar to the one described in the IDP theory. The results suggest that in the initial stages of development, this relationship shows a pattern which is similar to the one expected as per the IDP theory. However, in the third stage, the pattern is different from the one identified in the IDP theory.

Field of Research: Process of Economic Globalisation

#### 1. Introduction

As revealed by the United Nations Conference on Trade and Development (UNCTAD) in their World Investment Report 2006 (WIR 06), the developing and transitional economies, which were previously considered as mere recipients of Foreign Direct Investment (FDI), are increasingly becoming an important source of FDI. This holds true with India, as well as some other nations like China, Brazil, South Africa etc. Apparently, this trend seems to be a diversion from the traditional theories, particularly the Investment Development Path (IDP) theory that was introduced by John H Dunning (1981). The IDP theory explains the development of a country through five phases, generally starting with the stage of early development, through to the fifth or last stage, which is represented by today's developed countries. Dunning (1981) and Dunning and Narula (1996) have used gross domestic product (GDP) as an indicator of the countries' development level. These studies analysed the IDP stages of the countries by regressing GDP per capita on Net Outward Investment (NOI) per capita (NOIpc). The purpose of this paper is to analyse India's economic development in the light of the country's foreign direct investment inflows and outflows, using the theoretical framework of the IDP Theory.

If the IDP theoretical framework is used to analyse India's economic development, one important issue needs to be addressed, and that is, the beginning of the development. Industrialisation has started in India way back in early 1900, and during the colonial era, India was involved in exporting goods to other countries as well.

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However, at the time of Independence in August 1947, India was one of the poor and under-developed countries. Therefore, the beginning of 20<sup>th</sup> century cannot be treated as the first stage of India's development. After Independence, until the year 1990, Indian economy was full of controls and foreign investments were seen only in public sector, normally as an aid from the World Bank, or the joint large public sector projects with the erstwhile USSR. The IDP theory cannot be applied to that time period, as IDP theory explains the stages of development in the light of foreign direct investments – inward and outward capital flows.

In late 1980s and beginning of 1990s, India experienced a balance of payments crisis, and as such, found it increasingly difficult to borrow internationally. Dr Manmohan Singh, a renowned economist and now the Prime Minister of India, was then the Finance Minister, who started the process of economic liberalisation in India. India made various agreements with the International Monetary Fund (IMF) and other organisations, and the process of liberalisation was geared up. The economic reforms created a competitive environment for Indian industries since 1991, which has led to significant changes. 'Indian companies have upgraded their technology and expanded to more efficient scales of production. They have also restructured through mergers and acquisitions', (Ahluwalia, 2002).

With the policy of liberalisation, Indian government stepped up the efforts to encourage FDI inflows. The measures included doing away with investment licensing, ending public sector monopoly in most of the sectors and initiating a policy of automatic approval for foreign direct investment in certain industries, establishing Special Economic Zones (SEZs), where FDI up to 100 per cent is allowed etc. In 2001, following a dispute settlement with the World Trade Organisation (WTO), the consumer goods were freed from licensing. Today there are very few goods that require import licence.

'The 1990s reforms were also accompanied by the lifting of exchange controls that had served as an extra layer of restrictions on imports' (Panagariya, 2004). The lifting of exchange controls gave a further boost to inward and outward foreign investments.

It was only after the beginning of liberalisation process in 1991, when Indian firms started developing in a competitive atmosphere where a free flow of foreign capital to and from the country was made possible. Therefore, in this paper, we have analysed India's investment development path from the year 1991. This study investigates whether the relationship between India's economic development as measured by per capita GDP, and its per capita net FDI outflows, shows a pattern similar to the one described by the IDP theory.

#### 2. Literature Review

The IDP theory discussed an association between a country's net FDI (outward less inward FDI) position and its level of development (using GDP per capita as a measure of economic development). As per the IDP theory, countries tend to evolve through five stages, from being a net FDI recipient to being a net source of FDI (Dunning 1981, Dunning and Narula 1996), which explains a country's evolution from early development through to the fully developed stage.

The first stage is marked by very little inward and outward FDI. There are few factors, with possible exception of rich natural resources that could attract inward FDI. The local firms are not in a position to invest overseas, as they don't possess many firm-specific advantages.

In the second stage, the level of inward FDI starts increasing. There are some location specific advantages like basic infrastructure that result from government policies, and increased per capita income. The outward FDI is still negligible, resulting in negative NOI.

Then comes stage three, where the rate of growth of inward FDI is expected to start declining, as the local firms become more competitive. Outward direct investment will gradually start rising since the domestic firms have acquired ownership advantages over the period of time and they will now start making investments overseas for asset seeking etc. In the fourth stage, a country will become a net outward investor. This change is attributed to the development of ownership advantages achieved by the local firms that make them increasingly competitive. In the fifth or final stage, the country's net FDI position tends to be around zero, with nearly equal amounts of inward and outward FDI flows. This stage is observed with today's most developed countries.

Researchers have used the IDP theory to study FDI behaviour and economic development of the nations around the globe. Herrera and Mellina (2001) analysed the relationship between foreign direct investment and economic development in the less developed countries of Latin America. Using IDP framework, they analysed the heterogeneity of development among those countries. In case of the economies at stage III of IDP, a relation of causality was found between the inflow of direct investment and economic growth, probably due to the availability of human capital in these countries. However, in case of the countries that were at the first or second stage of IDP, a strong heterogeneity of results was observed. Bellak (2000) studied Austria's IDP and concluded that even though Austria is more developed than many other European nations, its NOIP has always been negative. The factors that seem to be responsible are the geographical and industrial structure of domestic industries and the policies pursued, rather than the general level of development.

Buckley and Castro (1998) applied the IDP theory to study the relationship between net FDI and per capita income for Portugal for the period 1943-1996.

The results of this study supported the IDP theory, which states that international investment follows a more or less predictable path, accompanying and influencing economic growth. However, their analysis of Portuguese conditions suggested that apart from the government policy to improve infrastructure and encourage inward FDI, some external factors like European Union integration and the fall of the Berlin Wall, also influenced the IDP of this nation.

Mazerolle (2006) studied the impact of enlargement on FDI growth (both inward and outward), using the theoretical framework of IDP. This study compared the FDI and GDP growth, as experienced by two regions - the Pan Pearl River Delta Region (Pan-PRD), and EU25 during the year 2005. For both these regions, the 'core' region was first defined and then addition of new provinces or countries was considered as 'enlargement'. The results showed that the additional 8 provinces to Pan-PRD (the enlargement), attracted less than 1% of world inward FDI stocks. As compared to this, the 10 countries added to EU (enlargement), received 2.7% of the world inward FDI stocks. An important contributing factor for the large FDI receipt by EU countries, was the close cultural and geographical ties between the Central and Eastern Europe (CEE) countries, and the key western European markets.

Some studies focused only on certain aspects of IDP theory. Antaloczy and Elteto (2002) investigated the factors that motivated top Hungarian firms to make direct investments overseas. This study found the main home-country factors for outward FDI to be the firm's strong financial situation and development, high competition and saturation in domestic markets and somewhat sluggish stock market leading to problems in raising capital. The choice of destination for the foreign investments by the Hungarian firms was influenced by certain host-country factors like infrastructure, economic policy, macroeconomic factors like inflation, and political stability and decreasing bureaucracy. Galan et al (2007) examined the most important factors for and against the location decisions in foreign direct investment made by a sample of 103 multinational enterprises. The study found that while investing in more developed countries, strategic asset-seeking was an important motive, whereas social and cultural factors played a more determinant role while investing in developing countries. Kimino et al analysed the macro determinants for the 17 source countries of FDI inflows to Japan. They found the factors like relative currency volatility, relative borrowings and source country risk to be significant determinants to Japan's inward investment. In their study of Central and Eastern European countries, Kottaridi et al found that location characteristics like market size and quality of labour play an important role in attracting FDI.

Many studies have analysed the relationship between FDI flows and GDP of a nation. FDI inflows may not necessarily boost an increase in GDP. Axarloglou and Pournarakis (2007) analysed the effects of FDI inflows on local employment and wages (labour market effects) in manufacturing industries across a sample of US firms. Their study found rather weak labour market effects across the states. Also, the results varied across the subgroups of industries. Alfaro (2003) has similar findings. The effect of FDI on growth

showed sector-wise differences. The FDI inflows in the primary sector show a negative effect on growth, while investment in manufacturing exhibited a positive one.

The recently published WIR06 by UNCTAD, has used the IDP theory to analyse the emergence of trans-national corporations (TNCs) from developing and transition economies. Though the findings of this study generally supported IDP theory, it was observed that many developing countries, such as Brazil, China, India, Mexico, South Africa and Turkey, which are home to leading TNCs and are investing significant amounts of FDI overseas, are actually at stages 1 and 2 of the IDP; and they have therefore begun outward FDI earlier than might be expected on the basis of the IDP.

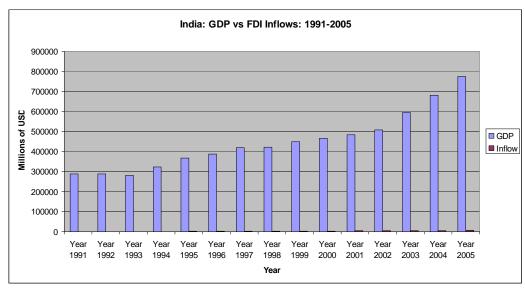
## 3. Methodology and Research Design

As IDP investigates the relationship between the NOI and the GDP of a country; the FDI inflows, FDI outflows, GDP and population data has been used. After gaining Independence in 1947, India opened its economy gradually to the foreign investment flows in the year 1991. Therefore, data has been used for the years 1991 to 2005, which is the latest data available at the time of writing. The FDI inflows and outflows data has been collected from UNCTAD's World Investment Reports for the years 1991 to 2006. The GDP figures are used from UNCTAD's WIR Annex Tables. The population figures are obtained from UN's Demographic Yearbooks for the years 2003 and 2004. Population figures for the year 2005 are obtained from the United Nations Population and Vital Statistics Report 2007. Keeping in line with the previous IDP studies, particularly Dunning (1981), Dunning and Narula (1996) and Buckley and Castro (1998), the following model has been used:

NOIDC =  $\alpha + \beta$ 1GDPDC +  $\beta$ 2 GDPDC<sup>2</sup> +  $\varepsilon$ 

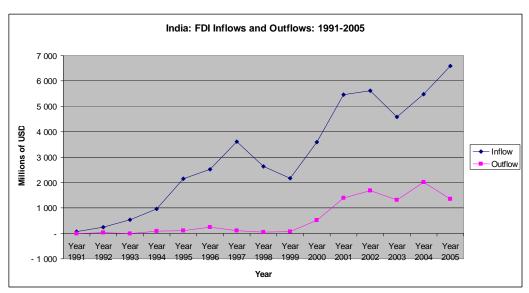
## 4. Discussion of Findings

The economic reforms in India that started in 1991, gradually removed the obstacles for FDI inflows and outflows. Keeping in line with the IDP theory, both the inflows and outflows of FDI were small in the beginning (Phase 1). In 1990, India's FDI receipts were 0.002 per cent of the GDP that gradually rose to 0.009 per cent of GDP in the year 2005.



Data Source: UNCTAD: Key Data from WIR Annex Tables

However, India's economic development was not necessarily accompanied by increase in FDI inflows. The increase in FDI inflows was negligible as compared to the growth in GDP.



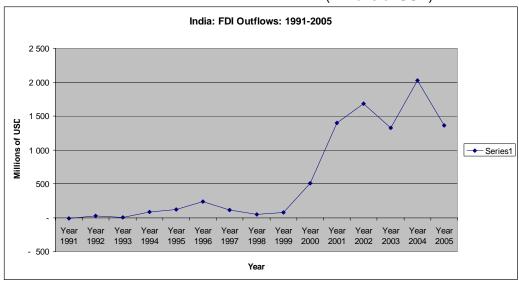
Data Source: UNCTAD: Key Data from WIR Annex Tables

The IDP theory states that the economic and political drivers that trigger the internationalization of the firms can be wide ranging, but often include a small home market, competitive pressures and government policies aimed at encouraging foreign expansion. In the second stage, inward FDI starts to rise, while outward FDI remains low or negligible, mainly because the firms are still developing. In the third stage, as domestic firms start becoming more

competitive, inward FDI starts declining whereas outward FDI gradually starts rising. In case of India, such clear-cut stages are not observed.

FDI Outflow from India during 1991 – 2005

(millions of USD)



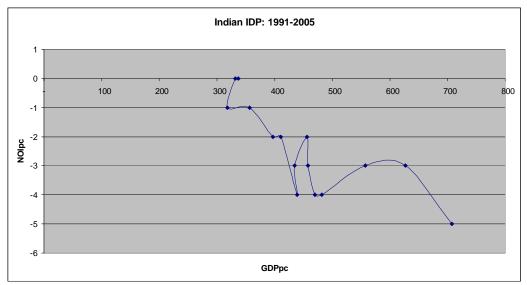
Data Source: UNCTAD: Key Data from WIR Annex Tables

In absolute terms, India's outflows increased to \$1397 million in the year 2001 which was an increase of 174.46 per cent from the previous year which recorded an outflow of \$509 million. Instead of showing a constant rise, the FDI outflows actually declined in the years 2003 and 2005 as compared to previous years. The FDI outflows don't show a smooth pattern of constant growth as expected in the second and third phases of IDP.

The year 2007 saw a sharp rise in the overseas investments by Indian firms. Tata Steel's takeover of Anglo-Dutch company 'Corus' for \$12.2 billion (Financial Times), acquisition of aluminium sheet maker Novelis by Hindalco Industries for \$5.9 billion (The Hindu), Jindal Steel & Power's \$2.1 billion iron ore and steel project in Bolivia, (Economic Times), attracted the attention of the world. The Associated Chambers of Commerce and Industry of India (Assocham) has predicted that the FDI outflow of \$15 billion from India is likely to surpass the inflows in the year 2007 – 08, mainly by India's booming manufacturing sector, (Times of India).

Such a sudden sharp rise in FDI outflows from Indian firms does not fit perfectly in the IDP framework. Apparently, this rise can be explained with firm-specific factors, since all the above mentioned companies are one of India's largest companies. The purpose for these takeovers are also firm specific. Tata Steel will benefit from the advanced European technology, Hindalco will have a large market share after the acquisition of Novelis, and

Jindal Steel will benefit from acquisition of mines and coal fields in the developing countries.



Data Source: UNCTAD: Key Data from WIR Annex Tables

#### 5. Conclusion

India's economic development and the inward and outward FDI, initially do show a pattern which is similar to first two stages of the IDP theory. As expected in the initial stage, FDI inflows are much higher as compared to outflows, showing decreasing NOIpc. However, suddenly in 1998, the outward investment started increasing. This trend continued until the year 2000, thereafter it took a reverse direction. In the year 2006 there were some large takeovers by Indian firms. The Assocham study expects the FDI outflows to be higher than the FDI inflows in the year 2007-08. This is something that is expected to happen in the fourth or fifth stage of IDP. This is where India's development path slightly differs from the IDP that was shown in Dunning, and Dunning and Narula's studies. Apparently, the main reason for this diversion is that, India's FDI outflows are more firm-specific, and most of the outflow in 2006 was caused by Tata Steel and Hindalco. Rather than the FDI inflows, it is the competitive atmosphere and removal of barriers like licence etc, that has contributed more to India's increase in GDP. The FDI inflows for India are very small and did not grow as fast as it did for China, owing to some macro level factors like infrastructure, speed of regulation change, power-shortage in many parts of the country, red tape etc. This has mainly lead to the situation where the FDI outflows are more firm-specific, rather than representing a trend for the whole nation, and most probably, that is the reason why India's FDI outflows are sporadically too high in certain years, than would have expected in the IDP framework.

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