IMPACT OF FOREIGN DIRECT INVESTMENT IN MICRO SMALL MEDIUM ENTERPISES (MSME) IN INDIA

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Abstract

FDI plays an important role in any country's economical activities. Companies big or small cannot solely depend on the conventional source of finance all together. For financial and technological support they have to depend on foreign resources. For big companies getting FDI is not difficult issue because of financial security, reach in global market and business experience but in MSME it stills an unsolved puzzle or a buzzword. The paper is concerned with one of the ways of contributing to strengthening the indigenous MSME sector in a situation of resource scarcity. Specifically, the paper is concerned with the potential role of foreign direct investment (FDI) in relation to the long term competitive development and inter-nationalization of the MSME sector in transition and developing countries.

Keywords: Foreign Direct Investment (FDI), MSME, Global Market.

Introduction

Capital is stated as the engine of economic growth. Foreign direct investment (FDI) plays an extraordinary and growing role in global business. It can provide a firm with new markets and marketing channels, cheaper production facilities, access to new technology, products, skills and financing. For a host country or the foreign firm which receives the investment, it can provide a source of new technologies, capital, processes, products, organizational technologies and management skills, and as such can provide a strong impetus to economic development. Foreign direct investment, in its classic definition, is defined as a company from one country making a physical investment into building a factory in another country. In other word FDI is an investment involving a long term relationship and reflecting a lasting interest and control of a resident entity in one economy in an enterprise resident in an economy other than that of the foreign direct investor. The direct investment in buildings, machinery and equipment is in contrast with making a portfolio investment which is considered an indirect investment. In recent years, given rapid growth and change in global investment patterns, the definition has been broadened to include the acquisition of lasting management interest in a company or enterprise outside the investing firm's home country. As such, it may take many forms, such as a direct acquisition of a foreign firm, construction of a facility, or investment in a joint venture or strategic alliance with a local firm with attendant input of technology, licensing of intellectual property. In the past decade, FDI has come to play a major role in the internationalization of business. Reacting to changes in technology, growing liberalization of the national regulatory framework governing investment in enterprises, and changes in capital markets profound changes have occurred in the size, scope and methods of FDI. New information technology systems, decline in global communication costs have made management of foreign investments far easier than in the past. The sea change in trade and investment policies and the regulatory environment globally in the past decade, including trade policy and tariff liberalization, easing of restrictions on foreign investment and acquisition in many nations, and the deregulation and privatization of many industries, has probably been then most significant catalyst for FDI's expanded role.

The most profound effect has been seen in developing countries, where yearly foreign direct investment flows have increased from an average of less than $10 billion in the 1970's to ayearly average of less than $20 billion in the 1980's, to explode in the1990's from $26.7billion in 1990 to $179 billion in 1998 and $208 billion in 1999 and now comprise a large portion of global FDI.Driven by mergers and acquisitions and internationalization of production in a range of industries, FDI into developed countries last year rose to$636 billion ,from $481bilion in 1998 (source UNCTAD) For small and medium sized companies, FDI represents an opportunity to become more actively involved in international business activities.

FDI policy in India:

FDI means investment in a foreign country through the acquisitionof a local company or the establishment there of an operationon a new site. In simple words, FDI refers to capitalinflows from other country that is invested in or to enhancethe production capacity of the economy.Foreign Investment in India is governed by the FDI policy announcedby the Government of India and the provision of theForeign Exchange Management Act (FEMA) 1999. The ReserveBank of India (RBI) in this regard had issued a notification,which contains the Foreign Exchange Management (Transferor issue of security by a person resident outside India) Regulations,2000. This notification has been amended from timeto time.

The Ministry of Commerce and Industry, Government of Indiais the nodal agency for monitoring and reviewing the FDI policyon continued basis. The FDI policy is notified through PressNotes by the Secretariat for Industrial Assistance (SIA), Departmentof Industrial Policy and Promotion (DIPP).The foreign investors are free to invest in India, except fewsectors/activities, where prior approval from the RBI or ForeignInvestment Promotion Board (FIPB) would be required.

Types of Foreign Direct Investment

FDI is defined as cross-border investment by a resident entity in one economy with the objective of obtaining alasting interest in an enterprise resident in another economy. The lasting interest implies the existence of a long-termrelationship between the direct investor and the enterprise and a significant degree of influence by the direct investoron the management of the enterprise. Ownership of at least 10% of the voting power, representing the influence by theinvestor, is the basic criterion used (OECD, 2014).

Broadly, foreign direct investment includes "mergers and acquisitions, building new facilities, reinvesting profitsearned from overseas operations and intra company loans". In a narrow sense, foreign direct investment refers just toobuilding new facilities. The numerical FDI figures based on varied definitions are not easily comparable.
As a part of the national accounts of a country, and in regard to the GDP equation;
Y=C+I+G+(X-M)
[Consumption + Gross Investment + Government spending +(eXports - iMports], where I is domestic investmentplus foreign investment, FDI is defined as the net inflows of investment (inflow minus outflow) to acquire a lastingmanagement interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that ofthe investor. FDI is the sum of equity capital, other long-term capital, and short-term capital as shown the balance ofpayments. FDI usually involves participation in management, joint-venture, transfer of technology and expertise.
There are two types of FDI: inward and outward, resulting in a *net* FDI *inflow* (positive or negative) and "stock offoreign direct investment", which is the cumulative number for a given period. Direct investment excludes investmentthrough purchase of shares. FDI is one example of international factor movements.

Horizontal FDI

Horizontal FDI arises when a firm duplicates its home country-based activities at the same value chain stage in ahost country through FDI. Horizontal FDI occurs when MNCs roughly have the same production process in the homeandhost country, with the headquarter in the home country and where each plant provides products for its local market(Protsenko, 2003). So, horizontal FDI may act as a substitute for exporting and a desire to be close to the foreignmarkets and thereby avoiding transportation cost and other trade barriers. Horizontal FDI is also often referred asmarket-seeking FDI.

Vertical FDI

Vertical FDI refers to multinationals that fragment production process geographically. It is called vertical becauseMNC separates the production chain vertically by outsourcing some production stages abroad. The basic idea behindthe analysis of this type of FDI is that a production process consists of multiple stages with different inputrequirements. If input prices vary across different countries, it becomes profitable for the firm to split the productionchain (Protsenko, 2003). The basic idea behind vertical FDI is that each production process has different inputrequirements. For example, processes like assembling need cheap labor and headquarter activities needs technology and skilled labor. Through the differences in prices of these different kinds of input between countries, it generallybecomes cost-effective to separate the production. Thus, the main motivation for vertical FDI is to lower the costs ofthe production. Furthermore, vertical FDI can be distinguished into backward and forward vertical FDI, based onwhere all the various kinds of input are coming from. In case of backward vertical FDI, foreign affiliates act assuppliers of input for the parent firm. This type of investments can typically be seen in primary sectors like mining, oiland agriculture. Consequently, backward vertical FDI is also referred to as resource seeking FDI. In case of forwardvertical FDI, the parent companies export their products to foreign affiliates for further production, where intermediateor final products are send back to the home country or even exported to a third country (Doan,2009).

Literature review

The existing FDI literature shows an increasing number of studies examining the technology spillovers from FDI todomestic firms. However, the evidence that foreign presence generates positive productivity externalities remainslimited since the empirical literature indicates mixed results. Many show significant positive spillover effects fromFDI while some find no or statistically insignificant result from technology spillover. The diverse results may beattributed to differences in countries' ability to benefit from foreign investment reflecting varying levels of absorptivecapacity and market structure.

The earliest discussions of spillovers in the literature on foreign direct investment date back to the 1960s. The firstauthor to systematically include spillovers (or external effects) among the possible consequences of FDI wasMacDougall (1960), who analyzed the general welfare effects of foreign investment. Other early contributions wereprovided by Corden (1967), who looked at the effects of FDI on optimum tariff policy, and Caves (1971), whoexamined the industrial pattern and welfare effects of FDI (Blomstrom and Kokko, 1997).

Advantages of Foreign Direct Investment

Foreign Direct Investment (FDI) is the investment of funds by an organisation from one country into another, with the intent of establishing 'lasting interest'. According to OECD (Organisation for Economic Co-operation and Development), lasting interest is determined when the organisation acquires a minimum of 10% of voting power in another organisation. For instance: the act of an Indian company such as Ola opening another headquarters in Sydney, Australia will be considered as bringing FDI into Australia.

Reinvestment of profits from overseas operations, as well as intra - organisational loans and borrowings to overseas subsidiaries are also categorised as FDI.

The meaning of FDI is not restricted only to international movement of capital. Its definition also encompasses the international movement of elements that are complementary to capital - such as skills, processes, management, technology etc.

There is a difference between FDI and FPI (Foreign Portfolio Investments), wherein the investor purchases equity of foreign companies. FPI means only equity infusion, and does not imply the establishment of a lasting interest.

FDI can be Greenfield, wherein an organisation creates a subsidiary concern in another country and builds its business operations there from the ground up. Greenfield investments provide the highest degree of control to the organisation. It can construct the production plant as per its specifications, employ and train human resources as per company standards, as well as design and monitor its operational processes.

Alternatively, FDI can be brown field - wherein an organisation expands by way of cross-border mergers, acquisitions and joint ventures - by either leasing or purchasing existing facilities for its production. The clear advantage of brown field investments is the savings in cost and time for starting up, as well as engaging in construction activities. Addition of equipment to an existing facility also qualifies as brown field investment.

It is difficult to overstate the global and macroeconomic significance of FDI. As per UNCTAD (United Nations Conference on Trade and Development), global FDI amounted to around $ 1.8 tn in 2015.

There are many ways in which FDI benefits the recipient nation:

1.Increased Employment and Economic Growth

Creation of jobs is the most obvious advantage of FDI. It is also one of the most important reasons why a nation, especially a developing one, looks to attract FDI. Increased FDI boosts the manufacturing as well as the services sector. This in turn creates jobs, and helps reduce unemployment among the educated youth - as well as skilled and unskilled labour - in the country. Increased employment translates to increased incomes, and equips the population with enhanced buying power. This boosts the economy of the country.

2.Human Resource Development

This is one of the less obvious advantages of FDI. Hence, it is often understated. Human Capital refers to the knowledge and competence of the workforce. Skills gained and enhanced through training and experience boost the education and human capital quotient of the country. Once developed, human capital is mobile. It can train human resources in other companies, thereby creating a ripple effect.

3.Development of Backward Areas

This is one of the most crucial benefits of FDI for a developing country. FDI enables the transformation of backward areas in a country into industrial centers. This in turn provides a boost to the social economy of the area. The Hyundai unit at Sriperumbudur, Tamil Nadu in India exemplifies this process.

4.Provision of Finance & Technology

Recipient businesses get access to latest financing tools, technologies and operational practices from across the world. Over time, the introduction of newer, enhanced technologies and processes results in their diffusion into the local economy, resulting in enhanced efficiency and effectiveness of the industry.

5.Increase in Exports

Not all goods produced through FDI are meant for domestic consumption. Many of these products have global markets. The creation of 100% Export Oriented Units and Economic Zones has further assisted FDI investors in boosting their exports from other countries.

6.Exchange Rate Stability

The constant flow of FDI into a country translates into a continuous flow of foreign exchange. This helps the country's Central Bank maintain a comfortable reserve of foreign exchange. This in turn ensures stable exchange rates.

7.Stimulation of Economic Development

This is another very important advantage of FDI. FDI is a source of external capital and higher revenues for a country. When factories are constructed, at least some local labour, materials and equipment are utilised. Once the construction is complete, the factory will employ some local employees and further use local materials and services. The people who are employed by such factories thus have more money to spend. This creates more jobs. These factories will also create additional tax revenue for the Government that can be infused into creating and improving physical and financial infrastructure.

8.Improved Capital Flow

Inflow of capital is particularly beneficial for countries with limited domestic resources, as well as for nations with restricted opportunities to raise funds in global capital markets.

9.Creation of a Competitive Market

By facilitating the entry of foreign organizations into the domestic marketplace, FDI helps create a competitive environment, as well as break domestic monopolies. A healthy competitive environment pushes firms to continuously enhance their processes and product offerings, thereby fostering innovation. Consumers also gain access to a wider range of competitively priced products.

For a multinational corporation, FDI in India is a means to access new consumption and production markets, and thereby expand its influence and business operations. It can gain access not only to limited resources such as fossil fuels and precious metals, but also skilled and unskilled labour, management expertise and technologies. FDI also enables an organisation to lower its cost of production- by accessing cheaper resources, or going directly to the source of raw materials rather than buying them from third parties. Often, there are various tax advantages that accrue to a company undertaking FDI. This can occur when the home country allows tax deduction on foreign income, or when the recipient country allows tax deductions and benefits for organizations incurring FDI in that country. Additionally, this can happen when the recipient country has a more beneficial tax code than the home country.

Problems Faced by SSI in Financing

- Finance is a key input of product distribution and development. It is therefore, aptly described as the life blood of industry and is a prerequisite for accelerating the process of industrial development.

- An important problem faced by small scale industries in the country is that of finance. The problem of finance in small sector is mainly due to two reasons. Firstly, it is party due to scarcity of capital in the country as a whole .Secondly it is party due to weak credit worthiness of small units in the country. Due to this weak economic base , they find it difficult to take financial assistance from the commercial banks and financial institutions. As such they are bound to obtain credit from the money lenders on a very high rate of interest and are thus exploited in practice.

- The small scale industries facing problems are regarding problem of raw material, problem of finance, problem of marketing, problem of underutilization of capacity, outdated technology, poor project planning and absence of vertical growth.

- Ancillary units face the problems of this own types ,like delayed payment by parent units, inadequacy of technological support extended by parents unit ,non adherence to quality and delivery schedules ,disturbing the programs of parent unit and absence of a well defined pricing system and regulatory laws.

- The lack of effective coordination among the various support organizations set up for the development of small scale industries .the problem of periodic markets ,location problem ,problem of space, infrastructural problems, market participants problem ,lack of storage facility and quick post harvest disposal ,problem of quick and cheap transportation ,problem of delayed payment, finance problem, inadequate market intelligence ,slow performance of operation and costly and inefficient labour are the major problem in financial performance.

Can FDI be an answer to financial problem of SSI: The current FDI norms impose a ceiling of 24 per cent FDI for companies in the SSI sector i.e. small scale units having capital investment in plant and machinery not exceeding Rs. 50,000,000 (USD 1,250,000). Further, SSI units with foreign investment exceeding the notified sectoral cap are liable to lose their status as SSI units. With a view to liberalizing the SSI sector and augmenting economic activity in the country, it is announced that FDI norms governing SSIs would be relaxed and a notification is likely to be tabled before Parliament, enabling an increase in the limits of FDI in the SSI sector. If such notification is passed, SSI units would be eligible to raise foreign equity in accordance with caps governing the sectors in which they operate, thereby improving their access to technology and capital and assisting in the growth and modernization of the sector.

Conclusion

FDI supplements and supplements local venture. The little and medium undertakings (SMEs) would be profited through FDI, by method for improved access to supplementary capital and cutting edge advancements, presentation to worldwide administrative practices and advances and additionally open doors for combination into worldwide markets.

Given the large scale attempts to promote industrial clusters in the SME sector, it needs to be underscored that, despite the potential of neo-localism, cluster promotion in the Indian context must move beyond the „sectoral‟ bind; a comprehensive regional development strategy needs to be woven into the cluster development policy.

While a plethora of new measures have been initiated in the recent MSMED Act, much would again depend upon how these function on ground. External orientation and a global outlook for the SME sector must first address persisting basic constraints facing the sector. The garment case brings out this point in some detail. In fact, as the Indian SMEs are looking forward to a newer and larger market space, with its numerous advantages of skills, raw materials and large domestic market as well, networking with various stakeholders both within and outside the country is a worthwhile attempt. To the extent such networking contributes to mutual benefit in terms of technology and market, the new initiatives are welcome. But complacency in such issues as employment creation and neglect of the vast segment of small and tiny units operating within a „low-road‟ syndrome could be a major roadblock to the sector. If globalization and external orientation, including being connected to the global production networks or value chains, fail to be broad-based and, essentially, turns advantageous to a small section of limited sectors of production, the strategy needs a serious rethink.

According to existing strategy, FDI in MSEs (as characterized under Micro, Small and Medium Enterprises Development Act, 2006 (MSMED Act, 2006) is liable to the sectoral tops, passage courses and other pertinent sectoral controls.

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