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Foreign Direct Investment in Multi-brand Retail Trade

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Abstract

The issue of FDI in multi brand retail has polarized political opinion in the country. Yet, clear economic arguments have not been forthcoming. One was expecting at least a white paper as a policy note or extensive public debate on the issue based on clear cut arguments, neither of which has emerged. The purpose of this article is to pinpoint clear economic arguments that should characterize such a debate.

A Simple Analysis of FDI in retail

A market consists of producers and consumers. Sellers of different commodities are not very often the producers of those commodities. The retailers are the link between the producers and the consumers. These retailers may range from big retail giants to small retailers such as what one finds in the vegetable market where hawkers sell vegetable door-to-door or in market places.

Government of India had already allowed FDI in single brand retail trade, and did not allow it in the multi-brand retail sector so far. Because of this new reform, the foreign retailers can sell all sorts of goods, from pin to agricultural goods, from groceries, to refrigerators and air conditioners, under one roof. At present, the giant foreign retailers that are interested in India's domestic market are Wal-Mart, Carrefour, Tesco etc. There are pros and cons of the entry of FDI in India's retail trade, which would be discussed here in three phases.

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The first phase is like a first semester course which consists of the basic arguments in favor of FDI, whereas the second phase similar to a 2nd semester course which would question the validity of the arguments proposed in the 1st semester. In the third phase, we would try to form our own judgments on alternative arguments that are discussed. So the first semester of the lecture constitutes the text book argument for FDI in retail vindicating the official position.

- When FDI is allowed in the domestic market, the number of retailers will increase. Suppose that India's domestic retail market earlier consisted of ten retailers. A new foreign retailer would raise the number to eleven. Twin effects will then take place in the market. In the first place, the number of buyers from the farmers would go up so that there would be more competition to buy the products from them. This higher demand would increase the prices of the products that farmers sell. It is therefore expected that the farmers would get better prices for their products, and hence, they would be better off. On the other hand, larger number of retailers in the trade would also increase the competition to sell off the goods. As a result, the selling price will fall to clear the market, so that the consumers will get the benefit of a lower price. Thus elementary ideas of economic theory tell us that the entry of FDI in multi-brand retail trade would benefit both the farmers and the consumers. Lastly, if the number of organization increases in the retail trade, such as from 10 to 11 in our example, the employment opportunities would also increase. These are the baseline arguments that the central government has been advocating in defense of FDI in multi-brand retail trade in India.

- A series of secondary effects might accompany the base line effects. Thus, the entry of big foreign retailers is expected to improve the existing supply chain, especially the cold-storage facilities, and transportation of goods, which will reduce wastage in storage and transit. We should thus expect that there will be development of infrastructure in agricultural marketing, generating long-run benefit to the society.

But these arguments are not beyond doubts even in terms of well accepted theoretical arguments. In the second semester course following issues can be raised by any student of economics.

- If a new foreign retailer, an addition to the 10th one, enters into the market, the farmers will get better prices for their products only when the competition is augmented, i.e. only when the number of retailers in the market goes up. But if it so happens that by the entry of the new retailer some of the existing retailers are pushed out of the market, it will reduce competition. This is indeed possible if the new entrant is a big retailer with deep pocket. In fact big retailers can undercut well below their own costs of production let alone the price of the other small retailers and such undercutting can build up a reputation so that no new small retailer dares entering the market. Those pushed away may have substantial reentry costs because of a stringent credit market. When firms do not have perfect information of costs of others, entry deterring effect of an aggressive retailer is a likely outcome. The smaller firms will not know for how long and what intensity they are likely to be undercut by the big and hence staying alive in the market becomes utterly difficult. Retail market with asymmetric players can generate welfare reducing outcomes. Works of Nobel winner R.Selten, and Stanford economists David Creps and Robert Wilson are quite relevant here.

- In many cases, small retailers cannot give sale on credit for a long time, which big retailers are able to give because of the ease of their credit arrangements. Also, they can provide many facilities to the consumers by way of coupons and discounts. If the big retailer can undercut the prices of the small retailers for a long time then this will surely act as a barrier to entry and the system will move away from competition. The fall in competition will, however, be reflected in both wholesale and retail markets. Less competition for the purchase of goods from the farmers would reduce their prices and, hence, farmers' income will be adversely affected. On the other hand, restricted competition will push up prices in retail markets, so that consumers will be adversely affected. Certainly, if a number of small retailers are to quit from the business, the employment opportunities will also shrink. It will be true especially in view of the fact that the retail mechanism in big foreign outlets like Wal-Mart may be much less labour intensive and those displaced from the domestic retail sector will not necessarily be those who will get jobs in the big chains.

- Think of those who currently buy from the farmers in very small scale and bring it to the local market, the daily unorganized street vendors. Surely there will be switch of demand away from them particularly that of relatively affluent customers. Even if there is an argument that they will coexist along with the big retailers, the average price they will receive now will be much lower since they will lose relatively affluent customers. There are millions of them. The query must be as to what extent their income will get hurt, how a mechanism of transfer can be designed by the government from big to small retailers, or whether such tiny retailers can get immediately absorbed in other economic activities. Any student of economics will understand that in developing countries costs of such relocation and adjustments are huge and become a huge burden for the displaced. The movement along the production possibility frontier (PPF), a basic tool in economics, is never as smooth as we draw on the board. In fact we largely operate inside the PPF with unemployed resources and movement inside the PPF is anybody's guess. Such concerns must be answered.

- In the present system of trade, the farmers enjoy some amount of insurance against risks. The revenue that the farmers get is the product of quantity and price. If there is a crop failure due to drought or flood, and the production falls, the revenue does not proportionately decrease since prices of the product go up owing to supply shortage. Thus, the farmers get some amount of immunity in earnings in the wake of natural disasters. But now that the government has given permission for FDI in retail trade, such insurances against risks are lost. Usually, the retailers source the products from the domestic market. But if there is a crop failure and the prices go up, the foreign retailer will weigh his choices between high-priced domestic products and cheaper imports from the neighboring countries like China. Even if the government imposes a restriction on sourcing the product outside a particular region, it will be a porous regulation. Monitoring such activities will be highly difficult. For example the big retailer may get it from a local agency which gets it from abroad. Source and destination problems are very difficult to handle in international trade policy negotiations. Thus, in the end, the local farmers will be exposed to greater risk and they will need greater insurance. In fact Joseph Stiglitz, the Nobel laureate, believes that the ability and intention of large retailers to import as and when required will hurt interest of the local farmers. (Times of India, 21st of October, 2012, page 24).

- The supplementary argument in favor of FDI (namely, that it would help to build up the infrastructure and avoid wastage) is not also very strong. A lot of the food is wasted in the FCI warehouses due to poor storage facility. This is well documented in various reports. Government has been quite silent on this for a long time. Also we need to have estimate of wastage of food materials in India due to lack of storage facilities. There is also a downside of excessive storage capacity. It might lead to excessive hoarding by big players. All these must be brought under proper scrutiny. But it seems rather strange that India had to wait for FDI in retail trade to bring about infrastructural development to control wastage in spite of her failure to address the problem in successive five-year plans. This the government should have done a long time ago.

We thus find that there are arguments in favour of and against the entry of FDI in the multi-brand retail trade. The question is then whether it will be beneficial for India at large. To enable the common people to form judgment of this type, the government should come up with a white paper containing thorough empirical research on these issues. We all appreciate that, unlike other countries, India is not homogenous. Each state here is like a country with its own set of problems. FDI in retail may be a welcomed by farmers in Punjab who have large consolidated holdings but it may not be welcome to the farmers in West Bengal where the land holdings are fragmented and each farmer has a voice. But the central government has not yet published any such white paper, and asks the public to believe that FDI in multi-brand retail trade is only good for India. No civilized society will accept such types of arguments.

We should also appreciate that there are certain spheres where India should initiate reform without any delay. Those are much more important than the reforms than FDI in retail trade. Two of such reforms are as under.

- Broadly, economic reforms can be categorized as (i) price-based reform involving taxes, tariffs and subsidies and (ii) Institutional reform. The reforms that were undertaken in the early 1990s were very different in spirit from those which are now required. We now urgently require reforms in terms of mechanisms to properly price public assets like coal and spectrum. It was long overdue in the on-going process of economic liberalization, but the inability of the government to take action in this direction caused a central minister landing up behind bars and the loss of at least three lakh eighty thousand crore of rupees. This is the estimate provided by the Comptroller and Auditor General of India (CAG). Unfortunately instead of admitting the mistake, the Government is bent on criticizing its own constitutional agency. The crux of the problem is, indeed, the faulty auction policy for the public asset. This is the root cause of mega corruption and that requires reform. One should note that in West Bengal under the new Govt. on line tendering and auction process has been made operational in all departments for better transparency and less corruption.

- Another important aspect of reform should be to find a way to target the below poverty line people , to identify them so that millions of public money is not wasted by giving benefits to others .

The main problem of policy making in this country is that the Government often fails to provide a white paper on a controversial policy before it is implemented. As if it is taken for granted that FDI in retail will yield only benefits to common people and if someone protests it is their responsibility to disprove the claim of the government. This is very much an uncivilized strategy. It is the responsibility of the Government to make sure that all costs and benefits of such a policy are placed in the public domain because the policy is being resisted by many states in the country.