

UNDERSTANDING FDI IN RETAIL: WHAT CAN ECONOMIC PRINCIPLES TEACH US?

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Abstract

The recent debate on the acceptability of FDI in the retail sector in India has been mostly political. It is therefore necessary to look into the pros and cons of FDI in retail from a purely economic point of view. After considering the economic arguments for and against multi brand retail we identify the safeguards that should be undertaken before allowing giant multinationals to function in the country.

The Scenario

The recent policy of allowing 51% FDI in multi-brand retail has generated more political feuds than proper economic debates so far. Politicians seldom speak with ifs and buts; their arguments are rarely burdened with caveats, warnings and qualifications. They take one-dimensional positions and avoid complicated reasoning with a view to be specific and least confusing to their audience. It is not at all surprising, therefore, that the political parties who are advocating FDI in retail, refuse to accept that there is any dark side to it while those who are opposing the policy, see none of its positive aspects. But the proposed policy is primarily economic and like many other economic policies it is likely to affect different groups of people differently. It is, therefore, both necessary and desirable to understand the possible effects of the policy on the overall economy and on the groups and fragments of people lying within it. In short, the economic truth, lying somewhere in between the two extreme

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positions politicians have taken, needs to be carefully located.

Before we get into such an endeavor, the salient features of the proposed FDI policy in multi-brand retail may be recollected. The policy, which was cleared by the Union Cabinet on November 24, 2011, allows up to 51% foreign equity in a retail company, provided the total investment by foreigners in the company is at least 100 million US dollars. Of this foreign investment, one-half is to be invested in back-end infrastructure including cold chains, refrigeration, transportation, packing, sorting and processing. These investments will be allowed only in cities with a population of more than one million. According to the 2011 Census, there are 53 such cities out of a total of 7935 cities and towns in the country. Finally, the retail company receiving the FDI is required to source at least 30% of its ware from Indian micro and small enterprises who have capital investment of not more than one million US dollars.

Big capital in retail is not new to the country — it has been a while since big domestic capital has entered the retail sector in India. One might have thought that entry of foreign capital would pose uncomfortable competition for the domestic capitalists who have invested in the retail sector. But this is not actually so. The announced policy has allowed the foreign investor to hold only 51% of the total shares leaving the remaining 49% for its domestic counterpart. Joint ventures are, therefore, built into the corporate structure which the new policy would entail. This has made the domestic capitalists happy. They expect to gain access to state of the art storage technologies and international markets through collaborations with giant international retailers and thereby increase their own profits. The domestic big retailers are, therefore, welcoming 51% FDI in multi-brand retail with open arms. It is a few others who are apprehensive.

Identifying the Changes due to FDI in Retail

But before we can draw up the full menu of gainers and losers from the new policy, it is necessary to understand the changes that are likely to be brought about through the introduction of giant multinationals into the Indian retail market. In particular, we must understand and identify the major changes which the multinationals are expected to bring about and which could not be brought about by domestic big retailers. After identifying the changes, we shall separately talk about the effects of these changes on different groups of the population.

As far as we can see, there are three such big changes. The first important change that the multinational retailers are likely to introduce is the state of the art storage technology that the multinational retailers possess and which is not known to the big domestic retailers. This technology is expected to improve the supply chain and prevent wastage in a big way. Estimates of wastage of food grains, fruits and vegetables in the country vary between 40% and 20% of the total produce. It is argued that a significant part of this wastage would be avoided if foreign investors come into the retail sector with their state of the art technology.

The second big change that the multinational retailers are likely to bring about is more free international trade. A little reflection will convince the reader that the magnitude of international trade depends on the extent to which arbitrage possibilities across countries can be made use of. Making use of arbitrage possibilities one can buy a commodity in a country where it is cheaper and sell it to another country where it is dear. A trader's job is to identify the international arbitrage possibilities and trade accordingly to make profits. It stands to reason that a giant multinational trader, with its more elaborate procurement and distribution networks, will do the job more efficiently and extensively than a relatively small domestic retailer. But if that is so, entry of multinational retailers into the Indian market are likely to increase the volume of Indian

international trade. This is likely to happen for any given level of restrictions on international trade.

The third change refers to the scale of operation of big retail in India. The giant multinationals along with the domestic retailers with whom they are going to form joint ventures, are going to have a much greater financial power than the domestic big retailers alone. Therefore, in the new set up, big organized retail is likely to cover a much larger portion of the market than before.

Advanced Storage Technology

The primary effect of an advanced storage technology is gain in efficiency. Agricultural products which were being wasted so far would be available for consumption, once the state of the art technology is introduced. This is pretty obvious. Much less obvious and of paramount importance is the answer to the question: who are winning and who are losing on account of this efficiency gain? Indeed, introduction of a better technology can lead to losses for some groups of people and gains from some others as the following example from history would illustrate.

Let us go back to the days of the industrial revolution in England. The industrial revolution started with mechanization of the production process. Mechanization replaced labour by capital. The instantaneous effect of this was a fall in the demand for labour in the economy. It is no accident, therefore, that the condition of the laboring class remained abysmal till the middle of the 1840s. This was true not only of England but also of continental Europe. Details of this predicament are found in the historical accounts of Hobsbawm (1962), in theoretical discourses of Hicks (1969, 1973) and in the literary narratives of Dickens and others. It also formed the empirical basis of the writings of Karl Marx and Friedrich Engels. Slowly, however, the condition of the working class started improving. The new mechanized processes, though employed less

labour, yielded more profits. These profits were reinvested and over time there was a significant expansion of economic activity in the European cities. This, in turn, increased the demand for labour and consequently the real wage. From Hobsbawm (1975) we learn that by the third quarter of the Nineteenth Century, there was a visible improvement in the condition of the working class all over Europe and a general faith in liberal capitalism was established in the West. This historical episode teaches us two important lessons. First, there was a tradeoff between the short and the long run as far as technical progress during the industrial revolution was concerned. In the short run it brought miseries for the laboring class, but in the long run it certainly improved their living standards. Second, this tradeoff is intergenerational and fell entirely on the working class.

We shall argue that the new storage technology, which the retail multinationals are likely to bring in, is likely to have an effect similar to that of mechanization during the industrial revolution. Under the assumption that the buyers' side of the market would become more competitive with the entry of the multinational retailers, an improvement in storage technology would increase the demand for agricultural goods in village markets. Moreover, products that went rotten and wasted before would now be available for sale to the urban markets which would imply a fall in selling costs to urban markets and a further rise in the demand for the product in the rural market. The rise in demand would increase the price of the agricultural commodities in question. Important question is: who will benefit and who will lose from all this?

A rise in the prices of agricultural goods in rural markets is likely to benefit farmers who sell parts of their products in the market. These are essentially large and medium sized farmers. A price rise would certainly benefit these farmers. The higher price would also induce these farmers to invest more in agriculture, thereby raising production and productivity.

There is a flip side though. Average landholding in rural India is not very high. According to estimates given by the National Sample Survey report Seasonal Variations in the Operational Land Holding in India, 2002-02 average operational holding in rural India is only 1.1 hectares. In addition, in some Indian states like West Bengal, Bihar, Orissa, Assam, Kerala, Tamil Nadu, Himachal Pradesh and Uttar Pradesh average land holding is below one hectare. These are mere average figures. There is a lot of inequality in land holding which these averages do not reflect. According to the Agricultural Census of India 2000-01, 63% of the total number of land holdings comprises of holdings by marginal farmers (with less than 1 hectare of land). But taken together, the marginal farmers account for only 19% of the total area operated. To this, one must add the large number of landless peasants in the agricultural sector. According to the National Sample Survey Report mentioned above, more than 40% of rural households do not have any land. These figures, in turn, indicate that a large number of rural households do not produce enough to sell to the market and a significant proportion of them actually buy from the rural market to sustain themselves and their families. A rise in agricultural prices, especially the prices of food grains, would certainly hurt these poor people, at least in the short run. Some of these poor bought the cheap rotten food available in the village market at throw away prices. Their survival will become difficult and poverty is likely to increase.

If farmers with positive marketable surplus start getting better prices for their produce and if due to the increased price incentive there is an expansion of agricultural output, one can argue that eventually there would be an increase in the demand for agricultural labour and a consequent increase in agricultural wage. In other words, higher farm prices induced by better storage technology is likely to have gradual trickle down effects and in the long run it is not unlikely that everybody in the rural sector will benefit from improved storage. So we find a clear analogy between

the European experience during the industrial revolution and what might have happened in the Indian rural sector after giant multinationals start acquiring food grains from Indian village markets. For the rural poor it would be miseries in the short run and a possible improvement in the long run. The problem is that no one knows how long the long run is going to be. If miseries continue for too long, the policy itself would become politically unsustainable, especially in view of the fact that, however faulty, India has a democracy which was absent in England during the industrial revolution and is missing in some contemporary nations like China which have brought in FDI into their retail sectors.

Some critiques of FDI in retail have, however, raised doubts as to whether farm prices are going to go up at all after giant multinationals start procuring from village markets. Their argument is that once the multinationals are into the market, the local supply chains will be destroyed and the big retailers will emerge as monopoly procurers. Once they establish themselves as monopoly procurers, they can dictate their price and it goes without saying that their dictated price will not be favourable to the farmers. Can this actually happen? Apparently, there are a number of factors which might prevent this from happening. First, there could be competition between multinationals over procuring farm products which will keep prices from falling too low. Second, even if multinationals enter into tacit collusions of not entering into one another's procurement territory and each emerge as local monopolies as far as procurements are concerned, there is always the possibility and incentive of domestic traders reentering the market as buyers if multinationals are offering very low prices. This will prevent the multinationals from actually reducing their buying price below a certain level. Third, the minimum support price offered by the government will act as another barrier to price reduction. If multinationals offer very low prices, the farmers will have an incentive of selling to the government which in turn will prevent

multinationals from offering very low prices.

Unfortunately, these factors may not necessarily stop the multinational from pushing a significant portion of the local traders out of the market. The multinational may do so by entering into exclusive interlinked contract with the farmers. It is well known that rural markets in India witness a lot of interlinked contracts. A common interlinkage is between the product market and the credit market. The local money lender, who also happens to be a trader, typically enters into an interlinked contract with a farmer by giving him a production loan with the stipulation that the farmer has to sell his output exclusively to the trader-cum-lender. The contract specifies the rate of interest on the loan and the price at which the commodity is to be sold. In such contracts, the trader-cum-lender would give a loan at a lower interest (compared to the interest at which the farmer can raise a loan by himself) to ensure production efficiency and at the same time buy the product at a price which is much lower than the market price. Now, the multinational, to ensure production efficiency and guarantee uninterrupted supply, can indeed enter into an interlinked contract with the farmer through contract farming arrangements. Since the multinational is likely to have access to a cheaper source of funds, it can drive out the local trader by offering a lower rate of interest to the farmer. But this does not improve the condition of the farmer, who will have to receive a lower price as well. His fate will simply shift from the grip of the local money lender to that of the multinational, and the latter would squeeze as much profit out of the farmer as possible just like the local money lender. However, as the multinational has a better storage facility, it is likely to lift more output from the farmers through interlinked contract farming than the output that was being lifted by local traders (who are now driven out of the market) through interlinked contracts. Therefore, the net output lifted from the market through interlinked contracts is likely to increase after the entry of the multinationals. This would imply a

rise in the open market price. As already discussed, the rise in price would be beneficial to net sellers to the open market and harmful for net buyers. For those under interlinked contract, the economic condition would hardly change.

To recapitulate, the multinationals can procure from the rural market in two different ways. They can either buy directly from the rural market or they can procure by entering into interlinked contracts. We have argued that both would lead to increase in farm prices in the rural markets benefitting net sellers and hurting net buyers. Viewed differently, the price rise is likely to benefit the relatively affluent and hurt the relatively poor in the rural sector, at least in the short run. The next obvious question is: how would the entry of giant multinational retailers affect the urban market and the urban consumers? To answer this we have to look into the second aspect of FDI in retail, namely, more free international trade.

Facilitating International Trade through Multinational Retailers

We have already argued that multinational retailers can facilitate international trade, that is, they can make unhindered flow of commodities across countries possible, more efficiently than domestic big retailers. This is simply because of the multinationals' size and reach. For a country like India what would it imply? Given that multinational retailers sell mostly consumers' goods, it is reasonable to assume that the giant retailers will be importing manufacturers from abroad, especially from China and other South Asian countries, and export agricultural goods to other countries through their overseas stores. This would be in conformity with the comparative advantage India has at present as far as consumer goods are concerned. Of course, there is a requirement that the retailers would have to source 30% of their domestic sales from the domestic market. This would imply that they would have to market some

Indian manufactures also, but the bulk of their sales should consist of foreign manufactures and Indian agricultural goods.

Urban consumers would certainly benefit from a wider variety of manufactured consumer goods from abroad. They would also enjoy the ambience provided by the giant retail stores. But what about the producers? What about employment? One has to concede that the Indian manufacturing sector is not yet matured enough to face Chinese competition. Indeed very few countries in the world are able to fight back the Chinese onslaught in this respect. It is more than likely, therefore, that the giant retailers will flood the Indian market with low priced Chinese trinkets and as a result Indian medium and small manufacturing units will suffer. Loss of employment is quite on the cards. It is not at all clear as to what extent it is necessary at this point in time to indulge into such unequal competition.

Export of agricultural goods has other kinds of problems. First, exports would tend to increase domestic prices. If food grains are exported and their prices go up, that would have an adverse effect on the poor. We have already indicated the possibility of price increase in the rural market and its effect on the rural poor. An increase in the price of food grains in the urban market, due to export of food grains, would affect the urban poor as well. Second, opening up to trade is likely to increase uncertainty of the farmers. There is a well-known literature following Newbery and Stiglitz (1984) which points to the possibility that in an uncertain environment with no formal insurance market, international trade in agricultural goods may hurt the trading countries. We simply repeat here the basic line of reasoning and argue that it applies to the present context as well. The essential idea runs as follows: agricultural output in a less developed country like India is heavily dependent upon the weather and hence is terribly uncertain. In a closed economy set up the market itself provides insurance. If output is low, the market price is high, and hence the product of price and quantity,

which is the farmer's gross income, is more or less stable. Similarly, if output is high, price is low and once more the product of price and quantity remains stable. But once the economy opens up to trade, this inverse relationship between price and quantity is lost. Most countries are unable to affect the international price. Therefore, when domestic output is low due to a bad rainfall, there is no guarantee that there will be a corresponding compensatory increase in the price. As a result the income of the farmer becomes risky and fluctuating. Coming back to the present context, we wish to point out that when a giant multinational retailer procures food grains, fruits or vegetables from a rural market in India, there is no guarantee that those products would be sold within India. Indeed, they could be sold in any part of the world at the international price. This increases the risk of a low income shock. In other words, farmers who are likely to get a better price on an average when multinationals procure from Indian rural markets will also be subjected to greater risk.

Yet another problem of opening up to trade is with respect to the balance of payments. While the inflow of foreign capital in the retail sector is likely to improve our balance of payments situation, as investment opportunities get saturated, this improvement in the capital account is likely to phase out with the passage of time. The current account, on the other hand, may worsen over time, with cheap manufactured imports exceeding uncertain agricultural exports. Therefore, a balance of payment crisis cannot be ruled out with the value of the rupee falling and the cost of oil imports increasing. If that happens, that is if the price of oil increases because of a balance of payment crisis, the poor will once more suffer.

Scale Effects of Organized Retail

Finally, we come to the much-debated issue as to whether and to what extent entry of foreign capital in organized retail would

lead to the closing down of traditional and unorganized trade. It will not be far-fetched to assume that the giant multinationals, would enter the Indian retail market at a scale which the domestic organized retailers can hardly match. This would be possible not only because of their superior storage technology, but also due to their immense financial strength and experience. The mammoth presence of these retailers, in turn, can hurt the traditional traders in two different, but not mutually exclusive, ways.

First, as the multinational retailers start procuring from the village markets, there will be less left for the indigenous traders to trade with. This will obviously reduce the volume of the latter's activities. In this context one can think of two existing supply chains. There is one that is routed through oligopolistic big traders controlling the village markets. We may call this the main supply chain. In addition, there is a small supply chain where the farmer or the small trader buying from the farmer sells directly to urban markets. Though the multinationals can do sufficient damage to the big-trader managed supply chains, the small supply chains, being run on a very low profit basis, may still survive. It is not unusual to find these small sellers selling to urban consumers in Western cities where big retailers control a significant portion of the market.

Second, the indigenous traders will face direct competition from the giant retailers in the urban consumer markets. Some argue that since FDI in retail is allowed only in big cities with large consumer markets, the effect of competition from giant retailers on indigenous traders will be negligible. On reflection, however, it does not appear to be so. If we assume that the total urban demand for consumer goods at any point in time does not change with the entry of the multinational, then any gain in sales by the giant retailer must denote a corresponding fall in sales by the indigenous traders. The situation could be somewhat different if the entrant multinational could create additional demand for its commodities without affecting the indigenous segment. The possibility cannot

be ruled out, but the extent to which it can happen remains doubtful. It is likely that the multinational retailers will differentiate their goods in terms of quality selling more standardized and quality controlled products and goods sold through their stores would bear the implicit or even explicit certificates of reliability. This would fragment the market, pushing upscale customers to the multinationals and the relatively less affluent to the traditional traders. In the process, because of the quality assurance, the multinational stores will create some additional demand. But it is inevitable that more affluent customers, who had been buying from small shops in the absence of better alternatives, will move to the giant stores, thereby eroding the customer base of the traditional shops.

Concluding Remarks

What can we conclude from all these arguments? Since we have tried to present the arguments both for and against FDI in retail, our stand may seem confusing. Therefore, it is necessary to be specific about the conclusions and policy suggestions we wish to make. We are not suggesting by any means that FDI should be prevented from entering into the retail sector. One must understand that one would be going against progress if one fails to take advantage of the capital and the advanced technology FDI in retail can offer. The new policy, however, will involve huge losses of jobs and livelihood among traditional traders. At the same time, new jobs would be created in the giant stores and their newly built supply chains. In the short run, the net outcome on aggregate employment is still likely to be negative, at best ambiguous. But in the longer run, as profits are reinvested and organized retail keeps on expanding, and as newer avenues would be opening up for the underprivileged, the policy would pay off. This had happened during the industrial revolution. This has happened more recently when computers came into our lives in a big way. It would not have been prudent, for example, if we had shunned modern word-processors

because they would destroy jobs for the numerous typists who used to crowd the city streets with their archaic typewriters and have virtually disappeared with the advent of the new technology.

But this long run view should not make us think for a moment that the short run can be ignored. We must realize that like in the past, the technological and organizational changes that the giant multinationals are likely to bring about entails short run sacrifices. Unfortunately, like always, the brunt of these sacrifices has come upon the less affluent. Therefore, the government should take enough protective measures to guard the interests of these helpless people. This is required not only on moral grounds but also for the sake of making the policy politically feasible.

What kind of protective measures can the government take? First, the PDS should have enough infiltration and bite in the rural areas to protect the rural poor from possible rises in prices of grains and vegetables. Second, the government should reconsider the gamut of tariffs and quantitative restrictions to counterbalance the effects of more easy international trade through multinational retailers. Third, the government should make an effort to compensate for the loss of jobs and livelihood, at least partially. The retail stores may be required to fill up a certain proportion of their labour requirement from displaced small traders. Also for the purpose of making these small traders employable in the new set up, appropriate training programmes may be set up by the government. The multinationals may be taxed, if required, to finance these programmes.

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