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Editor-in-Chief: Karl P. Sauvant (Karl.Sauvant@law.columbia.edu)
Managing Editor: Matthew Schroth (mas2443@columbia.edu)

How India can benefit from FDI: lessons from China*

by
Ilan Strauss and Vasiliki Mavroeidi**

With the launch of India's *Make in India* campaign, Karl P. Sauvant and Daniel Allman asked in their recent *Perspective*: "What can India learn from China?",[1] focusing on attracting FDI. However, the issue is not only attracting FDI, but benefitting from it fully. Liberalization alone will not enable *Make in India* to transform India into a manufacturing hub. Targeted industrial policies are required to ensure that FDI upgrades domestic capabilities.

China has outperformed India in leveraging FDI for upgrading domestic capabilities:

- Between 1995-2011, domestic value-added in China's manufacturing exports rose from 52% to 60%. In contrast, India's declined from (an unsustainably high) 87% to 64%.[2] This decline will eventually need to be arrested.

- Between 1992-2014, China's high technology manufacturing exports quadrupled as a share of manufacturing exports, from 6% to 25%; India's only doubled, from 4% to 8.5%.[3]

- This is partly due to foreign investors playing a more transformative role: between 2000-2013, foreign firms increased their share in China's domestic research-and-development (R&D) expenditures from 18% to 24%, and their share of foreign technology acquisitions from 21% to 61%.[4]

Benefiting from FDI was not an automatic, market-driven process for China. Industrial policies were central. In high-tech sectors, China exchanged market access for superior foreign technology and skills, using compulsory joint ventures, local procurement requirements and technology transfer agreements. Industries where export revenues were vital, such as textiles, were instead quickly liberalized. Unsurprisingly, China's FDI regime remains more restrictive than India's per the OECD FDI Regulatory Restrictiveness Index.

Benefiting fully from FDI also requires investment in infrastructure, skills and institutions to raise domestic absorption potential. Modi's *Make in India* campaign is successfully implementing several of these important reforms, but industrial policies to transform India's technologies capabilities are conspicuously absent.

How can India best utilize industrial policies, given the restrictions placed on their use globally?

For one, India is renegotiating its existing international investment agreements using its 2016 model bilateral investment treaty.[5] This will help preserve policy space by limiting national treatment to like circumstances post-establishment, and requiring exhaustion of local remedies before international arbitration.

Furthermore, India can push the boundaries of the WTO.

In particular, India's current subsidy scheme titled "Merchandise Exports from India" needs to be more generous and targeted and utilize all available policy tools to increase domestic value-added, including:

- *Non-specific subsidies tied to local value-added.* India could extend its "deemed export" duty drawback to priority manufacturing industries contingent on domestic content. Although potentially actionable under the WTO, these subsidies remain in widespread use in China and elsewhere,[6] in part because they can be difficult to prove.[7] India has had to remove several of these subsidies under the WTO; but if the subsidies are reconfigured, a new complaint would need to be made, and the entire dispute process restarted.[8]

- *Judicious use of infant industry protection.* Flexibility in India's bound tariff rates allows it to use import tariffs to foster infant industries. However, protection requires performance targets to ensure firms eventually "grow up." In China, the expectation that bureaucrats would be promoted based on local economic performance helped align bureaucratic incentives with firm growth.

- *R&D subsidies to foster domestic, scientific ties with foreign firms*. China makes ample use of these to extract benefits from manufacturing FDI.[9]

- *Government procurement can help nurture domestic suppliers*. India's solar panel procurement program could look to China's Golden Sun program for inspiration.

Moreover, India can pursue policies to foster industrial clusters and domestic linkages:

- *FDI-local stakeholder forums*. In China, Taiwanese firm associations worked closely with local governments to solve any issue that arose. From this grew "matching services" to find suitable domestic suppliers for foreign firms and "training services," so that domestic suppliers could better meet foreign standards.

- *Adopting a value chain perspective in FDI strategy*. Foreign component suppliers can be targeted to co-locate with their multinational enterprise buyers. This also helps foster industry-specific manufacturing hubs. China's "thick" supply base remains central to it attracting FDI.

- *Building manufacturing hubs around India's pre-existing strengths in services and engineering*, for example, by using its expertise in electronics design to attract and leverage global component fabrication producers.

China shows that India can maximize the benefits from FDI, and that this requires directed government industrial policies. Without these, *Make in India* risks reinforcing India's pre-existing strengths rather than building new ones.

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** Ilan Strauss (ilanstrauss@gmail.com) is a consultant with UNCTAD and a PhD candidate at the New School; Vasiliki Mavroeidi (vm314@cam.ac.uk) is a PhD candidate at Cambridge University, Development Studies Department. The authors are especially grateful to the peer-reviewers K.S. Chalapati Rao (with Biswajit Dhar), Michael Wendelboe Hansen and Premila Nazareth Satyanand for their valuable comments. **Columbia FDI Perspectives (ISSN 2158-3579) is a peer reviewed series.**

[1] Karl P. Sauvant and Daniel Allman, "Can India emulate China in attracting and benefitting from FDI?", *Columbia FDI Perspectives*, No. 168, Feb. 29, 2016.

[2] OECD, *OECD-TiVA Database*, https://stats.oecd.org/index.aspx?queryid=66237.

[3] World Bank, *World Bank Development Indicators*, http://data.worldbank.org/data-catalog/world-development-indicators.

[4] *China Statistical Yearbook on Science and Technology*, various years, http://tongji.oversea.cnki.net/chn/navi/HomePage.aspx?id=N2015040007&name=YBVCX&floor=1

[5] Available at https://www.mygov.in/sites/default/files/master_image/Model%20Text%20for%20the%20Indian%20Bilateral%20Investment%20Treaty.pdf .

[6] Holger P. Hestermeyer and Laura Nielsen, "The legality of local content measures under WTO law," *Journal of World Trade*, vol. 48 (2014), pp. 553–592; on the continued use of subsidies in China, *see* US- China Economic and Security Review Commission, *Annual Report to Congress* (2016), http://origin.www.uscc.gov/sites/default/files/annual_reports/2016%20Annual%20Report%20to%20Congress.pdf.

[7] Peter van den Bossche and Werner Zdouc, *The Law and Policy of the World Trade Organization* (Cambridge: CUP, 2013).

[8] The most famous example being*: https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds27_e.htm*

[9] In practice, the US maintains a safe harbor around the use of specific R&D subsidies.

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