

Foreign Direct Investment in Retail Market of India: Challenges & Prospects

Devesh Kumar

Department of Management, Shri Venkateshwara University, Gajraula, Uttar Pradesh, India

Article Info

Article history:

Received 9 January 2015

Received in revised form

15 January 2015

Accepted 22 January 2015

Available online 31 January 2015

Keywords

Foreign Direct Investment,
Liberalization,
Retail Market,
India

Abstract

India's retail market remains largely off-limits to large international retailers like Wal-Mart and Carrefour. Opposition to liberalizing FDI in this sector raises concerns about employment losses, unfair competition resulting in large-scale exit of incumbent domestic retailers and infant industry arguments to protect the organized domestic retail sector that is at a nascent stage. Based on international evidence, we suggest that allowing entry by large international retailers into the Indian market may help tackle inflation especially in food prices. Moreover, technical know-how from foreign firms, such as warehousing technologies and distribution systems can improve supply chain efficiency in India, in particular for agricultural produce. Better linkages between demand and supply have the potential to improve the price signals that farmers receive and also serve to enhance agricultural and other exports.

1. Introduction

India is now the last major frontier for globalized retail. In the twenty years since the economic liberalization of 1990, India's middle class has greatly expanded, and so has its purchasing power. Unlike other major emerging economies, India has been slow to open its retail sector to foreign investment. Recent signals from the government however suggest that this may be about to change: global supermarket chain stores such as Wal-Mart (United States), Carrefour (France), and Shoprite (South Africa) may finally be allowed to set up shop in India.

Foreign direct investment (FDI) in the retail sector in India is restricted. In 2004, the government eased retail policy for the first time, allowing up to 49 per cent FDI through the single-brand retail route (see Section 2 for a classification of organized retail in India). Since then, there has been a steady increase in FDI in the retail sector, and the cumulative FDI in single-brand retail stood at \$180 million.

Foreign Direct Investment (FDI) is an important source of private capital for developing countries. The UN conference on Finance for Development (FfD) argues that 'private international capital flows, particularly foreign direct investment, along with international financial stability, are vital complements to national and international development efforts' (Outcome: point 20, p. 5). Other international policy documents (e.g. the Cotonou Partnership Agreement, NEPAD) also emphasise the importance of private sector investment for development, both domestic and foreign, for development, and private sector investment features prominently in the UK White Paper Making Globalisation Work for the Poor (DFID, 2000)

Source: DIPP discussion paper, authors' calculations. Retail trade sales exclude expenditures on rent, fuel and power; transport and communication; recreation, education and cultural activities; and expenditures on food in hotels

Table: 1. Growth Rates in Private Final Consumption Expenditure: 2005-2009 (%) in constant prices.

Category	2005-06	2006-07	2007-08	2008-09
Food and Beverages	11.7%	11.1%	13.0%	10.4%
Clothing & Footwear	18.0%	25.0%	7.7%	5.2%
Rent, Fuel and Power	10.5%	12.5%	14.2%	16.6%
Furniture and Appliances	17.7%	22.2%	19.4%	9.4%
Medical Care	10.1%	10.1%	10.1%	10.1%
Transport and Communication	10.6%	14.1%	9.3%	16.5%
Recreation, Education and Culture	12.3%	12.9%	18.3%	13.3%
Miscellaneous Goods and Services	12.9%	27.1%	29.7%	29.0%
Total Private Consumption Expenditure	12.0%	14.8%	14.1%	14.2%
Estimated Retail Trade Sales	12.4%	14.9%	15.1%	12.5%

and restaurants.

In the past few decades large retailers have experienced substantial growth around the world. Evidence suggests while the impact of entry by large retail chains on employment and incumbent mom-and-pop stores is mixed, there can be substantial benefits to consumers in the form of lower prices and lowered food price inflation in particular. Similarly, by employing improved distribution and warehousing technologies, large retail chains are in a position to provide better price signals to farmers and to serve as a platform for enhanced exports.

At the same time, public outcry over the impact of these chain stores on other retailers and local communities

International Conference of Advance Research and Innovation (ICARI-2015)

is reported around the world. Small retailers, farmers, and even large organized competition have concerns about the entry of large global chain stores. On balance, however, in this paper we argue that opening up FDI in India to multi-brand retailers from abroad may be a catalyst to growth and the development of the retail industry, with positive externalities for the rest of the economy.

The paper is organized as follows. Section 2 provides details about the current regulation while Section 3 surveys retail sector growth forecasts in India. Section 4 highlights concerns raised by opponents of liberalizing FDI in retail trade. Section 5 provides arguments in favour of allowing foreign competition in this sector. Section 6 outlines challenges for organized retail in India and Section 7 concludes.

2. Taking Stock: The Current Regulation

The retail sector in India is organized into three categories. According to the Department of Industrial Policy and Promotion (DIPP) of the Government of India, single-brand retail comprises those retailers selling products “of a ‘single brand’ only, such that products should be sold under the same brand internationally; and single-brand product retailing covers only products which are branded during manufacturing. In this category, FDI is allowed to the extent of 51 per cent.

From 2006 to March 2010, around 94 foreign firms applied to invest through the single-brand route of which 57 were approved. Consequently, the percentage increase in FDI flows in the retail sector between 2008 and 2010 was even higher than that in sectors such as the services sector, trading and telecommunications, which have a much higher share in the country's overall FDI (DIPP, 2010).

In contrast, no FDI is allowed in the multi-brand retail category. This includes all firms in organized retail that seek to stock and sell multiple brands, such as large international retailers like Wal-Mart and Carrefour. This is the sector that is most under dispute.

The third segment, called ‘cash and carry’, refers to wholesale retail. The government defines this segment as the “sale of goods and merchandise to retailers, industrial, commercial, institutional or other professional business users or to other wholesalers and related subordinated service providers”. In India, FDI of 100 per cent is permitted in this segment.

As per the ‘cash and carry’ structure commonly employed in India, the wholesale and retail entities are maintained as separate entities without any cross-shareholdings. The retail entity is owned and controlled by the Indian partner while the wholesale entity can be owned by the foreign partner up to 100 per cent. Wal-Mart, for example, has already established a successful presence in this category of wholesale operations by entering into a joint venture with Bharti Enterprises Ltd. of India. The new entity, Bharti-Wal-Mart, is in operation with stores opening around the country. The yardstick used to determine whether an operation is wholesale or not is the type of customers to whom the sale is made and not the size and volume of sales.

3. Forecasts for Retail Sector Growth in India

The data from private consulting company reports suggest that growth in the retail market has been rapid despite major restrictions on FDI. In the third-quarter report of 2010, the BMI India Retail Report forecasts that the total retail sales will grow from US\$ 353 billion in 2010 to US\$ 543.2 billion by 2014.1 An important consideration, the report suggests, is the fast-growing middle and upper class consumer base. The analysis also suggests that in the next few years there will be major opportunities in India's smaller cities.

AT Kearney, a global management consulting firm, rates India as the most attractive nation for retail investment. The study, presented in the Global Retail Development Index of 2009, is carried out annually for 30 emerging markets, and has rated India highest four times in the last five years. This report expresses even more optimism, and estimates that suggests that India's retail market is expected to be about US\$535 billion by 2013, with around 10 per cent coming from organized retail.

Other estimates are more conservative, though still impressive. According to McKinsey, a research and consulting firm, organized retail in India is expected to increase from 5 per cent of the total market in 2008 to 14-18 per cent of the total retail market and reach US\$ 450 billion by 2015.

4. Concerns about Opening up Indian Retail to FDI

A number of concerns have been raised about opening up the retail sector for FDI in India. The first concern is the potential impact of large foreign firms on employment. Following agriculture, in 2007-2008, the retail sector is the second largest employer in India (National Sample Survey Organization, 64th round).5 Retail trade employed 7.2% of the total workforce which translates to 33.1 million jobs (DIPP Report, 2010). Moreover, the share of retail employment has risen significantly when compared to its share in 1993-1994. The pattern holds for both males and females, in rural, and in urban areas.

Table: 2. Employment Shares in Retail Trade, 1993-2008

	Urban			
	Male	Female	Male	Female
2007-08	5.6	1.7	18.8	8.6
1993-94	3.63	1.4	14.6	6.66

Source: Authors' calculations based on data from DIPP report. Each cell has the average percent of the retail sector in total employment over the given time period.

A second related concern is that opening up FDI may lead to unfair competition and ultimately result in large-scale exit of incumbent domestic retailers, especially the small family-owned business. Given the large unorganized component of the retail sector, this is a major concern. Kalhan (2007) highlights how small shops in Mumbai are adversely affected, in terms of falling sales, by the growing influence of shopping malls in the city. If employment too is adversely affected, it is not clear how organized retail may absorb this displaced labor.

A third concern raised by domestic incumbent firms in the organized retail sector is an infant industry argument: that this sector is under-developed and in a nascent stage. In this view, it is important that the domestic retail sector grow and consolidate first, before being exposed to foreign

investors. Domestic firms in this sector oppose liberalizing retail to FDI as they view multinational companies as direct competitors. A newspaper article describes opposition from an incumbent:

“Kishore Biyani [chief executive of the largest retailer in India] argues that the retail sector should not be given away to foreign players while it is too young to compete on a level playing field. He lacks the capital to build even average-sized Wal-Mart stores of 200,000 square feet—four times larger than his flagship Big Bazaar’.

In the Indian policy debate, a contrasting view is that growth in organized retail is expected to benefit producers, without (significantly) hurting smaller traders and that they may preserve their smaller domains without being swallowed up by large retailers. However, the experience of organized retail in other parts of the world does not always bear this out.

With respect to the impact of entry by big-box stores such as Wal-Mart on retail employment and earnings, evidence from the United States is mixed. Using county-level data, a recent study finds that Wal-Mart entry increases retail employment in the year of entry (Basker, 2005a) while contrasting evidence indicates that each Wal-Mart worker replaces approximately 1.4 retail workers representing a 2.7 percent reduction in average retail employment (Neumark, Zhang and Ciccarella, 2008). Yet other work on Wal-Mart expansion suggests that store openings reduced both average earnings of retail workers (Dube, William and Eidlin, 2007). Recent evidence also suggests that having a chain store in a market makes roughly 50% of the discount stores unprofitable and that Wal-Mart’s expansion over the 1990s explains about 40–50% of the net reduction in the number of small discount stores (Jia, 2008).

The retail experience in Thailand furthers this concern. Sarma (2005) chronicles how traditional shopkeepers continued to suffer even when the Thai economy recovered, after the Asian crisis of the late 1990s. Foreign-owned retailers, he argues, “grabbed a big share of the retail market, often through unethical means.” In response the government instituted safety nets in the form of strengthening the marketing of the products sold by small retailers, the provision of soft loans, and setting up a central logistics system to act on behalf of the small shopkeepers. And, in particular, to moderate the expansion of the foreign retailers. A similar story – of increased regulation of large retailers to prevent market capturing and uncontrolled proliferation – is told by Kalhan and Franz (2009).

The UK Competition Commission found in a 2000 study⁶ of major retail chains including Marks & Spencer, Sainsbury and Tesco that “the burden of cost increases in the supply chain has fallen disproportionately heavily on small suppliers such as farmers.” Apart from prices, the report states that smaller farmers came under severe pressure from supermarkets due to the latter’s requirement for large volumes of each product, pushing farmers to grow single crops rather than the multiple produce they would usually grow to minimise risk.

Observed supermarket practices too may work against the interests of incumbent retailers, even organized ones. Supermarket chains routinely sell some products at lower than market prices, which appears to benefit consumers, but

this puts pressure on small local stores and has an adverse impact on low-income and elderly consumers who rely on local shops. Supermarkets also tend to alter prices in different branches adjusting to local rivals, “price-flexing” as the UK Competition Commission termed it, again working to the disadvantage of local mom-and-pop stores. Guruswamy et al (2005) argue that firms with deep pockets are able to bear sustained losses, eventually forcing higher cost businesses (“small and dispersed competition”) out of business. This has a large effect on employment too.

In several South-East Asian countries, such as Malaysia and Thailand, the trend has been to move from many smaller suppliers to a few larger ones. Moreover, the share of fresh produce retail in supermarkets, as opposed to from so-called ‘wet markets’ has also increased substantially. “The emerging role of modern retail chains in fresh produce sales is most evident in Malaysia’s major cities, where they accounted for as much as 60 percent of fruit sales and 35 percent of vegetable sales in 2002. Close behind is Bangkok, where 40 percent of fruits and 30 percent of vegetables were sold through supermarkets and hypermarkets.⁷

The Food and Agriculture Organisation concluded in a report that such activities are observed in other countries and regions too. Organized retail increases pressure on farmers to produce standardized produce, pushes down prices and margins, and over time weeds out larger numbers of smaller suppliers in favour of fewer and larger “preferred suppliers”.⁸

5. Benefits of FDI and Competition in Organized Retail in India

The changing structure and scale of retail can critically impact several industries in the short term– the retail industry itself, manufacturing, and real-estate, to name a few. And in the long term, spill-over effects can be felt in other industries. The growth of retailing has the potential to impact the performance of interlinked sectors such as manufacturing of consumer goods and agriculture-based industries.

We begin by discussing the potential benefits of allowing entry by large foreign discount retail chains on lowering inflation, improving distribution and warehousing technologies. We do so by comparing findings from US studies that examine the effects of Wal-Mart and other large chains entering the US retail sector and the upheaval in the retail landscape brought about in the US beginning in the early 1990s. The section concludes by describing a couple of policy recommendations made in the Indian Government’s recent discussion paper on opening up the retail sector with a view to protecting domestic firms and increasing employment in the retail sector.

5.1 Lowering Inflation and Food Prices

Evidence from the United States suggests that FDI in organized retail could help tackle inflation, particularly with wholesale prices. Inflation is a politically sensitive subject, particularly for incumbent governments in a democratic country such as India, in particular because rising food prices tend to be regressive in their impact. This is underscored by the fact that the weight of food in rural and

International Conference of Advance Research and Innovation (ICARI-2015)

agricultural household consumption baskets is approximately 65-70%.

Recent studies quantify the price impact of entry by low cost entrants. For example, using average city-level prices of various consumer goods, price dynamics in 165 US cities before and after Wal-Mart entry suggest robust reduction in prices for several products while magnitudes vary by product and specification, but generally range from 1.5–3% in the short run to four times as much in the long run (Basker, 2005b) with significant increases in consumer surplus especially for lower income households (Hausman and Ephraim, 2007).

Taking into account demographics, store characteristics, and market conditions, corroborating evidence suggests that Wal-Mart decreases prices by 6%-7% for national brand goods and by 3%-8% for private label goods. Price decreases are most significant in the dry grocery and dairy departments. Moreover, Wal-Mart sets grocery prices significantly lower than its competitors (Volpe and Lavoie, 2008).

Hausman and Leibtag (2004) also argue that a more appropriate approach to estimating CPI figures which would lead to a continuously updated expenditure weighted average price calculation in comparison to the official Bureau of Labor Statistics (BLS) approach. Estimates using their new approach would lower food at home inflation by about 0.32 to 0.42 percentage points, in turn lowering the estimated inflation rate by about 15% per year (Hausman and Leibtag, 2004). In India, food accounts for nearly 50% of the consumption basket and the impact on inflation reduction could therefore be significant.

5.2 Improving Distribution and Warehousing Technologies

It is expected that technical knowhow from foreign firms, such as warehousing technologies and distribution systems, for example, will lend itself to improving the supply chain in India, especially for agricultural produce. Here there are multiple inefficiencies in the supply chain that leads from farm to the dinner table. While the Indian government is the largest purchaser of food crops for many farmers, the consequence of a poor distribution system is that much of the stockpile fails to reach consumers, and ends up rotting or as waste. India is the world's second largest producer of fruits and vegetables in the world after China, producing around 180 million tonnes per year. Official estimates are that about 25-30 per cent of this produce goes waste between harvest and consumption.

Encouraging wholesale trading can create demand throughout the supply chain. In this spirit, the recent discussion paper talks of earmarking 50 per cent of FDI inflows for building up of back-end infrastructure, logistics and agro processing (DIPP Report, 2010). In theory, if fresh produce is collected efficiently at the farm-gate, and end-to-end cold-chain is maintained in storage and transportation until it reaches supermarket shelves as in developed countries, this wastage can be eliminated, translating into better prices for farmers and lower prices for consumers besides greater availability of the produce for processing, export and other value-addition.

Creating better linkages between demand and supply also has the potential to improve the price signals that

farmers receive. This could allow them to better respond to market demand, and thus reduce uncertainty. The Indian Prime Minister, Dr Manmohan Singh, called for a debate on the opening up of the sector on similar lines, pointing to the vast difference between farm gate and consumer prices.⁹ In this context, the DIPP's discussion paper points out that the farmers get just a third of the total price paid by the final consumer, as against two-thirds realized by farmers in nations with a higher share of organized retail. FDI in retail, therefore, could be an efficient way of addressing concerns of farmers and consumers (DIPP Report, 2010).

Evidence from the United States also however suggests by connecting suppliers worldwide with downstream buyers, the retail sector as a whole, has become more efficient at providing consumers with the goods they want at better prices and with increased convenience (Basker, 2007).

An added benefit of improved distribution and warehousing channels may also come from enhanced exports. A recent study notes that each of the world's largest retailers—Wal-Mart, Carrefour, Tesco, and Metro—entered China after 1995 and that their subsequent expansion in China may have influenced Chinese exports through two channels (Head, Jing and Swenson, 2010). First, the authors argue that large retailers may have enhanced bilateral exports between the retailers' Chinese operations and destination countries also served by stores in the retailers' networks. Second, Chinese city-level exports to all destinations may have grown if multinational retailer presence enhanced the general export capabilities of local suppliers. Evidence from Chinese city-level retail goods exports supports the capability hypothesis as the expansion of Chinese city exports follows the geographic expansion of the retailers' Chinese stores and global procurement centers (Head, Jing and Swenson, 2010). Wal-Mart has therefore contributed to the trend of increased outsourcing which could bode well for agricultural exports from India.

5.3 Employment Effects and Small Domestic Firms

Moreover, expansion in the retail sector could also generate significant employment potential, especially among rural and semi-urban youth. The discussion paper considers the possibility of reserving 50 per cent jobs in FDI-funded retail outlets for rural youth. Other issues up for debate include identifying possible locations for such outlets. The current thinking is that these stores could initially be allowed to come up in cities with populations of over one million, particularly on the outskirts.

6. Challenges for Foreign Firms in Organized Retail

The first challenge is competition from the unorganized sector. Traditional retailing has been established in India for many centuries, and is characterized by small, family-owned operations. Because of this, such businesses are usually very low-margin, are owner-operated, and have mostly negligible real estate and labor costs. Moreover, they also pay little by way of taxes. Consumer familiarity that runs from generation to generation is one big advantage for the traditional retailing sector. It is often said that the mom-

International Conference of Advance Research and Innovation (ICARI-2015)

and-pop store in India is more like a father-and-son enterprise.

Such small shops develop strong networks with local neighbourhoods. The informal system of credit adds to their attractiveness, with many houses 'running up a tab' with their neighbourhood kirana store, paying it off every fortnight or month. Moreover, low labor costs also allow shops to employ delivery boys, such that consumers may order their grocery list directly on the phone. These advantages are significant, though hard to quantify. In contrast, players in the organized sector have to cover big fixed costs, and yet have to keep prices low enough to be able to compete with the traditional sector.

Getting customers to switch their purchasing away from small neighbourhood shops and towards large-scale retailers may be a major challenge. The experience of large Indian retailers such as Big Bazaar shows that it is indeed possible. Anecdotal evidence of consumers who return from such shops suggests that the wholesale model provides for major bargains – something Indian consumers are always on the lookout for.

The other major challenge for retailers in India, as opposed to the US, is the storage setup of households. For the large-scale retail model to work, consumers visit such large stores and return with supplies likely to last them for a few weeks. Having such easy access to neighbourhood stores with whom, as discussed above, it is possible to have a line of credit and easy delivery service, congested urban living conditions imply that few Indian households might be equipped with adequate storage facilities.

In urban settings, real estate rents are also very high. Thus the opportunities in this sector are limited to those retailers with deep pockets, and puts pressure on their margins. Conversely, for retailers looking to set up large stores at a distance from residential neighbourhoods may

struggle to attract consumers away from their traditional sources of groceries and other products.

7. Conclusion

India's retail sector remains off-limits to large international chains especially in multi-brand retailing. A number of concerns have been raised about opening up the retail sector to FDI in India. The first concern is the potential impact of large foreign firms on employment in the retail sector. A second related concern raised in the DIPP's report is that opening up FDI would lead to unfair competition and ultimately result in large-scale exit of incumbent domestic retailers, especially the small family-owned business. A third concern raised by domestic incumbent firms in the organized retail sector is that this sector is under-developed and in a nascent stage.

In this paper we argue that the potential benefits from allowing large retailers to enter the Indian retail market may outweigh the costs. Evidence from the United States suggests that FDI in organized retail could help tackle inflation, particularly with wholesale prices. It is also expected that technical know-how from foreign firms, such as warehousing technologies and distribution systems, for example, will lend itself to improving the supply chain in India, especially for agricultural produce. Creating better linkages between demand and supply also has the potential to improve the price signals that farmers receive and by eliminating both waste and middlemen also increase the fraction of the final sales prices that is paid to farmers. An added benefit of improved distribution and warehousing channels may also come from enhanced exports. India's experience between 1990-2010, particularly in the telecommunications and IT industries, showcases the various benefits of opening the door to large-scale investments in these sectors. Arguably, it is now the turn of retail.

References

- [1] Department of Industrial Policy and Promotion, Foreign Direct Investment (FDI) in Multi-Brand Retail Trading, Discussion paper, 2010
- [2] Dube, Arindrajit, Lester, T. William, Eidlin, Barry, Firm Entry and Wages: Impact of Wal-Mart Growth on Earnings Throughout the Retail Sector, Available at <http://ssrn.com/abstract=841684>, 2007
- [3] Basker, Emek, Job Creation or Destruction? Labor Market Effects of Wal-Mart Expansion, *Review of Economic Statistics*, 87(1), 2005a, 174-183
- [4] Basker, Emek, Selling a Cheaper Mousetrap: Wal-Mart's Effect on Retail Prices, *Journal of Urban Economics*, 58(2), 2005b, 203-229
- [5] Basker, Emek, The Causes and Consequences of Wal-Mart's Growth, *Journal of Economic Perspectives*, 21(3), 177-198
- [6] Guruswamy, Mohan, Kamal Sharma, Jeevan Prakash Mohanty, Thomas J Korah, FDI in India's Retail Sector: More Bad than Good?, *Economic and Political Weekly*, 40(7), 2005, 619- 23
- [7] Hausman, Jerry A. and Ephraim Leibtag, CPI Bias from Supercenters: Does the BLS Know that Wal-Mart Exists?, NBER Working, 2004, 10712.
- [8] Hausman, A. Jerry, Ephraim Leibtag, Consumer Benefits from Increased Competition in Shopping Outlets: Measuring the effect of Wal-Mart, *Journal of Applied Econometrics*, 22(7), 1157–1177
- [9] Head, Keith, Ran Jing, and Deborah L. Swenson, From Beijing to Bentonville: Do Multinational Retailers Link Markets? NBER Working, 2010, 16288
- [10] Jia, Panle, What Happens When Wal-Mart Comes to Town: An Empirical Analysis of the Discount Retailing Industry, *Econometrica*, 76(6), 1263–1316
- [11] Kalhan, Anuradha, 2007, Impact of Malls on Small Shops and Hawkers, *Economic and Political Weekly*, 42(22), 2063-66
- [12] Kalhan, Anuradha, Martin Franz, Regulation of Retail: Comparative Experience, *Economic and Political Weekly*, 44(32), 2009, 56-64
- [13] Neumark, David, Junfu Zhang, Stephen Ciccarella, The Effects of Wal-Mart on Local Labor Markets, *Journal of Urban Economics*, 63(2), 2008, 405-430
- [14] E. A. S Sarma, Need for Caution in Retail FDI, *Economic and Political Weekly*, 40(46), 2005, 4795-98
- [15] R. J. Volpe, N. Lavoie, The Effect of Wal-Mart Supercenters on Grocery Prices in New England, *Applied Economic Perspectives and Policies*, 30(1), 2008, 4 - 26