



# Implications of foreign direct investment in India's retail sector



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**Abstract** Supply chain is the backbone of retail business. Adoption of an efficient supply chain between producers and consumers by modern large retailers could reduce average transaction and information costs of market exchange; generate surplus for stakeholders such as producers, farmers, and consumers; expand output; and could thereby contribute to economic growth and net employment gains. Foreign players can introduce a highly advanced supply chain and develop local producers and generate externalities. This paper develops a simple theory of supply chain and economic growth. It shows the implications of adaptation of the Wal-Mart model of retailing on India's retail business.

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## Introduction

In the year 2012, the Government of India announced liberalization of entry of multi-brand multinational firms (MNCs) with 51% equity stake into the retail sector. However, several state governments announced that they would not allow retail MNCs into their states. This is because of the opposition from several interest groups representing wholesalers and unorganized retailers on the grounds that entry of foreign players destroys small businesses and employment, and that foreign players make monopoly profits at the cost of consumers and suppliers. These calculations are based on expected short and interim rather

than the possible long-term outcomes of the reforms (Patibandla, 2006). The objective of this paper is to analyze the net effects of allowing FDI into the retail sector in India. The main proposition is that adoption of efficient supply chain augments economic growth by reducing average transaction and information costs of market exchange. Economic growth is characterized in terms of increase in surplus of the different players such as producers, consumers, and retailers and the consequent increase in productivity.

To illustrate the point, in the mid-1980s the Indian government initiated certain partial reforms, allowing multinational firms in such industries as the two-wheelers. The Indian (family business) industrialists such as Bajaj organized themselves as the "Bombay Club" to block the reforms in the name of "nationalism". However, the government continued with the reforms. Competition from Honda forced Bajaj to restructure itself technologically and organizationally and over time it has become

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internationally competitive. The volume of sales and total profits at Bajaj are higher in the post-reform period. Furthermore, the development of auto-component supplier firms by the multinationals has made the industry internationally competitive (Patibandla, 2006).

The entry of foreign retailers will have an effect on different stakeholders. On the demand side, it will affect consumers, small retailers, wholesalers, and local large retailers. On the supply side, it will affect employment, farmers, manufacturers, middlemen, and government agents. The net effects are in terms of increase (or decrease) of total surplus of the system. In distributional terms, there could be some losers such as the wholesalers and numerous commission agents, and gainers could be farmers, small- and medium-scale manufacturers, consumers, and large retailers. Employment effects should be seen not only in terms of some direct short-term losses and gains but also long-term net gains through increase in number of supplier firms, real incomes, and consequent increase in investments.

I have developed a simple theory that shows the link between adoption of supply chain and economic growth. I then analyze Wal-Mart's model of retailing and its supply chain to understand its implications on the Indian retail sector.

### Supply chain and economic growth

The main proposition of this section is that adoption of efficient supply chain contributes to economic growth by increasing total surplus of different agents of the system. In standard micro-economics textbooks, producers sell directly to consumers. The question which follows is this: What is the economic rationale for existence of a middleman such as a retailer between producers and consumers? The economic rationale could be drawn from information (Akerlof, 1970; Spence, 1976) and transaction cost economics (Coase, 1937; Williamson, 1975). Market exchange involves information and transaction costs at different levels and dimensions. If a large number of small producers and consumers act autonomously, the unit information and transaction costs of exchange would be higher than if they could pool these costs and realize economies of scale. A retailer performs the job of pooling these costs and reduces the unit costs through realization of economies of scale by adoption of supply chain.

The surplus equation when the market is served by large of number of small firms is:

$$S = P(Q)Q - bQ - [(Is + Ts)] \quad (1)$$

The surplus equation after the entry of a large retailer is:

$$S = P(Q)Q - bQ - (Ir + Tr + d + m) \quad (2)$$

$S$  is the surplus,  $P$  is market price,  $Q$  quantity of output,  $b$  is long run average cost of production,  $Is$  is information costs and  $Tc$  is transaction cost of a small producer (which is assumed to be similar for all the producers),  $Ir$  and  $Tr$  are that information and transaction cost of a retailer,  $d$  is the deadweight loss owing to transfer of output through the retailer and  $m$  is the mark-up of the retailer. The

condition for a positive surplus owing to the entry of the retailer is:

$$[(Is + Ts) > (Ir + Tr + d + m)] \quad (3)$$

In the first case, we assume that the output is a homogenous good. In this case the role of the retailer is to match supply and demand both in static and dynamic terms by processing information and assessing uncertainty. This is highly relevant to markets for perishable food products such as vegetables, fruits, meat, and fish, and also products such as rice, wheat, and pulses. A small producer does not possess information and capital for realizing a price that reflects inter-temporal demand of spreading the supply from one harvest to the next harvest time through storage. She/he has to sell the total output at the time of harvest. A large retailer could invest in storage costs and process the information of inter-temporal demand and pass on the information to producers. The extension of this argument could be a large retailer assessing the inter-regional demand within a country and also at the global level. For example, basmati rice could be produced only in the states of Punjab and Haryana of northern India but major part of consumption of rice is in the south.

$P_{in}$  is the price of inter-temporal demand,  $P_h$  is the price of the harvest time,  $m$  is the unit mark-up of the retailer and  $c$  is the unit cost of storage.  $P_{in} - P_h - m - c$  is the surplus that a farmer could realize because of the retailer.

The link for productivity can be seen in terms of distress sales by farmers at the time of harvest. This discourages farmers from investing in productivity-enhancing practices. If a farmer incurs additional costs for improving productivity, this will increase output, which, in turn, increases supply at the time of harvest. This depresses price realized by the farmer further. If a large retailer undertakes matching of inter-temporal demand and supply, this could mitigate distress sales and result in increase in surplus to farmers which incentivizes them to invest in productivity-enhancing investments.

Transportation and infrastructure costs should not be confused with transaction costs. Nobel laureate Oliver Williamson (1985) conceptualizes transactions costs in terms of uncertainty, frequency, and asset specificity in the context of incomplete contracts. Essentially, transaction costs are the costs of formulating and executing contracts. In the case of a large number of small producers producing a homogenous good, theoretically speaking, transaction costs are not relevant because if one supplier fails to supply, the retailers can procure a similar amount from other players. However, if the homogenous good is produced by a few large players, the retailer has to get into a contract for the quantity to be supplied based on the predicted demand. As mentioned before, the uncertainty element of transaction cost is relevant if the homogenous good is produced by a large number of players especially in agriculture because change in weather conditions could affect production of all producers disrupting the supply chain of the retailer.

Larger the number of producers, larger the total transaction costs of contracts. However, average transaction costs could decrease with increase in the number of

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