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FDI and Business Internationalization of the Unorganized Sector: Evidence from Indian Manufacturing

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Summary. — Available evidence, though limited to the organized sector only, suggests that FDI flowing in with MNE activities or direct FIIs generate technological and market access spillovers for firms outside the core group in destination countries. We investigate the organizational link between formal and informal sectors in India and argue that the spread of internationalization is more when production outsourcing prevails between such units. Higher wage in the organized sector is a factor that breaks standard institutional barriers leading to outsourcing of production to informal units. The evidence is puzzling to the extent that foreign capital and better know-how as drivers of international business to developing countries usually relax the credit constraint facing formal sector units at the destination and cause expansion of formal units. Using a measure of technology and a panel data for a large number of industrial units in India, we show that FDI transmitted through technology spillover leads to significant increase in the gross value added for several industries located in the informal sector. The paper points out that production re-organization associated with international capital movements should provide additional insights for standard measures of internationalization of production and services.
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Key words — FDI, organized firms, outsourcing, technology, India

1. INTRODUCTION

Studies on international business indicate that internationalization of firms is a process by which the localized firms gradually increase their international involvement. The degree to which internationalization of firms become of critical importance for a country may depend substantially on the institutional and organizational structures adopted and prevalent in such places. At the same time, the nature of the business activities, knowledge of the market, resource, and market commitments (see earlier work by Johanson and Vahlne (1977)) at the level of the firm could turn out to be important factors discerning the more international firms from the ones [1] that operate within a limited domain and remain "local". Such internationalization may work through various linkages, including cross-border engagements in joint ventures, Greenfield investments and acquisitions. A number of influential country studies delineate the scope and extent of each of these avenues leading to internationalization of firms (viz. Kogut & Singh, 1988; Steuber, 1973), whereby "local" firms produce and sell back to the "global" parent firm. The extant literature, however, does not discuss the spillover of internationalization through outsourcing of production from formal to informal firms within a country. Since both the direction of international trade and capital mobility have turned predominantly into north–south phenomena over the last two decades, investigating the degree to which formal and informal firms interact in the south cannot be neglected altogether in view of a better understanding of the depth of internationalization. The present paper tests the hypothesis that foreign direct investment flowing from the industrialized to less industrialized countries may lead to production spill over from the formal or organized firms to the informal or narrowly defined, unorganized firms. [2]

Once the involvement of firms typically outside the domain of organized business activities is taken into consideration, the overall degree of internationalization for firms in a given country may turn out to be much more than originally estimated (Tokman, 1978). It is also well-known that important policy changes have taken place since the opening up of trade (reduction in tariff, interest rates, etc.) and revision of financial limits facing production units under small-scale and cottage industries in India. In spite of growing competition from large-scale industries and MNCs these policies create, to some extent, favorable conditions for the development of small-scale and rural industries. These units by taking advantage of the rising demand from national and overseas market for crafts and esthetic value-oriented goods (handmade goods) gain from trade. Consequently, units which have access to sufficient capital and marketing outlets expand faster, while larger units owing to organizational complexity and yet structural backwardness often get tied to the local moneylenders, traders, and not-so-efficient marketing enterprises. The internationalization of informal units selling garments, conch shell crafts, handicrafts made of lac and horn-ware etc., without dependence on formal entities, would be a lot smoother if the local impediments were minimized (available evidence for India suggests that small number of informal firms export directly, especially to bypass inefficient marketing agencies; see Marjit & Kar, 2011, Chap. 8 using village survey data from parts of India). Our empirical results show that while the informal firms in India may not be receiving foreign capital directly, through sub-contracting from formal firms these are

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increasingly exposed to international trade and capital movements. The internationalization is not restricted to adoption of technology, licenses, and production processes only. The increased use of contractual labor to support production expansion via international contracts is also a visible development in the south. In the following section we shall briefly discuss what is to be expected in terms of outsourcing in the event of greater accommodation of informal labor in formal enterprises. These together offer new dimensions in the literature concerned with internationalization of firms. In fact, Ramaswamy (1999) points out that the increased intensity (during 1970–90s) of subcontracting by formal manufacturing enterprises to the informal units within India has been a dominant strategy. But, it was still the era of "License Raj" and bureaucratic red tapes (see Saha, 2001). The degree of informality should go down with reform that India strongly engaged with, thereafter.

It should nevertheless be reminded that sweeping revolution in the information technology has caused increased fragmentation of production (Hanson, 2001). Simultaneously, the inflow of foreign direct investment (FDI) to the developing countries over the last few decades has been one of the most vibrant instruments of such production fragmentation. Generally speaking, production fragmentation allows firms to utilize cheaper resources, such as low-cost labor inputs along the value-added chain leading to gains from specialization (Deardorff, 2005). That outsourcing is a dominant characteristic of modern production organization is consequently well reflected in the theoretical and empirical literature (Grossman & Helpman, 2005; Helpman, 2006 for a review). Note however, that production outsourcing in developing and transition countries that attract much research attention actually covers the domain of formal firms only and leaves out the large informal counterpart despite the fact that informal units produce a considerable share of industrial and semi-industrial output in such countries.

In support of the objective laid out in the previous paragraph, therefore, we explore the pattern of production outsourcing between organized and unorganized units in India in the presence of foreign capital inflow. The international business implications of this FDI-linked production outsourcing from formal to informal units seems quite pervasive for India, where the share of workforce involved in informal activity is close to 93% (NCEUS, 2009). The spread of technology, of know-how, the rise in capital intensity and the possible expansion of global business links all seem to offer positive implications associated with such international business activities between the north and the south. [3]

Various industrial and service sector firms in India receive contracts and foreign investments to facilitate production and a large number of such firms regularly outsource parts of the output (often intermediate goods) to firms in the informal sector (see Chen, 2006). Whether FDI comes into support production of semi-conductors, or export quality leather shoes or to the domestic transport sector, a portion of the output is produced by such firms that do not have the same legal and institutional standings as displayed by formal firms. The mostly unregistered, non-taxpaying, violators of labor laws, environmental laws, industrial rules, and property rights become the conduits of production under such circumstances. [4] Since, the informal sector by definition accounts for these pseudo-legal arrangements, we do not explicitly consider each constituent element in the empirical analysis. However, other forms of production re-organization are not uncommon.

Related literature (Lau & Ngo, 2001) suggests that, a different variety of firms (not necessarily in the informal sector) in China receive large positive spillovers from foreign investors of non-Chinese origin. The organizational development (OD) in case of domestic transfers of production is usually less complicated compared to approaches made directly by MNCs of foreign origin, although many western firms are open to OD compared to local firms in East Asia. A different stream of literature in Altenburg and Meyer-Stamer (1999), Mehrotra and Biggeri (2005), Chhair and Newman (2014), Siba, Söderbom, Bigsten, and Gebreeyesus (2012), etc. discuss formation of clusters which supports the existence of micro and small enterprises mostly against unfavorable macroeconomic conditions. These are also the ones that harbor low skills and low investments. [5] Essentially therefore, the larger discussion on spillover is associated with the cluster studies literature referred to here. In case of Cambodia (Chhair & Newman, 2014) or Ethiopia (Siba *et al.*, 2012), for example, the subject of intra-firm spillover has come up for rigorous empirical discussion. In Cambodia, the clustering of formal and informal firms lead to negative competition effect in the former and in turn facilitates the latter via productivity spillover within the informal firms. The manufacturing firms also seem to gain from clustering among themselves via productivity spillover, but not formal and registered units. The formal to informal spillover of output and technology remains largely under-explored in this literature.

India, with an overwhelming share of informal firms located across different regions of the country, should offer an interesting case and help understand formal-to-informal production link through production outsourcing. While a large number of analytical exercises offered in recent times engage with related questions (see Maloney, 2004; Marjit & Kar, 2011; Mehrotra & Biggeri, 2007, etc. for detailed case studies on the widespread presence of informal sector in the low- and middle-income countries, etc.), empirical verification of the outsourcing between formal and informal firm is relatively few (exception being Ramaswamy, 1999). Available literature (viz. Guha-Khasnobis & Kanbur, 2006; Harriss, 1990; Marjit 2003; Siggel, 2010, etc.) did not inquire if such tendencies rise with foreign capital flowing into the formal sector and how pervasive this effect might be. Using recent survey data on unorganized manufacturing units in India, we establish that foreign investments flowing into the organized sector may in fact lead to outsourcing to the unorganized sector. This is often influenced by the benefits of lower production costs creating an opportunity to remain viable and attractive to foreign investors. In the process, the entire informal sector may undergo a significant rise in the level of value added.

From the year 2000 inflow of FDI has been promoted hugely in India, including permission for 100% share with automatic approval in many sectors like, textiles, paper, chemicals, drugs and pharmaceuticals, rubber and plastic, non-metallic mineral products, metal products, machinery and equipment and automobiles. Notably, all these products have parallel production in the unorganized sector creating scope for outsourcing. We measure the effects of (i) prevailing wages in the organized sector, (ii) of technology, (iii) FDI inflow to the formal sector and (iv) the informal wage as primary variables of interest, on the gross value added (GVA) of the unorganized firms. This idiosyncratic characteristic of doing business in developing countries has been discussed in popular forums, in the media, and even in Hollywood films. In the film "Outsourced", a local electrician working in the informal sector fixes the power lines and saves the "night" for a MNC-controlled BPO (Business Process Outsourcing) unit operating from the open terrace of a rented apartment whose ground floor gets waterlogged due to poor drainage. The adoption

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