World Development Vol. 59, pp. 327–340, 2014

0305-750X/$ - see front matter

ELSEVIER
www.elsevier.com/locate/worlddev

http://dx.doi.org/10.1016/j.worlddev.2014.01.013

The Liberalization of Retail Services in India

CSILLA LAKATOS
Purdue University, West Lafayette, USA

and

TANI FUKUI *
US International Trade Commission, Washington, USA

Summary. — Despite the recent controversy about opening up the distribution sector to foreign retailers, there is political will that remains in favor of pushing through reforms in India. In this paper, we quantify the economic impact of the removal of barriers to foreign investment in multi-brand retailing on different stakeholders using a newly developed general equilibrium model. The model accounts explicitly for both foreign direct investment and the activities of foreign affiliates using heterogeneous production technologies. We find that the unilateral reduction of barriers to FDI in distribution services in India benefits the economy as a whole, consumers, and foreign producers but hurts domestic distributors. Nevertheless, when we consider the associated productivity improvements documented in the literature to downstream and upstream industries, we find that domestic producers are expected to benefit from the liberalization of the distribution sector as well.

Key words — India, retail services, general equilibrium models

1. INTRODUCTION

Nationwide protests erupted in December 2011 in India against the government's decision to allow 51% foreign direct investment (FDI) in multi-brand retailing, with protestors labeling FDI a "fast death instrument" for the Indian economy. As a result of the intense political and social pressure, the Government of India revoked its decision to allow global supermarket chains such as Wal-Mart, Carrefour or Tesco to set up business in India. In 2012, the Cabinet revived this policy and it has once again become a hot debate. Many questions have been raised by this debate: is FDI in retail services good for India as a whole? What benefits, and costs, should the Indian government expect? What is the magnitude of the effect? Who will win and who will lose? We address some of these issues in this paper.

The debate over liberalizing barriers to foreign investment in India is not a new one. The 2011 policy proposal was made 16 years after the first time it was proposed, and has been blocked numerous times by those portions of the economy fearing negative consequences.[1] Foreign investment policy changed dramatically with the economic reforms of 1991 which liberalized many of the highly protected public sectors by removing entry barriers to private participation and by allowing foreign investment in 35 high-priority manufacturing sectors. While these measures managed to attract foreign investment and technology in manufacturing sectors it capped foreign ownership at 51% and left most of the services sectors including retailing, highly protected. After 1991, barriers to foreign investment were further relaxed. This included progressive de-licensing, allowing 100% foreign ownership in certain sectors, and broadening the liberalized sectors to include services.

In 1997, 100% foreign ownership was permitted in FDI in "cash and carry" and wholesale trading. Single brand retailing was opened to foreign investment in 2006 but the rate of foreign participation was capped at 51%; this limitation was finally removed in November 2011. At the same time, the government attempted to allow 51% ownership in multi-brand retailing. The multi-brand retailing measure was met with strong opposition; it was reversed and reinstated in subsequent months as the many stakeholders debated the measure.

Permitting the entry of foreign retailers is seen to threaten the existence of millions of small traditional stores and street vendors that dominate the Indian retailing industry, as well as traders and middlemen that service those stores. Domestic organized retailers may also be affected, as their product and mode of delivery are similar to foreign entrants. The retail sector is a major employer, particularly of low skilled workers who run a single shop as their livelihood (Joseph, Soundararajan, Gupta, & Sahu, 2008). Although the Indian government has made efforts to expand employment opportunities for low skilled workers, they have had limited success. Any large scale disruption of employment to the retail sector would have major political ramifications.

On the other hand, the entry of organized retailers, particularly foreign retailers with knowledge and capital, could provide much needed productivity improvements to the retail and upstream sectors. Winners of the new policy would include customers facing lower prices, and farmers receiving a greater share of the final consumer price.

The academic literature has attempted to quantify the effects of FDI liberalization in a number of ways. There are two distinct lines of research. The first examines econometrically the effects of FDI on countries. This literature is predominantly concerned with the productivity improvements that may be generated by FDI in the host country. The second set of literature examines FDI in the context of the general equilibrium modeling. In this study, we examine both aspects, using the

* The authors would like to thank the participants of the USITC International Trade Seminar Series for valuable comments on previous versions of this work. Final revision accepted: January 19, 2014.

direct effects of FDI estimated by the econometric literature to obtain quantified effects on the broader global economy.

This study sheds light on whether opening up multi-brand retailing and more generally trade to foreign investors in India would indeed be a "fast death instrument (FDI)" in harming certain sectors or stakeholders. We quantify the economic impacts of the removal of barriers to foreign investment in a comparative static computable general equilibrium (CGE) framework developed exclusively for better representing multinationals and FDI. More specifically, we develop an extended GTAP model and associated global database that accounts for both foreign direct investment and multinational companies differentiated by the region of ownership which use different production technologies to produce a given a good. The model is calibrated on the GTAP v8 database augmented by global foreign affiliate statistics data described in Fukui and Lakatos (2012) and the FDI stocks data from Gouel, Guimbard, and Laborde (2012). We examine the effects of liberalizing the distribution (retail and wholesale) sectors. We find that the unilateral reduction of barriers to FDI in distribution services in India benefits the aggregate Indian economy, and Indian consumers and foreign producers but hurts domestic distributors. When we consider the associated productivity improvements documented in the literature to downstream and upstream industries, we find that domestic producers are expected to benefit from the liberalization of the distribution sector as well.

The rest of the paper is organized as follows. Section 1 introduces the paper and Section 2 reviews some of the existing literature on the advantages and disadvantages of allowing FDI in multi-brand retailing. Sections 3 and 4 describe in detail the modeling framework and the databases used in calibrating the model. Section 5 provides details about the design of the simulations carried out in the paper while Section 6 analyzes the economic impact of the elimination of the barriers to FDI in retailing in India. Finally, Section 7 concludes.

2. BACKGROUND AND LITERATURE REVIEW

(a) *India's retail services sector*

The distribution sector, including both wholesale and retail, is one of most important sectors of the Indian economy, accounting for 16% of GDP and 14% of total employment.[2] It is also growing rapidly: according to some industry experts, the retail services sector expects an 11–15% annualized growth rate over the next several years.[3]

Despite the growth, foreign multinational firms face daunting challenges in the Indian economy. A unique feature of the Indian retail sector is the small share of "organized retail" in the sector. The term organized retail is used to denote branded stores with multiple outlets. Foreign multinationals, if they are permitted to enter the market, would fit within this category; however, even domestic organized retail firms have had very little success obtaining market share. McKinsey and Company (2008) estimated the 2007 share of organized retail to be 4–5% of total retail sales, and Singh and Mall (2011) estimated the 2010 share to be 6–7%. Most of this share is domestic firms, as permitted foreign retailers (i.e., single-brand retailers) take up only a fraction of this share.[4]

The penetration of the organized varies by good. Food is particularly confined to the unorganized retail sector, relative to other goods. According to Sharma (2011), less than 1% of food was sold in organized retail stores, while 19% of clothing and footwear was sold in organized retail stores.

(b) *Liberalization and controversy*

Foreign investment policy was dramatically liberalized beginning with the economic reforms of 1991 which liberalized many of the highly protected public sectors by removing entry barriers to private participation and by allowing foreign investment in 35 high-priority manufacturing sectors. While these measures managed to attract foreign investment and technology in manufacturing sectors, the policy capped foreign ownership at 51% and left most of the services sectors, including retail services, highly protected. Since 1991, barriers to foreign investment were further relaxed by progressive delicensing and allowing 100% foreign ownership in certain sectors.

Firms in "cash and carry" and wholesale trading have been permitted to have 100% foreign ownership since 1997. Single brand retailing was also opened up to foreign investment in 2006 but the rate of foreign participation was capped at 51%.

In 2011, liberalization of multi-brand retail was contemplated in earnest. In the first formal step toward a policy change, the Cabinet of India approved measures to permit majority ownership in multi-brand retail firms on November 24, 2011.[5] The proposed changes included permitting up to 51% foreign ownership in multi-brand retail as well as 100% ownership in single brand retail. Several restrictions were proposed alongside this liberalization, including micro, small, and medium-sized business domestic content requirements for the foreign retailers, a minimum investment of $100 million, and geographic restrictions on store locations. Moreover, the policy implementation depended on the further approval of state governments. As of this writing, there are 12 states, including Maharashtra and Karnataka, that have announced they will permit foreign firms to enter their market. The implementation is also vulnerable to changes in state governments. However, the uproar from various interested parties, particularly traders and politicians, against this policy almost immediately forced the Cabinet to suspend the decision only a few weeks later.[6] On September 14, 2012 the Cabinet revived this policy.[7] As of December 2013, only one firm (Tesco) had applied to enter the Indian market.[8]

There has been a substantial discussion in the popular press and by industry experts about the potential costs and benefits to various sectors in the economy. There are many groups who fear losing out as a result of FDI in retail. The small traditional stores and street vendors that dominate the Indian retailing industry are threatened by the potential competition of foreign-owned organized retail. Kalirajan and Singh (2013) found in survey work that 30% of small firms near organized retailers closed down after the organized retailer arrived. As argued in Kohli and Bhagwati (2011), organized and unorganized retailers are only partially substitutes. Unorganized retailers may provide customers different services such as lines of credit, sales of smaller quantities, or home delivery. They are also on average much closer to home, and therefore provide greater convenience. Large format outlets may be used for more occasional purchases, or by a wealthier clientele with the means to purchase, transport, and store larger amounts of goods.

Another major concern raised by the entry of foreign retailers is labor displacement and wages. The retail sector is a major employer in the Indian economy, and disruptions to employment and wages can have serious implications for other segments of the economy. Additionally, labor movement is a politically sensitive topic, and politicians are loath to implement policy changes that may cause even temporary uncertainty in the labor market.