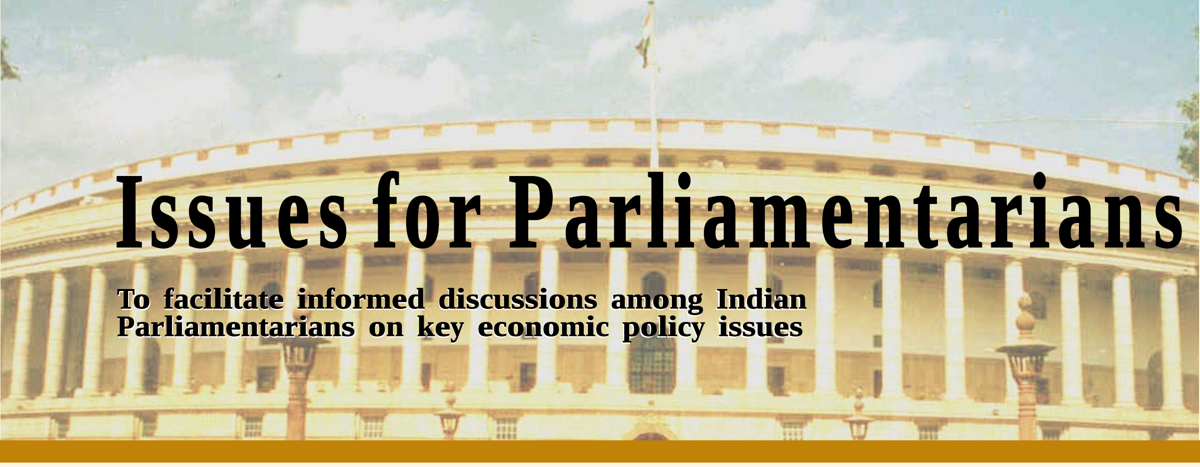

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FDI in Multi-brand Retailing

– Adequate Safeguards is Key to Success

The government's decision to allow 51 percent foreign direct investment (FDI) in multi brand retail trading (MBRT) has attracted a huge debate in the country. It has been argued that the policy will result in greater benefits to consumers and farmers. However, concerns have been raised that the outcomes will be the opposite. The decision is now postponed to be adopted after wider stakeholder consultation.

This paper reviews the situation in a dispassionate manner and argues that FDI in MBRT should be allowed but adequate safeguards should be built in so that it does not end up in a losing proposition and justify the right fears of it being another rip off.

WHY FDI IN RETAIL?

Since the last few years, domestic enterprises have already entered into the arena of MBRT, with consumers welcoming them. While consumers have benefited, farmers have not benefited as expected. The reason for that is neither the government nor the domestic players have been able to create the necessary back-end infrastructure which could provide a seamless flow of goods from the farm to the fork.

Prima facie, this failure can be attributed to inappropriate policy and regulatory frameworks, including wide variations and uncertainty amongst states, lack of agriculture marketing reforms and backlash in certain states against organised retailers (such as against 'Reliance Fresh' in Uttar Pradesh, Jharkhand etc.). Furthermore, lack of relevant technology and managerial capacity on part of domestic players, if not the capacity to invest on such a large scale, are other valid reasons.

One cannot argue against the fact that multinational MBRTs are endowed with sound long term experience and technology. Everywhere they have helped to build up good supply chains from the farm to the stores. The Indian players are new kids on the block, and are still in a learning mode.

MAJOR MYTHS AND REALITIES

The opposition to the said policy decision is mainly on the following grounds that it will:

- crowd out small retailers;
- adversely impact small traders involved as intermediaries in the supply chain;
- will not actually benefit domestic manufacturing sector;

- will not really help small farmers; and
- harm consumers due to anticompetitive practices.

Let us examine these concerns one by one and explore counterfactuals and ways to deal with them, so that there is a 'win-win' situation.

Myth 1: Crowding out of small retailers/kirana stores

This is the most vocal concern. Research shows that in recent years, the growth rate of domestic organised retail in India has been faster than that of the traditional retailers. This, however, does not prove that small retailers in unorganised sector have been crowded out in an absolute sense of the term. Nonetheless, a 2008 Indian Council of Research in International Economic Relations (ICRIER) survey[1] did find that small retailers situated in the vicinity of the organised Indian retail outlets have been adversely affected. The point to be noted, however, is that both organised and unorganised retail markets are growing, and this is likely to happen in future as long as the Indian economy is growing leading to an increasing middle class population of consumers.

From global experience it can be said with some certainty that small retail outlets in many countries have remained largely unaffected from introduction of foreign investment in retail. In densely populated countries (with consequent higher real estate prices) of Europe and Japan, small-store formats thrive and flourish even in the face of competition from big-box retail. However, introduction of foreign competition forced manufacturers to cut costs in their supply chains and small stores became far more efficient.

> The domestic MBRTs like Spencer, Subhiksha, Big Bazaar, Vishal Megamart, Reliance Fresh, More etc. have been operating for the last decade in India and are fast increasing in number as well as coverage.
>
> Retail chains like Big Bazaar and Vishal Megamart can now even be seen in smaller cities with population below one million. The preference for and growth in organised retailing in the present decade may be gauged by the rise in number of shopping malls, which are coming up fast in smaller cities and towns.
>
> In the midst of all these developments, crowding out of *kirana* stores or hawkers has hardly been observed. Can introduction of foreign big-box retail do what domestic players could not? Not likely in near future and certainly not as being projected through street demonstrations.

In Germany one of the large chains is actually a cooperative of small stores. By coming together under a large cooperative, the small retailers retained a large level of ownership and independence while gaining the cost, marketing and process-capability advantages of modern retail. Hence, it is possible for small stores owners to respond and acquire many of the key advantages of large stores while building on their own areas of strength.

Innovative government interventions (one can learn from practices in China, Singapore, Hong Kong, Japan etc. where government policies directly supported modernisation of local wetmarkets by encouraging formation of cooperatives of traditional retailers and formation of the semi-public chains which now operate as profit-oriented enterprises and compete with large private firms), can further mitigate the remaining adverse effects on small retailers.

In China, since liberalisation of retail sector in 1992, the number of small outlets increased from 1.9 million to over 2.5 million, and employment in both wholesale and retail sectors has nearly doubled from 28 to 54 million in less than a decade. In Malaysia, some small retail establishments, which do complementary business other than those

1. ICRIER (2008): Impact of Organized Retailing on the Unorganized Sector, Working Paper No. 222.

covered by supermarkets, were found to benefit from the proximity of supermarkets in their vicinity.

The adverse impact of foreign players observed on the local stores in the case of Thailand can as much be attributed to the recessionary economy during late 1990s as any other reason. Nonetheless, FDI liberalisation in retail in Thailand did undoubtedly help the significant growth of domestic food processing industry which benefited from increased agricultural exports in processed food.

In the end, the net impact of retail sector liberalisation as usual will be a function of the initial sectoral conditions, consumer behaviour and shopping preferences, and the level of development of the economy and its structure. Because of entrenched consumer habits, preferences and allegiance, the likely adverse effect further gets mitigated. This has been seen in Indonesia and Brazil, where even after opening the retail sector to FDI, 50-70 percent of the trade in groceries, fruits and vegetables continues to take place through the traditional small stores.

Apart from consumer preference, in India, the advantages of close proximity of *kirana* stores or even the itinerant hawkers, inter-personal relationships between the customer and retailers, credit availability for all customers and home delivery facility are major factors which will continue to favour existing small retailers. Because of their size, the MBRTs will never be able to replicate these attributes.

Experience from around the globe suggests that the retailers (big or small, domestic or foreign) need to worry more about the spread of e-commerce or online retail, than the presence of foreign corporate retail. While India's organised retail industry is growing at a compounded annual growth rate (CAGR) of 15-20 percent, online retailing or e-tailing, which at present occupies less than one percent of the organised retail trade, is witnessing a growth of 40-50 percent year-on-year. India has 11 million online consumers, and the number of e-buyers will grow to 38 million by 2015, according to estimates by financial services firm Avendus Capital. This in turn, will transform the sector from the current US$800mn to US$11.8bn in 2015.

Myth 2: Crowding out of the 'middlemen'

With the kind of procurement practices that global retail players adopt – sourcing directly from producers – there are likely to be a welcome displacement of traders who have been acting as rent seeking intermediaries between producers and retailers, particularly those dealing in agriculture produce. While there are ways to absorb (including offering retraining facilities) these displaced traders in other economic activities, the streamlining of the long chain of middlemen is deemed necessary to curb the growing food inflation – a big concern for the government and consumers alike.

It is possible that the displaced traders will likely be absorbed by the rise in food processing activities due to the growth in demand for processed and branded food (already evident in the metro cities with large

> Many have been demanding an overhaul or scrapping of the APMC Act, which breeds profiteering middlemen, but the movement has been slow or inadequate. Political patronage among other factors is the reason for its slow movement.
>
> The onion price crisis in 2011 was mainly due to the fact that wholesale traders indulged in price gouging though not necessarily in a cartelised fashion. This has happened many times before and will continue to happen in future also. Price leaders set the trend for increased prices, which may be termed as abuse of collective dominance. It is also a result of governance failure, when the administration was not alert and did not use recourse to law or other safeguards.
>
> One service which these middlemen offer to farmers is unsecured credit, which in fact ties them to bring their produce to them. Alternative credit mechanisms will need to be developed to help farmers.

and rising female participation in workforce), because evidence shows processing units are the biggest source of supply to the big retail outlets. The entrepreneurs amongst them are likely to open and own small food processing units and become suppliers to the big retailing houses thus becoming net beneficiaries. The FDI policy proposes that at least 30 percent sourcing would mandatorily have to be from "small industries", and which is being considered to be increased. This measure would further incentivise this phenomenon.

Myth 3: Adverse effect on domestic manufacturing sector

Domestic retailers source the bulk of their produce domestically. International retailers, on the other hand, operate on the principle of buying internationally at the cheapest cost. It is feared that most of the items to be sold by MBRTs are going to be sourced from competitive economies like China, leading to a fall in manufacturing sector jobs. It is true that for countering this, we need to improve physical infrastructure, low-cost utilities, competitive interest rates, reduction in transaction costs, and trade facilitation. Once these reforms bring down the cost of our manufacturing goods, we can expect global retailers to source domestically and also export to their chains outside India.

In fact, one can take heart from the recently announced manufacturing policy, which attempts to remove the shackles hobbling the Indian manufacturing sector. This, in turn, will promote competitiveness of domestic products encouraging the organised retailers to source domestically. At the moment, with the low import duty regimes under the World Trade Organisation and other free trade agreements, most traditional and domestic organised retailers are already sourcing key products from abroad. This too can have similar harmful impact on domestic manufacturing employment and which is unlikely to change even if foreign MBRTs are debarred from entering India. So the only viable way forward is to increase local productivity and competitiveness of domestic products.

The growth of organised retail (and in particular large format retail chains) has the potential of providing market access to manufactured products from small and medium enterprises (SMEs) in rural and distant places by integrating into the product supply chain of the large retailers. The trend is already visible in India, and could further increase its pace with the entry of big-box retailers, in view of the mandatory requirement of 30 percent sourcing from SMEs. Small and regional brands like Baidyanath Ayurved, Wagh Bakri tea, Super-Max shaving products, Nilon's pickles, Dukes biscuits, NR Group's Ripples fragrances are already tying up with retail giants to push their merchandise. As a result, the share of organised retail in total sales of these brands has risen from near zero to about 15 percent.

Myth 4: Adverse effect on small farmers

As stated above, the main rationale behind permitting FDI in organised retail sector is that it will benefit farmers when these firms buy directly from them, with or without prior agreements (contract farming). It must be noted that the *status quo* is also not working for farmers and new opportunities for assured and remunerative market for farmers has long been felt.[2] According to National Sample Survey Organisation (NSSO) survey, more than 40 percent of farmers are willing to quit farming for any opportunity of a job. More than 4mn farmers have already left farming since 1991. Permitting FDI in organised retail sector is likely to open opportunities for assured and remunerative marketing for farmers, most likely in fruits and vegetables.

2. For instance see the Fourth Report of the National Commission on Farmers, headed by Dr. M S Swaminathan, titled "*Jai Kisan*: A Draft National Policy for Farmers"

According to the 2008 study by ICRIER, profit realisation for farmers is estimated to surge to 60 percent when the produce is sold directly to organised retailers as compared to selling through *mandis*. Recent evidence suggests that marginal farmers (in Punjab) who have entered into contracts with Pepsi India have on average realised twice the price in comparison with the local *mandi* and the local *mahajan* (in absence of the local *mandi*).

Similarly, in West Bengal it was reported[4] that Pepsico was paying ₹300-320 per 50 kg bag of potatoes against the market price of ₹110. Around 200 small growers organised under the Panpara Sech and Agricultural Welfare Society growing potatoes on a total of 29 acres of land are assisted by Pepsico on quality production methods and work together to produce and sell to Pepsico. Prices are preset and they get assured market with no middlemen. Though similar to contract farming, the process is much safer besides being immune to vagaries of the market. Pepsico also provides storage infrastructure.

> Apart from direct procurement, the investment in efficient back-end infrastructure, which is the most likely outcome of allowing FDI in organised retail, in view of an expanding market, could further add to farmers' welfare.
>
> According to a World Bank study, as a consequence of inadequate infrastructure the Indian farmer realises only 1/3rd of the total price paid by the final consumer as against 2/3rd with higher degree of retail, and that for horticulture produce it is barely 12 to 15 percent of what is paid at the retail outlet. For instance, an apple farmer in Himachal Pradesh receives about 15 percent of the end-consumer price. A wheat farmer receives less than 50 percent of the price the Indian government is willing to pay for highly subsidised imported wheat. *Amla* (Indian Gooseberry) farmers in UP receive about 10 percent of the final end consumer price for their produce (Pandey *et al*, 2007).[3]

The opportunity loss of farmers due to presence of a complex chain of procurement involving several middlemen is a known fact. It is believed that FDI in retail, coupled with agriculture market reform, will create an enabling environment for farmers, which will ensure direct procurement from farmers in an integrated supply chain and help them secure better price by providing them with an alternate market than the APMC *mandi*. In addition, these developments would help bring down food inflation that is causing severe harm to the economy for last few years.

However, some concerns for small farmers also arise viewing the inequality of power in favour of global retailers, which can be dealt by suitable government interventions, and by the Competition Commission of India (CCI) under the Competition Act.

Most Indian farmers, by virtue of being small, ignorant and cash-crunched, are vulnerable to exploitation by buyers and there is no guarantee that they would not be exploited by corporate retailers, *desi* or *firanghi*. Therefore, there is a need to develop a comprehensive, clean, equitable and farmer-centric model procurement agreements with special attention to clauses dealing with quality standards, withdrawal conditions, pricing standards, paying arrangements, force majeure and arbitration mechanism, so that the farmers do not get a raw deal.

Along with this an extension programme should be launched for farmers, as Safal is doing in 14 states, so that they could meet the desired standards of foreign retailers. In addition, in view of the small holding size of Indian farmers, they would also need to form cooperatives and/or 'producer companies' in order to enhance their economies of scale and to negotiate better prices for their produce. This could be facilitated by the government through creating a suitable policy environment.

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3. Venkatesh, Umashanker; The Case for Organised Agri-retail – The Indian Imperative; Journal of Services Research, Vol 8, No.1 (April-September 2008), Institute for International Management and Technology.
4. "Multinationals to the rescue of potato growers", *Anand Bazar Patrika,* January 20, 2012

The possible monopolistic/monopsonistic tendencies of the large retailers (fears of 'predatory behaviour' and 'abuse of dominance') would have to be proactively dealt by CCI to ensure competition in the market. Appropriate policy formulation can also aide this cause, as was done during the telecom sector liberalisation with the National Telecom Policy mandating that each circle should have at least 4-6 players. It is to be understood that free and fair competition in procurement of farm produce is the key to farmers' enhanced remuneration.

Therefore, liberalising retail *per se* may or may not yield this desired outcome and FDI in retail is certainly not a panacea, although it can be a good starting point. To ensure benefits to farmers FDI in retail must be backed by appropriate and proactive government intervention.

Myth 5: Harm to consumers due to anticompetitive practices

Indian consumers have benefited from the domestic organised retail that is operating for some time now. According to a survey conducted by ICRIER, consumers from low income groups have found to be benefitted more from the growing organised retail in India. With foreign retailers operating in the Indian market, there will be more competition within and between organised retail and unorganised retail, and hence more benefit to consumers.

Furthermore, FDI in retail and subsequent creation of 'back-end' infrastructure would reduce wastage of perishable food items, like fruits and vegetables, which has been estimated to be in the tune of 25-30 percent, consequently benefitting consumers, as consumers would have to pay for the cost of wastage. Additionally, with the removal of 'middlemen' due to propagation of direct procurement from farmers, food inflation would be under control, thus benefitting consumers.

Another benefit to consumers can come through proper weights and measures, which traditional stores are able to easily bypass. Secondly, in India we also have the curse of revenue losses to the government because small retailers do not often issue cash memos, which large retailers cannot indulge in.

Viewing the Indian market structure, the fear of predatory pricing and subsequent abuse of dominance seems unfounded as this strategy is unlikely to succeed. If at all such strategy is adopted by foreign players, the CCI is well equipped to tackle such anticompetitive practices.

There does exist some concerns for consumers. For one, it is feared that in the initial period the foreign big-box retails would adopt the strategy of predatory pricing. Subsequently when it gathers dominance in the market, they could abuse their dominance by price gouging of consumers. However, this is already a common occurrence in India, whenever traders find an opportunity to exploit the market, so price gouging by foreign retailers will not be any different. And anyway, other than the use of Competition Act, states too can take action under several local laws.

More importantly, predatory pricing can be a concern in markets with high barriers to entry, which the Indian retail market is not. Given that unorganised retailing has low entry barriers, pricing below cost may succeed temporarily in driving out unorganised retailers from a market, but once prices return to normal levels, the same or other nimble-footed unorganised retailers can reappear. Thus, it is difficult, if not impossible, to point to sustainable benefits that can be obtained by an organised retailer using predatory pricing. Even the fear of collusion by organised retailers to make monopoly profits is unwarranted, as absence of high entry barriers will surely be an incentive for other, unorganised and organised, retailers to enter the market.[5]

5. Kohli, R. and Bhagwati, J. (2011). 'Organized Retailing in India: Issues and Outlook', Columbia Program on Indian Economic Policies, Working Paper No. 2011-1.

CONCLUSION

The discussion above highlights:

(1) Small retailers will not be crowded out, but would strengthen market positions by turning innovative/contemporary.

(2) Growing economy and increasing purchasing power would more than compensate for the loss of market share of the unorganised sector retailers.

(3) There will be initial and desirable displacement of middlemen involved in the supply chain of farm produce, but they are likely to be absorbed by increase in the food processing sector induced by organised retailing.

(4) Innovative government measures could further mitigate adverse effects on small retailers and traders.

(5) Farmers will get another window of direct marketing and hence get better remuneration, but this would require affirmative action and creation of adequate safety nets.

(6) Consumers would certainly gain from enhanced competition, better quality, assured weights and cash memos.

(7) The government revenues will rise on account of larger business as well as recorded sales.

(8) The Competition Commission of India would need to play a proactive role.

It needs to be understood that farmers need better remuneration, which in turn require creation of back-end rural infrastructure among other things, which will require a huge investment. Now the question is, whether government should make such investment or should private players be incentivised for this purpose? The present fiscal situation indicates that the government may find it difficult to invest on such a large scale or it may have other social priorities, for instance, education and health, which also require huge investment. The upcoming Food Security Bill would also require huge investment by the government.

On the other hand, large scale MBRT will catalyse investments in back-end infrastructure bringing in efficiency in their establishment and operation, consequently boosting our economy without putting further pressure on the public exchequer. It has been observed that domestic private players have failed to invest in creating adequate back-end infrastructure. Hence, allowing FDI in organised retail seems to be a 'win-win' solution.

A recent study by University of North Carolina economist Anusha Chari and T C A Madhav Raghavan shows that the potential benefits of allowing large retailers into the country significantly outweigh the costs. These benefits largely accumulate through productivity gains. From roughly the mid-1990s to 2004, the last year for which relevant data exists, many reputed economists, including Princeton's Nobel laureate Paul Krugman and Harvard's Kenneth Rogoff, a former chief economist at the International Monetary Fund, attribute big-box retail, most pivotally Wal-Mart, as a significant driver of US productivity growth, which surged during this period. Rather than restricting entry of large foreign retailers, creating the right regulatory conditions in India is important to ensure that a similar experience is seen at home.

Be that as it may, one of the main reasons for the present standoff in this policy appears to be that of political opportunism[6] and playing to the gallery of vested interests in an election cycle. BJP's response at the moment seems to be the same as that of the Congress Party, when they were in opposition. It may be recalled that in 2002, when the BJP-led National Democratic Alliance (NDA) government wanted to allow FDI in

6. The most striking example is the case of Punjab, where the benefits to potato farmers from the affiliation with Pepsi prompted the Punjab Deputy CM to openly acknowledge the benefits of FDI but which was subsequently withdrawn due to political pressure from BJP.

retail, it was the Congress Party that opposed it, branding the decision as anti-national, among other things. One wonders if anything substantive has changed in the last decade that merits such radical swings in positions, other than the quirky principle that when in opposition, just oppose.

Furthermore, the proposed Policy speaks about opening the FDI in MBRT to cities above 1.00mn population and that too if the concerned States agree to implement the policy. This means that there will be no compulsion on any state to allow Foreign MBRT. It also signifies a gradual approach rather than a wholesale approach. In policy terms this is a good process.

The polity and state governments need to reconsider their decision in light of the pressing needs of farmers and their own present endeavours to reform the distorted agriculture procurement and marketing system. There are instances, where state governments had shown reluctance in the beginning but later adopted certain reform measures realising net societal gains, but not before losing out to the first movers in this competitive environment. Whether it was adoption of Value Added Tax, or reform of APMC Act or allowing private universities, all had faced initial resistance by some states but later they realised the merits of compliance. Is FDI reform in retail headed the same way?

More importantly, the debate on FDI in retail has been sending wrong signals to the world that our FDI policies can be thwarted by polemics rather than logic.

Another important issue which has not been mentioned in the debate is that Indian FDI is also happening in foreign countries, and hence when Indian MBRTs can gain the experience and skills, they can also invest abroad. For instance, in UK, Indian FDI is the largest employer in the manufacturing sector.

ISSUES FOR DISCUSSION

- Given a choice, States are welcome to allow or not allow foreign MBRT and only in big cities, hence why the opposition?
- Is it necessary to differentiate between foreign investment and (large) domestic investors as far as organised retail sector is concerned? Both types of investments tend to have similar behavioural patterns and impact insofar as small retailers are concerned.
- How to monitor and implement the built-in "conditions" for allowing FDI in the retail sector so that benefits to farmers, SMEs and other stakeholders are maximised? (For instance what constitutes 'back-end infrastructure' and how to ensure 50 percent investment of total FDI brought in for the same?) Is self-certification for fulfilling conditions be sufficient or other mechanisms would be required? What would be the role of States in this regard?
- Should only Greenfield FDI be allowed in MBRT, like in the debate on pharmaceutical sector, discouraging brown-field acquisition/takeover of existing domestic organised retail chains?
- What other measures (including safety nets) would be required to realise the prospective advantages and mitigate adverse impact of MBRT on small farmers?
- What affirmative measures are required to mitigate adverse effect on small retailers (*kirana* stores and hawkers) and small traders (intermediaries)? What would be the role of Centre and States in this regard?
- How can competition policy and law be used to promote competition in agriculture produce procurement and marketing system?

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