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India's Inward FDI Experience in the Post-Liberalisation Period

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Abstract: The issue of differentiating between FDI and FPI is related to the functional aspects of the investments. The internationally adopted definition which relies on a numerical benchmark of 10% is thus of limited practical utility for policy makers. However, because of its widespread adoption and ease of identification, there could be preference for the 10% criterion especially because it removes the arbitrariness in identifying control/influence. There is a large variety even within FDI and FPI. Definitions and classifications should therefore follow behaviour rather than the other way round.

This note argues that while control/influence is a better indicator of the effectiveness of foreign association through investment in risk capital, since foreign investors' objectives in exercising that control/influence could differ significantly between financial investors and others, a case-by-case approach is preferable in case of sectors where foreign control is seen to be inimical to national interests and sensitivities. Since control is unavoidable in many situations and if the policy makers are convinced that there is no alternative to have foreign investment, they will have to settle for some tolerable level of foreign control. The oft-used 49% foreign share in equity and majority in the board of directors by Indian partners do not guarantee local control.

The Context

More than two decades after widening the gates to foreign investments, the Government of India is now grappling with the question of distinguishing between foreign direct investments (FDI) and foreign portfolio investments (FPI). The distinction would be relevant at least on two counts. One, though the caps on foreign shares in the equity of companies in different sectors are being progressively dispensed with, the issue is unlikely to disappear completely on grounds of national security, national sensitivities, public health, etc., which even developed countries employ to screen foreign investments. A related issue that often crops up is whether investments by foreign institutional investors (FIIs) should be taken note of for administering the caps. In fact, the present policy explicitly makes such a distinction in a few sectors.¹ Second is the present emphasis on attracting long term FDI over volatile FPI in view of the large current account deficit (CAD). Thus the matter at

The views expressed here are those of the individual authors and do not necessarily reflect the official policy or position of their respective institutions or the sponsors of the research project.

¹ For instance, in case of Commodity Exchanges, FDI and FII have the sub-limits of 26% (approval route) 23% (automatic route) respectively. In case of Asset Reconstruction companies 100% foreign investment (FDI+FII) is allowed subject to the condition that investment up to 49% would be through the automatic route and government approval is needed if it exceeds 49%. DIPP Press Note No. 6 (2013 Series), August 22, 2013.

hand is not of a statistical nature but is related to the functional aspects of foreign investment.

The Finance Minister had set the ball rolling in his Budget Speech 2013-14 when he said:

In order to remove the ambiguity that prevails on what is Foreign Direct Investment (FDI) and what is Foreign Institutional Investment (FII), I propose to follow the international practice and lay down a broad principle that, where an investor has a stake of 10 percent or less in a company, it will be treated as FII and, where an investor has a stake of more than 10 percent, it will be treated as FDI.

This was followed by the appointment of the “Committee for Rationalizing the Definition of FDI and FII” headed by the Secretary, Department of Economic Affairs, now popularly known as Mayaram Committee. While the Committee was said to have submitted its report in mid-June 2013, the same has not been made public so far.² Interestingly, the press reports highlight the Committee’s recommendations regarding relaxation of FDI caps but are silent on its observations/suggestions on the distinction between FDI and FII. On its part, the Securities and Exchange Board of India (SEBI) had appointed another committee earlier in December 2012, headed by a former Revenue Secretary, to study the convergence of the various portfolio investment regimes. One of the recommendations of the Committee is in line with the Finance Minister’s statement as it suggested 10% as the cut-off point for distinguishing the two types of foreign investments. Treatment of Foreign Venture Capital Investments (FVCIs) seems to be an area where the two committees were in disagreement.³ Incidentally, RBI in its “Master Circular on Foreign Investments in India” shows FVCIs as a separate category, distinct from direct investments.

It needs to be spelt out that while India started reporting FDI inflows as per international best practices beginning 2000-01, the adoption of best practices has been confined to reporting reinvested earnings, equity capital of unincorporated foreign bodies and other associated capital (mainly loans). This was mainly adopted to make India’s inflows look relatively better in comparison to those of China. What are given as FDI equity inflows are not based on any criterion of foreign share or control/influence. All investments by persons/entities resident outside India in the capital of Indian companies other those through the portfolio investment scheme are treated as FDI. Not all the reported FDI is really of the ‘direct’ variety -- no consideration of voting share, no control, no influence, no long term interest. FDI

² Strangely enough, the Committee’s report was said to be in the form of a Discussion Paper. One fails to understand why a Discussion Paper was not released for public comments. See: “FDI policy: Mayaram committee pitches for complete overhaul”, *Indian Express*, June 19, 2013. One is also not aware whether the Discussion Paper by Reserve Bank of India which was to aid the Committee in its deliberations was ever prepared. See: “Discussion paper on FDI, FII soon”, *Indian Express*, April 5, 2013.

³ “Panels divided over redefining FDI, FII”, *Financial Express*, July 19, 2013.

reported For purposes of carrying out studies of “Finances of Foreign Direct Investment Companies”, however, the RBI identifies FDI companies “based on 10 per cent or more equity holding by foreign investor/s”.⁴

The basic characteristics which distinguish FDI from other investments and for which the developing countries are persuaded to attract FDI are that the foreign investors have some special characteristics like advanced technology and management capabilities which these countries need to achieve faster economic development. This was clearly reflected in the Budget Speech 1991-92 (July 24 1991) which said:

Direct foreign investment would provide access to capital, technology and markets. It would expose our industrial sector to competition from abroad in a phased manner. Cost, efficiency, and quality would begin to receive the attention they deserve.

Further, the Statement on Industrial Policy issued on the same day said:

While Government will continue to follow the policy of self-reliance, there would be greater emphasis placed on building up our ability to pay for imports through our own foreign exchange earnings.

...

Foreign investment and technology collaboration will be welcomed to obtain higher technology, to increase exports and to expand the production base.

In sharp contrast, the Budget Speech 2013-14 said:

... India, at the present juncture [of facing a huge CAD], does not have the choice between welcoming and spurning foreign investment. If I may be frank, foreign investment is an imperative. What we can do is to encourage foreign investment that is consistent with our economic objectives.

International Practice

The earlier Budget Speech reflects the spirit of FDI while the latest speech reduces it to a mere number. The only thing that goes in the latter’s favour is that it is in line with the internationally prescribed and widely used definition of FDI. The 10% share is expected to represent the lasting interest of the foreign investor and his influence on the affairs of the domestic company. Both the characteristics which 10% is expected to represent are never defined precisely.⁵ Nor there is unanimity. Over

⁴ “Finances of Foreign Direct Investment Companies: 2010-11”, *Reserve Bank of India Bulletin*, December 2012, pp. 2389-2422.

⁵ See for instance, Robert E. Lipsey, “Foreign Direct Investment and the Operations of Multinational Firms: Concepts, History, and Data” Working Paper No. 8665, National Bureau of Economic Research, accessed from <http://www.nber.org/papers/w8665>. It was said:

The dominant current definition of a direct investment entity, prescribed for balance-of-payments compilations by the International Monetary Fund (IMF) ..., and endorsed by the OECD. ..., avoids the notion of control by the investor in favor of a much vaguer concept.

Similarly, Ann Soci, “FDI: a difficult connection between theory and empirics”, in Bernard Fingleton (ed.), *New Directions in Economic Geography*, Edward Elgar, 2007, said:

The idea of ‘control’, which was present in earlier definitions, has been abandoned in favour of a broader though no less vague concept. What ‘lasting interest’ means is ‘a stake of 10% or more of

the years ‘control’ gave way to a much less demanding ‘significant influence’. The ambiguity/transition is well reflected from the following Box.

Box: While OECD Moves away from Control, UNCTAD Still Doesn’t

OECD, <i>Benchmark Definition Fourth Edition, 2008</i>	UNCTAD, <i>World Investment Report, 2013</i>
<p>Foreign direct investment (FDI) is a category of investment that reflects the objective of establishing a <u>lasting interest</u> by a resident enterprise in one economy (...) in an enterprise (...) that is resident in an economy other than that of the direct investor. The <u>lasting interest</u> implies the existence of a <u>long-term relationship</u> between the direct investor and the direct investment enterprise and a <u>significant degree of influence</u> on the management of the enterprise. The direct or indirect <u>ownership of 10% or more</u> of the voting power of an enterprise resident in one economy by an investor resident in another economy is <u>evidence</u> of such a relationship.</p> <p>Some compilers may argue that in some cases an ownership of as little as 10% of the voting power <u>may not</u> lead to the exercise of any <u>significant influence</u> while on the other hand, an investor may own <u>less than 10%</u> but have an <u>effective voice</u> in the management. Nevertheless, the recommended methodology does not allow any qualification of the 10% threshold and recommends its <u>strict application to ensure statistical consistency across countries</u>.</p> <p>OECD, “Glossary of Foreign Direct Investment Terms and Definitions”, accessed at http://www.oecd.org/daf/inv/investmentfordevelopment/2487495.pdf. This glossary was part of the 4th Edition of the OECD, <i>Benchmark Definition of Foreign Direct Investment</i>, 2008.</p>	<p>Foreign direct investment (FDI) is defined as an investment involving a <u>long-term relationship</u> and reflecting a <u>lasting interest</u> and control by a resident entity in one economy (...) in an enterprise resident in an economy other than that of the foreign direct investor (...). FDI implies that the investor exerts a <u>significant degree of influence</u> on the management of the enterprise resident in the other economy.⁶</p> <p>...</p> <p>An <u>equity capital stake of 10% or more</u> of the ordinary shares or voting power for an incorporated enterprise, or its equivalent for an unincorporated enterprise, is <u>normally</u> considered as the threshold for the control of assets.⁷</p> <p>UNCTAD, <i>World Investment Report 2013: Methodological Note</i>, accessed at http://unctad.org/en/PublicationChapters/wir2013chMethodNote_en.pdf</p>

the ordinary shares or voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise’ (OECD, 1996, p. 8). This is the threshold in the United States, whereas the legislation in the European Union is not yet completely uniform.

As an example she states that in Germany 25% share is used as the threshold to distinguish FDI from FPI.

⁶ According to UNCTAD this general definition of FDI was based on OECD, *Detailed Benchmark Definition of Foreign Direct Investment*, third edition and International Monetary Fund, *Balance of Payments and International Investment Position Manual*, sixth edition.

⁷ According to UNCTAD, in some countries, an equity stake of other than 10% is still used. In the United Kingdom, for example, a stake of 20% or more was the threshold used until 1997.

While the OECD's Benchmark Definition of Foreign Direct Investment (Fourth Edition), framed in 2008, does not mention control, UNCTAD is still referring to 'significant influence' and its much stronger cousin 'control' in the same breath. OECD also refers to even the weaker sibling 'some degree of influence'.

The main motivation of the direct investor is to exert *some degree of influence* over the management of its direct investment enterprise(s) whether or not this entails exercising a controlling interest.⁸ (emphasis added)

The earlier edition had said:

An *effective voice* in the management, as evidenced by an ownership of at least 10 per cent, implies that the direct investor is able to *influence* or *participate* in the management of an enterprise; it does not require absolute control by the foreign investor.⁹ (emphasis added)

The *System of National Accounts*, 2008, authored by European Commission, IMF, OECD, United Nations and the World Bank says:

Direct investment is a category of cross-border investment associated with a resident in one economy (...) having *control* or a *significant degree of influence* on the management of an enterprise (...) that is resident in another economy.¹⁰ (emphasis added)

As can be seen from the above, the expressions influence, some degree of influence, significant degree of influence, effective voice, participation in management and even control have been used to characterise FDI. Similar is the use of lasting/long term interest. 10% voting rights is taken as the proxy for it.

While the 10% threshold is given such an importance, the threshold itself is not free from arbitrariness. For instance, one of the tasks assigned to the Direct Investment Technical Expert Group (DITEG), a joint IMF/OECD expert group set up to make recommendations on the methodology of direct investment statistics for the revision of the IMF Balance of Payments Manual and the OECD Benchmark Definition, was to examine whether this threshold could be raised to 20 per cent. The DITEG recommended the increase in the threshold to 20 per cent in the following manner:

The group endorsed the proposal to move to 20 per cent of voting power or ordinary shares as the threshold for the operational definition for a direct investment relationship, even though it was recognised that changing the current threshold of 10 per cent to 20 per cent would not have a significant impact on the data. *The group found that there were no strong conceptual grounds for choosing 10 or 20 per cent, and so any choice below 50 per cent would be arbitrary.* However, there are *strong practical arguments for supporting the change to 20 per cent threshold*, viz. with regard to accounting standards. International

⁸ OECD, *Benchmark Definition of Foreign Direct Investment*, Fourth Edition 2008, p. 22.

⁹ OECD, *Benchmark Definition of Foreign Direct Investment*, Third Edition, 1996 (reprinted in 1999), p. 8. For a somewhat elaborate discussion on the issue one may refer to K.S. Chalapati Rao and Biswajit Dhar, *India's FDI Inflows: Trends and Concepts*, Joint RIS-ISID Publication, 2011.

¹⁰ *System of National Accounts* 2008, New York, 2009, para 21.34, p. 430.

Accounting Standards (IAS) as well as the accounting standard used by the United States utilize a 20 per cent threshold for financial statements.¹¹ (emphasis added)

As is evident from the above Glossary, the 10% threshold was retained to ensure international comparability. The percentage is prescribed more as a convenient tool rather than definitive indicator of what it was supposed to be representing. The 10%-based definition is neither related to the nature of foreign investor nor does it refer to the characteristics associated with FDI. Thus it fails to convey the nature of influence, the tenure of investment and its developmental impact which are relevant for the caps and CAD, the main contexts in which India's exercises at the demarcation are being conducted. It is obvious that while the concept is clear, the operationalization is fraught with serious ambiguities.

FPI & FDI, the Basic Differences

(i) FPI

Leaving aside round-tripping investments by domestic investors, foreign investors can be visualised as belonging to two broad categories: one, who merely seek return on their investments and the other perceiving the host country operations as integral to their global operations. Both may exercise control/significant influence. The first category essentially comprises a host of financial investors like financial institutions, private equity, venture capital, hedge funds, mutual funds, pension funds, sovereign wealth funds, etc.. Such investments can come via the stock market or through private placement. While meeting the financing requirements of the domestic entrepreneur, the control is likely to be used to protect foreign investors' investments instead of restricting the domestic entrepreneur in other ways. On the other hand, it is unlikely to contribute in terms of technological and managerial expertise which can be obtained *only* from a foreign investor. Thus, on its own, it cannot enhance the abilities of domestic enterprises to earn foreign exchange.

A foreign financial investor investing in an unlisted company may remain invested a little longer than the one investing on the stock market.¹² But neither will be of *lasting* nature. Additionally, even if some foreign private equity investors take full control of a domestic enterprise, it will only be transitory. At best, portfolio investments may be recycled to other Indian enterprises. This will be truer with country/region-specific funds. It needs to be mentioned that private equity/venture capital has often been associated with subsequent loss of control by the original promoters. If the control passes on to another foreign investor at a premium (which often happens) there will be

¹¹ Direct Investment Technical Expert Group (DITEG) "Outcome Paper # 2" (Revised version), September 24, 2004. The DITEG was created in 2004 as a joint IMF/OECD expert group.

¹² Interestingly, RBI also categorises SWFs, multilateral agencies, endowment funds, insurance funds and pension funds as long term investors. FEMA Notification Jan 19, 2013.

double counting of foreign investments with the net inflow being much smaller than the combined inflows.¹³ Interestingly, Hymer, while classifying foreign investments where the investor seeks control to ensure safety of his investments as Type 1 FDI, also acknowledged that the theory of Type 1 direct investment was very similar to the theory of portfolio investment.¹⁴ Obviously in terms of objectives, behaviour and impact the two cannot be distinguished from each other.

(ii) FDI

FDI is primarily categorised into four different types: (i) resource seeking; (ii) market seeking; (iii) efficiency seeking; and (iv) strategic asset seeking. It is easy to see that FDI, irrespective of the percentages, as it is primarily return seeking, does not fall into any of the categories. Investors who invest in their respective lines of businesses are more likely to integrate the domestic operations into their global businesses¹⁵ and depending upon the nature of activity contribute in terms of technology, managerial expertise and foreign exchange earnings through exports, etc. But in order to safeguard their interests, they can constrict the freedom of the domestic partner, if any. Their contribution to earnings of foreign exchange depends upon the motive of investment - market seeking, efficiency seeking, resource seeking, etc. The earnings could however be more than offset by outgo on various accounts. While in the ordinary course, the initial investments will remain for the long term the benefits that CAD expects from them can be momentary or worse still can escalate even in the medium term due to outgo on account of imports, royalty payments, dividends, etc. Thus long term interest of an FDI investor does not automatically guarantee a positive CAD impact. If the shares are issued against import of capital goods or capitalisation of payments for technology, even the initial 'inflows' will be notional. The same holds true for reinvested earnings which, in addition, result in progressively larger payments on account of dividends. If the investment is of displacing nature (M&A), then some of the benefits might not be there even in the short term. Then the question to be asked is whether the FDI was associated with transfer of advanced technology, spill overs and additional export earnings to justify the emphasis on FDI.

¹³ For instance, in case of the takeover of Paras Pharma by Reckitt Benckiser, the gross inflows were \$887 million. However, since Reckitt Benckiser acquired the stakes of foreign private equity investors at a considerable premium, the net inflows turn out to be only \$380 mn.

¹⁴ Stephen Hymer, "On Multinational Corporations and Foreign Direct Investment" in John Dunning (ed.), *The Theory of Transnational Corporations*, UN Library on Transnational Corporations, Volume I, Routledge, 1993, p. 25.

¹⁵ See for instance: John H. Dunning, "Trade, Location of Economic Activity and the Multinational Enterprise: a Search for an Eclectic Approach", in John Dunning (ed.), *The Theory of Transnational Corporations*, UN Library on Transnational Corporations, Volume I, Routledge, 1993, p. 185. UNCTAD too made similar observations when comparing foreign portfolio and direct investments. See: UNCTAD, *World Investment Report*, 1997, Chapter III (Foreign Portfolio Equity Investment).

It is logical to expect that non-financial investors would not invest in other businesses without a strategic intent.¹⁶ Can a foreign retail major be treated as a portfolio investor if he invests 9.99% in multi-brand retail trade while securing certain rights as to sourcing, pricing, distribution, etc. with or without representation on the board? On the other hand, there could be some exceptions. Just as some financial investors might take transitory charge of a non-financial enterprise, some non-financial companies can float financial outfits like venture capital arms. There again the behaviour could be like that of financial investors described above. Such investments are being floated by Indian business groups as well. It might be better to treat them as a special category and examine them case-by-case.

To elaborate further, a Unilever, a Coca-Cola and a Suzuki will not leave the country in the *ordinary course* of business. On the other hand, the same cannot be held true for a Morgan Stanley or a Goldman Sachs investing in non-financial activities, irrespective of the percentage shares held. They will not remain attached to the investee company in the *ordinary course*. Hence their investments cannot automatically be counted as FDI when the share exceeds 10%. The exceptions could be when the investment is made to promote their further operations in the host country like a bank investing in another bank or an NBFC or other financial services enterprise. The essential point is: foreign investors investing in their respective lines of businesses can exhibit the characteristics expected from direct investments. Their characteristics and behaviour does not change with the labels given by us. Definitions and classifications should therefore follow behaviour rather than the other way round.

If these issues are settled, the solution to the problem of whether the caps should include or exclude FII investments would turn out to be less vexing. The crucial questions one should ask in the context of whether or not FII investments should be considered for implementing the caps are: who is investing and towards what end the control is being sought?

Can these Facts be Ignored?

RBI studies of Finances of Foreign Direct Investment Companies, even though they suffer from the problem of following the liberal 10% criterion for classifying companies into FDI and non-FDI ones, have consistently shown that FDI companies have been net losers of foreign exchange – overall as also on trade account. Some recent data are given in Table-1. As can be seen from the Table,

¹⁶ For instance, according to Prowess database of CMIE, for the year ending March 2012, out of the 2,958 companies having investments in equity shares, as much as 93 per cent of the total investment went into the shares of group companies. A closer examination of some large investors suggest that what were termed as non-group companies could in fact be belonging to the promoters and thus share of group companies in equity investments would be even higher. Out of the total investments about two-thirds went into equity shares.

dividend payments increased sharply from Rs. 4,400 crore in 2008-09 to Rs. 11,598 crore in 2010-11. Indeed, the ratio of ordinary dividends to ordinary paid-up capital was not only high, but the ratio increased within this period. Excluding the premium component, if any, it is obvious that the ordinary capital could have been fully repatriated within the three years. For manufacturing and information technology related companies, the repatriation could have far exceeded the ordinary capital. These ratios too rose sharply (See table-2). One, however, needs to follow up these studies to understand the ground realities better, because of classification issues. Yet another feature of the working of 'FDI' companies is that substantial amounts are getting added to the reserves through retained earnings which form the basis for much larger future outgo in the form of dividends.

Table-1: Earnings/ Expenditure in Foreign Currencies of Select 745 Foreign Direct Investment Companies, 2008-09 to 2010-11

Item		(Rs. Cr.)		
		2008-09	2009-10	2010-11
		1	2	3
1	Expenditure in foreign currencies	1,53,795	1,55,389	1,82,334
1a	(a) Imports (on c.i.f. basis)	1,16,493	1,17,245	1,35,867
1b	(b) Other expenditure in foreign currencies	37,302	38,144	46,467
	of which: Dividend	4,400	5,578	11,598
2	Earnings in foreign currencies	1,25,975	1,25,172	1,37,970
2a	of which: Exports (on f.o.b. basis)	78,386	79,023	91,940
	Balance of Trade (2a-1a)	-38,107	-38,222	-43,927
	Net inflow (1-2)	-27,820	-30,217	-44,363

Source: Based on RBI, "Finances of Foreign Direct Investment Companies: 2010-11", Reserve Bank of India Bulletin, December 2012.

Table-2: Select Ratios of Dividends and Retained Earnings of FDI Companies

Industry/Sector	Ordinary dividends to ordinary paid-up capital (%)			Retained earnings to net profits (%)		
	2008-09	2009-10	2010-11	2008-09	2009-10	2010-11
All Companies (745)	29.1	41.0	43.7	75.2	72.2	69.1
Manufacturing Companies (465)	54.3	78.6	79.5	66.6	62.8	61.3
- Food Products & Beverages (34)	83.7	83.3	91.3	57.4	64.6	60.0
- Chemicals & Allied Products (78)	128.6	142.8	175.9	48.0	61.8	57.0
- Rubber & Plastic Products (29)	4.7	9.6	8.7	82.7	82.7	90.7
- Machinery & Machine Tools (66)	43.5	39.8	36.0	69.7	68.0	77.6
- Electrical M/c & Apparatus (32)	47.3	48.7	63.0	84.6	85.3	77.1
- Motor Vehicles & Other Tpt. Equipments (52)	42.4	107.2	105.0	72.3	58.1	62.0
Service Companies (223)	9.8	10.3	13.1	87.1	89.0	83.1
- Computer & Allied Services (81)	43.9	42.5	65.7	78.0	81.8	72.7
- Construction (22)	3.6	3.3	4.7	95.1	95.8	91.1
- Wholesale and Retail Trade (24)	10.0	11.9	11.6	83.3	91.7	82.0
- Transport Storage & Communications (23)	3.6	3.2	3.3	94.1	95.6	94.2

Figures in brackets indicate the number of companies studied. All companies include manufacturing, service and other companies.

Source: See Table-1.

Though it might appear to be a bit of digression, the dividend behaviour of FDI companies makes one look at the BoP data a little closely. On the other hand, the pressing problem being how to address the CAD and it is planned to be met by attracting more foreign investments, examination of other aspects which could be contributing to CAD makes such a digression not wholly inappropriate. In the context of large CAD, the discussion is generally focused on import of crude oil and gold. But there are certain other items of invisibles in the current account, of which dividend payment is only one item, that call for attention. Of late there has been a recognition that royalty payments are increasing fast and relative to FDI inflows these are turning out to be more and more significant. These increased from \$ 0.7 bn. in 2004-05 to \$3.2 bn. in 2011-12 (See table-3).¹⁷ Substantial increase in payments is also recorded in case of architectural and engineering services and for maintenance of offices abroad and business travel. Even more importantly, payments under the broad head 'Business, Management consultancy and public relations services' increased the maximum: from about \$1.2 bn. to more than \$10.2 bn. While not all of these payments would be related to inward foreign investments, the galloping outflows need to be examined carefully for possible leakages and undesirable transfers, especially in the name of outward FDI.

Table-3: Select Items of Invisible Payments of India's Balance of Payments

Year	(\$ mn.)						
	Dividends and profits	Reinvested earnings	Royalty, copyright and license fees	Architectural, engineering and other technical services	Business, management consultancy and public relations services	Remittances for maintenance of offices abroad	Business Travel
2004-05	1,991	1,904	712	1,111	1,279	2,618	3,222
2005-06	2,502	2,760	594	1,414	1,806	2,074	3,452
2006-07	3,486	5,828	1,030	3,025	3,486	4,032	2,822
2007-08 R	3,226	7,680	1,037	3,091	3,422	3,555	3,296
2008-09 PR	3,171	6,426	1,722	3,130	3,530	3,387	1,908
2009-10 R	3,810	8,668	2,017	4,252	5,376	3,573	3,569
2010-11 PR	4,681	13,102	2,424	5,127	10,613	6,072	4,978
2011-12 P	4,861	8,204	3,208	4,871	10,224	5,066	7,297

P: Provisional; R: Revised; PR: Partially Revised.

Sources: (i) *Reserve Bank of India Bulletin*, March 2010 for 2004-05 to 2008-09.

(ii) *Reserve Bank of India Bulletin*, August 2012 for 2009-10, 2010-11 and 2011-12.

¹⁷ The relative tax advantage enjoyed by royalty payments over dividends was said to be one of the reasons in the spurt of payments for royalty. There is also a feeling that the payments are unrelated to the extent of transfer of technology and some of them are even for use of brand names and trademarks. Should foreign subsidiaries be allowed to pay for use of brand names of parent companies which are in the normal course of promoting their *own business*. (See: "Government may reimpose curbs on royalty payments to foreigners", http://articles.economictimes.indiatimes.com/2013-08-08/news/41202236_1_royalty-account-deficit-dipp)

One could even make a case for levying a tax for using international brand names which give them an advantage over domestic players.

Relevance of Exon-Florio Process from National Security Angle¹⁸

While for statistical purposes USA also follows the 10% or more of voting power criterion, for scrutinising foreign takeovers under the Exon-Florio process the country applies the test of control. While there is no statutory definition of control, the US Treasury regulations define 'control' not as a 'numerical benchmark' but base it on its functional aspects. According to these regulations:

The term control means the power, direct or indirect, whether or not exercised, and whether or not exercised or exercisable through the ownership of a majority or a dominant minority of the total outstanding voting securities of an issuer, or by proxy voting, contractual arrangements or other means, to determine, direct or decide matters affecting an entity; in particular, but without limitation, to determine, direct, take, reach or cause decisions regarding [a number of functional aspects like principal assets of the entity, reorganisation, merger, dissolution, major investments and capital raising, new business lines and ventures, proprietary information, appointment of senior managers, etc.]¹⁹

Transactions which are not subjected to review include:

A purchase of voting securities or comparable interests "solely for the purpose of investment," or an investment in which the foreign investor has "no intention of determining or directing the basic business decisions of the issuer".

In addition, investments that are solely for investment purposes are defined as those:

- 1) in which the transaction does not involve owning more than 10% of the voting securities of the firm;

or

- 2) those investments that are undertaken directly by a bank, trust company, insurance company, investment company, pension fund, employee benefit plan, mutual fund, finance company, or brokerage company "in the ordinary course of business for its own account."²⁰

While we have reservations regarding the first category of exempted investments, in the light of the foregoing discussion they can be exempted only if they are not associated with various powers such as those listed in the above long quote. USA probably uses it as a precautionary threshold. The second category of exemptions is for financial investments. What India should do is to similarly apply context-specific criteria rather than using the international thumb rule. There could definitely be a conflict when reporting for international data purposes. But that requirement should not be allowed to cloud domestic policy-making. Control for SEBI takeover regulations need not be the same for investments in a media company.

¹⁸ James K. Jackson , "The Exon-Florio National Security Test for Foreign Investment", Congressional Research Service, March 29, 2013, accessed at http://assets.opencrs.com/rpts/RL33312_20130329.pdf

¹⁹ *ibid.*

²⁰ *ibid.*

While sectoral and national issues are the focus of foreign investment policy, both SEBI and the Companies Act are primarily concerned with investor protection. In fact, in 2011 SEBI raised the trigger point for takeover from 15% to 25% which is far higher than 10%. Thus a uniform approach to control across different regulatory institutions may not be appropriate.

Following Press Note 2 of 2009, for measuring indirect foreign equity, further investments by companies with 49% foreign equity and controlled by Indians are treated as domestic investment. Compared to the earlier proportionate method, this is definitely a better way of looking at FDI from the point of caps as caps are meant to restrict foreign influence/control rather than the economic benefit that is derived by the foreign investor. However, it is debatable if any foreign investor contributing up to 49% risk capital would be content to remain a sleeping partner. In fact, the Discussion Paper on FDI Caps “implicitly recognises that foreign equity, up to 49%, is purely a source of funding, as long as ‘control’ is not yielded to non-resident investors/entities”.²¹ It would also be unrealistic to expect that the foreign investor would not be interested in securing his technology and reputation besides maximising his overall gains. On the other hand, the Indian partner would go for an FDI relationship, mainly to derive substantial advantages in terms of technology, goodwill, etc. apart from obtaining stable risk capital. This is likely to place him at a disadvantage in negotiating with the foreign partner and thus he is more likely to concede control over operations and strategy to the foreign investor. The subordinate relationship would be covered up only to meet the official policy on FDI which places limits on foreign participation.²²

Therefore, in the interest of achieving the objectives for which the caps are primarily meant, there should be better vigilance and scrutiny. No doubt there is now a better understanding of the ground realities as is evident from the scrutiny of Jet-Etihad deal. Press Note 4 of 2013 also demonstrates such an understanding of how control operates when it says “‘Control’ shall include the right to appoint a majority of the directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreements or voting rights”. It is interesting to note that the shareholding of Mr. Naresh Goyal and companies controlled by him from abroad will not be treated as FDI. Otherwise, there would not be any scope for FDI in Jet Airways as the FDI limit is set at 49%. The DIPP is reported to have extended the special dispensation for NRI investments in the civil aviation sector also to

²¹ DIPP, “FDI Policy-Rationale and Relevance of Caps”, June 2011. http://dipp.nic.in/English/Discuss_paper/DiscussionPaper_relevance_23June2011.pdf.

²² OECD also implies the practice when it recommends that “Such supplemental statistics [about cases in which a qualitative assessment has been made that effective control has been achieved through a minority stake in an enterprise] may be particularly relevant where majority ownership by non-resident investors is restricted”. See: OECD, *Benchmark Definition of Foreign Direct Investment: Fourth Edition 2008*, 2009, para 402, p. 128.

joint ventures.²³ In spite of adopting a more realistic definition of control, there is still the possibility of right to appoint majority directors may be given undue weightage. The case of Cedar Support Services Ltd in which Walmart acquired the right to appoint directors as also managed to neutralise the numerical majority of the Indian promoter in the board without holding even a single equity share and that of Axa which secured joint control with just 10% share in equity illustrate ground realities and consequent challenges the administrators might have to face.²⁴

Interference by foreign investors cannot be ruled out especially when they hold 49% share. The policy makers' job is to see to what level and type of interference by them could be tolerated. The type of influence exercised by a foreign portfolio investor to safeguard his return on investment may be more tolerable than that by an investor belonging to the same line of activity which is likely to affect core business decisions. For instance, in the retail sector can one equate Warburg Pincus and Franklin Templeton with a Walmart or Tesco, irrespective of the extent of shareholding? Interestingly, even while the government is struggling with the retail FDI policy, already foreign portfolio investors have invested in some of India's retailers: Future Retail (24.89%); Trent (15.61%); Rei Six Ten Retail (10.02%); Shoppers Stop (9.14%); and Bombay Swadeshi Store (8.77%).²⁵ Product mix, markets to be served, sourcing of materials, technology choices/development, etc. in case of a manufacturing company; core banking operations in case of a banking company; editorial policy in case of a media company, etc. should be outside the purview of the foreign investor. The real issue, however, is can one find such FDI investors especially when they are expected to hold 49% equity? Then there is also the category of financial investors sponsored by states called Sovereign Wealth Funds (SWFs). One may not like to give any role to such investors in defence, mass media, advanced research-based enterprises and strategic fields.

Will FDI Inflows Increase Manifold?

It should be underlined that India cannot attract lot more FDI by just chipping away the last remaining restrictions which in any way are applicable to a limited number of sectors or by strictly adopting the international definition. One

²³ "Jet-Etihad deal: Goyal's stake not to be treated as FDI", <http://www.thehindubusinessline.com/industry-and-economy/logistics/jetetihad-deal-goyals-stake-not-to-be-treated-as-fdi/article4941864.ece>

²⁴ See: K.S. Chalapati Rao and Biswajit Dhar, "Vaulting over India's retail FDI Policy Wall", *Economic and Political Weekly*, November 17, 2012, pp. 10-13 and K.S. Chalapati Rao and Biswajit Dhar, "Foreign Direct Investment Caps in India and Corporate Control Mechanisms", *Economic and Political Weekly*, April 02, 2011, pp. 66-70.

²⁵ The shares in brackets are those held by FII's at the end of June 2013. Interestingly, both RBI and the Ministry of Finance are reported to be seeking clarification on portfolio investments in retail companies consequent to Future Retail's representation to the Finance Minister for increasing the FII limit from 24 to 49%. See: "Multi-Brand Retail: RBI, Finmin seek clarity on portfolio investments", http://articles.economicstimes.indiatimes.com/2013-09-11/news/41971899_1_multi-brand-retail-investment-limit-foreign-retailers.

needs to keep the global trends in sight. There has been a significant decline in the overall FDI outflows since 2007. At another level, aggregate global FDI flows are misleading. A significant portion of it comprises reinvested earnings which are not actually cross-border flows. Secondly, outward FDI investments by fellow developing countries (including China) have gained in importance. But these could have different motives and qualities. The following figures help understand the developments better.

- Between 2007 and 2012 global FDI outflows declined from \$2,272 bn. to \$1,391 bn. Outflows from developed countries fell even sharply: from \$1,890 bn. to \$909 bn. *i.e.*, by more than 50%. On the other hand, outflows from developed and transition economies increased: from \$382 bn. to \$482 bn. *i.e.*, by 26%.
- Between 2000 and 2012 there has been a steady decline in the share of developed economies in the global FDI outflows: from 88% to 65%. Correspondingly, the share of developing and transition economies rose from 12% to 35%. China's share including that of Hong Kong was almost two-fifths of the outflows from the developing countries. The share of developed countries declined sharply between 2007 and 2012: from 83% to 65%.
- For 37 selected developed economies, the share of reinvested earnings in outflows doubled from 30% to 61% during between 2007 and 2012. For United States the figures are even more startling: from 53.5% to 84.8%. In fact, equity outflows from US actually fell from \$201 billion to \$35 billion during the same period. During 2005 to 2011, the average share of reinvested earnings in FDI inflows varied for different groups of countries: developed (17%), developing (36%) and transition economies (32%).²⁶

Since India looks for FDI from developed countries, it is obvious that the scope for attracting large inflows is quite limited.

India's thrust for OFDI coupled with lack of analytical scrutiny of the character of FDI and its contribution to the economy in general and to the current account in particular, one could even suspect that the bogey of CAD might be a ruse to move towards full convertibility and in the process FDI policy became a major casualty. It seems that every crisis offered an opportunity to further relax the policy. Relaxations may increase the scope but equally important is the understanding of the global situation.

Quo Vadis QFI?

Every 'reform' on the external front is accompanied by the expectations of attracting large inflows. For instance, not so long ago, a lot was expected from the QFIs. Last year the investment banks told that India could get \$80-90 bn. in the next two years through this route. The minimum that India should expect was \$25 bn.²⁷ It ultimately turned out to be a damp squib. In spite of subsequent relaxations, what one could show is a total investment in Indian corporate debt of Rs. 163.70 crore as

²⁶ Based on data reported by UNCTAD and US Bureau of Economic Analysis.

²⁷ "Govt roadshows overseas to sell India to QFIs", *Financial Express*, June 8, 2012.

on April 13, 2013 against the limit of Rs. 2,44,000 cr. (\$51 bn.). In equity instruments it was a little better at Rs. 730.77 crore. But as much as Rs. 697.18 crore of it was accounted for by just two companies: Shriram Transport Finance Co. Ltd (STFC) (Rs. 669.13 cr.) and Claris Lifesciences Ltd (Rs. 28.05 cr.).²⁸ In fact, South Africa's Sanlam Insurance's investment in STFC was reported to be the single largest QFI investment in India. Incidentally, Sanlam, besides being the joint venture partner of the Shriram group in insurance business, also invested in other companies of the financial services group. The investment in STFC is thus more akin to FDI than QFI. Incidentally, two of Sanlam's arms have since been registered as FIIs with SEBI.²⁹ Sanlam acquired the stake in STFC, along with others, from the American private equity firm TPG. TPG in the process made a six-fold gain in seven years.³⁰ As far as India is concerned one foreign investor replaced another foreign investor and there is little addition to the stock of foreign investment. Indian policymakers have obviously been led up the garden path by the international financial community. With the on-going efforts to define FPI in which QFI would be merged, the failed QFI experiment will soon be forgotten.

What Role for DIPP?

The Department of Industrial Policy and Promotion (DIPP) in its website claims that its role and functions include "Formulation of Foreign Direct Investment (FDI) Policy and promotion, approval and facilitation of FDI". This role was also noted by the Supreme Court when deciding on the PIL filed in the context of permitting FDI in India's multi-brand retail trade. Events, however, raise many questions about DIPP's actual role and its position vis-à-vis the Ministry of Finance. During the NDA regime, the Foreign Investment Promotion Board was taken away so suddenly in 2003 from the Ministry of Industry and was transferred to the Ministry of Finance that even the secretary concerned was reported to be unaware of it. Now when FDI was to be defined it is again the Ministry of Finance which had the upper hand in the Committee for Rationalizing the Definition of FDI and FII. Apparently serious objections were raised by the DIPP regarding the adoption of the 10% thumb rule. The reported objections are:

- a percentage definition does not take note of the qualitative aspect of more stable nature of FDI;
- change in definition would create complications as the current policy is bound in a number of bilateral and multilateral agreements; and
- the OECD Benchmark definition is not followed even by all the OECD member countries.

²⁸ <https://www.cdslindia.com/qfi/qfi.html>

²⁹ These are: Sanlam Asset Management (Ireland) Ltd (March 13, 2013) and Sanlam Life & Pensions UK Ltd. (April 26, 2013).

³⁰ "TPG sells 10% stake in Shriram Transport, South African financial services group Sanlam buys 3.7% for Rs. 650 crore as buyout firm makes six-fold gains in seven years", *Economic Times*, February 22, 2013.

A DIPP official was reported to have said that “we need to sit down and decide if there could be an alternative to the percentage thresholds”.³¹ Given the tendency of the officials to follow the line of their respective ministers, it is quite likely that the Committee would have opted for the 10% thumb rule proposed by the Finance Minister. The Committee’s recommendations were reported have formed the basis for the recent relaxations of FDI caps. The Committee’s report, however, has not been made public so far. Recent reports even suggest that the report is still under preparation.³² On its part the PMO was reported to have ignored the concerns expressed by DIPP in allowing Mylan to takeover Agila Specialities of Strides Arcolab.³³ It is the Finance Minister who had underlined that foreign investment is imperative and at best we may try to attract FDI that is in national interest. But there is hardly any internal body which assesses the efficacy of FDI. Interestingly, the Parliamentary Standing Committee on Industry while asking for validation of the figures given out by an institute on which the government relied to open up multi-brand retail trade to FDI noted that

The Committee finds this arrangement rather strange where Government commissions a study with an independent research body which in turn depends on another non-Government source for data and estimates. The Government should ascertain the methodology of study and validate the estimates and figures, before taking such a major policy decision on the basis of this study.

....

The Committee takes cognizance of several studies done by industry bodies and refers to study note provided by the DIPP, in support of prospective benefits which FDI in multi-brand retail may bring. However, the Committee suggests that the Ministries of MS&ME and DIPP should have done a study on impact of FDI in single brand retail and wholesale sectors in the MSME segment and the same could have been factored into the recent policy.³⁴

These further raise questions about the way FDI policy evolves in India and the role of bodies designated for the purpose.

By Way of Summing Up

Mere labelling of an investment as FDI based on the 10% criterion will not serve the purpose either in the medium or long term. Just because an investment has been defined the basic characteristics are not going to change. Nor do FDI floods in by adopting the international definition. FPI and FDI investors have their distinctive characteristics and roles they can play. When the pressing need is to distinguish among the FDI investors themselves, by clubbing FDI and FPI through the adoption

³¹ “Finmin versus DIPP over FDI Definition: Reforms get stuck in FDI versus FII fight”, *Economic Times*, May 8, 2013.

³² “FinMin to define FDI in line with global benchmarks”, *Indian Express*, September 23, 2013.

³³ “PM Vetoes DIPP, Health Min to Clear the Way for Pharma FDI”, *Economic Times*, August 17, 2013.

³⁴ Rajya Sabha, Department-Related Parliamentary Standing Committee on Industry, *Two Hundred and Fiftieth Report, on Impact of Foreign Direct Investment (FDI) in Multi-Brand Retail on MSME Sector Pertaining to the Ministry of Micro, Small and Medium Enterprises*, July 2013.

of some thumb rule, just because it is internationally accepted, one is likely to lose track of the real story. India's approach towards foreign investments is unlikely to bail her out of the CAD problem, the single-most determining factor now. India's reported FDI inflows, dominated as they are by non-manufacturing activities, do not, in general, directly contribute to export earnings while placing demands on outflows in terms of capital appreciation, dividends, etc. By relying more and more on external capital which does not generate substantial surpluses on current account, one is not only postponing the problem but is actually exacerbating it. International definitions are not gospel truths and thus are not incontrovertible. Understanding the distinctions between FDI and FPI instead of going by an arbitrary percentage which was retained to maintain international comparison would help in being better prepared for the future. Neither share, nor control or influence, what really matters is nature of the foreign investor. Policymakers may find it convenient to take the easy 10% criterion. But as Cohen said, the time has come to "avoid simplicity and embrace complexity".³⁵

³⁵ Stephen D. Cohen, *Multinational Corporations and Foreign Direct Investment: Avoiding Simplicity, Embracing Complexity*, Oxford University Press, 2007.