DISCUSSION PAPER

FDI POLICY-RATIONALE AND RELEVANCE OF CAPS

Invitation of Views

1. As part of its inclusive approach to the formulation of various policies, this Department has been engaging in prior public consultations on important issues on which policy reform is contemplated. These structured discussions are triggered by the publication of Discussion Papers (DPs) outlining such issues. The Department has, so far, published eight discussion papers, of which five have a direct nexus with FDI policy. Of these five, policy action has been completed in respect of three DPs and is ongoing in respect of two DPs.

2. This is the ninth Discussion Paper in the consultation series. Views and suggestions are specifically invited on Section VIII of the paper entitled *'Issues for Consideration'* and any related issues **by 15th July, 2011**. The objective is to examine whether some elements of FDI policy need to be reviewed. It is requested that facts, figures and empirical evidence may be furnished, in the context of the specific observations/suggestions made.

3. The views expressed in this discussion paper should not be construed as the views of the Government of India. The Department hopes to generate informed discussion on the subject, so as to enable the Government to take an appropriate policy decision at the appropriate time.

I. EVOLUTION OF FDI POLICY IN INDIA

4. The evolution of FDI policy in India has broadly gone through four phases[1].

5. The *first phase*, between 1948 and 1969, was characterised by a cautious welcome to foreign investment, as outlined in the Industrial Policy Statement of 1948, which observed that the '*participation of foreign capital and enterprise will be of value to the rapid industrialisation of the country*.' It, however, noted that '*the conditions under which it may participate be carefully regulated in the national interest. As a rule, majority interest in the ownership and effective control should always be in Indian hands*.' During this phase, foreign firms were encouraged to invest in protected industries, such as fertilisers and machine tools and extensive concessions and tax advantages were offered to attract multinational oil companies.

6. The *second phase*, between 1969 and 1991, was marked by the coming into force of the Monopolies and Restrictive Trade Practices Commission (MRTP) in 1969, which imposed restrictions on the size of operations, pricing of products and services of foreign companies. The Foreign Exchange Regulation Act (FERA), enacted in 1973, limited the extent of foreign equity to 40%, though this limit could be raised to 74% for technology-intensive, export-intensive, and core-sector industries. A selective licensing regime was instituted for technology transfer and royalty payments and applicants were subjected to export obligations. The year 1977 witnessed a reversal of the policy, when Coca Cola was asked to move out of the country.

7. The *third phase*, between 1991 and 2000, witnessed the liberalisation of the FDI policy, as part of the Government's economic reforms program. Under the *'Statement on Industrial Policy'* (July, 1991), FDI was allowed on the automatic route, up to 51%, in 35 high priority industries. Foreign technical collaboration was also placed under the automatic route, subject to specified limits. A dividend-balancing condition was imposed for all sectors. This was later restricted to 22 notified consumer items *(Press Note 12 of 1992).* In 1996, the automatic approval route for FDI was expanded, from 35 to 111 industries, under four distinct categories (**Part A**–*up to 50%,* **Part B**–*up to 51%,* **Part C**–*up*

[1] See for example : *'India-China : A comparative analysis of FDI Policy and Performance'* by Ashok Kundra; Academic Foundation, 2009 and *'Foreign Direct Investment: Contemporary Issues'* by Usha Bhati; Deep and Deep Publications, 2006

to 74%, and **Part D**-*up to 100%).* Press Note 18 of 1998 limited the scope of foreign companies starting new joint-ventures, using the same technology as an existing JV. A Foreign Investment Promotion Board (FIPB) was constituted to consider cases under the government route.

8. The *fourth phase* of FDI policy, between 2000 till date, has reflected the increasing globalisation of the Indian economy. In the year 2000, a paradigm shift occurred, wherein, except for a negative list, all the remaining activities were placed under the automatic route *(Press Note 2 of 2000).* The dividend-balancing condition was removed *(Press Note 7 of 2000).* Caps were gradually raised in a number of sectors/activities. The NBFC Sector was placed on the automatic route *(Press Note 2 of 2001).* The insurance and defence sectors were opened up to a cap of 26% *(Press Notes 10 of 2000, 4 of 2001 and 2 of 2002*). The cap for telecom services was increased from 49% to 74% *(Press Note 5 of 2005).* FDI was allowed up to 51% in single brand retail *(Press Note 3 of 2006).* In the year 2009, the next significant shift took place, with the differentiation between *'ownership'* and *'control'*, for the purpose of calculating the total foreign investment-direct and indirect-in an Indian company *(Press Note 2 of 2009).* Indian companies having FDI, owned and controlled by Indian residents were allowed downstream investments without government approval (*Press Notes 2 and 4 of 2009).* Limits on payment of royalty were removed *(Press Note 8 of 2009).*

9. The year 2010 saw the continuation of the rationalisation process. All existing regulations on FDI were consolidated into a single document for ease of reference *(Circular 1 of 2010).* Downstream investment through internal accruals was specifically permitted *(Circular 2 of 2010).* Circular 1 of 2011 allowed issue of shares against non-cash considerations (*in respect of import of capital goods/ machinery/ equipment and pre-operative/ pre-incorporation expenses)* and also provided flexibility in fixing pricing of convertible instruments through a formula, rather than upfront fixation. The requirement of Government approval for establishment of new joint ventures in the *'same field'* was also done away with. As a result, non-resident companies were allowed to have 100% owned subsidiaries in India. Government has since allowed FDI, in Limited Liability Partnerships *(Press Note 1 of 2011).*

10. The evolution of the FDI policy, towards more rationalisation and liberalisation, has narrowed down the instruments regulating FDI policy broadly to three:

(i) ***Equity caps:*** *restricting foreign ownership of equity capital*

(ii) ***Entry route:*** *requiring prior Government oversight, including screening and approval*

(iii) ***Conditionalities:*** *comprising of operational restrictions/licencing conditions*, such as nationality criteria, minimum-capitalisation and lock-in period etc.

11. In respect of **equity caps**, the first three historical phases described in paragraphs 5 to 7 above, adopted a *'positive listing'* for sectors eligible for FDI, implying that sectors in which FDI was permitted were listed, with the caps/entry routes/related conditionalities being specified. FDI was not permitted in any sector, other than those specified. The *'positive list'* was gradually expanded, till in the year 2000, a broad approach of *'negative-listing'* was adopted. This implied that only those sectors, which were restricted to FDI, were listed. FDI, up to 100%, under the automatic route was permitted in all sectors not explicitly mentioned in the list. The present specification of sectors/activities is still largely a *'negative list'* but it retains some elements of *'positive listing'* (e.g. FDI in NBFCs is restricted only to eighteen listed activities).

12. **'Entry route'** essentially relates to whether FDI can be brought in through the *'automatic route'* or through the *'Government route'*- i.e. whether prior Government approval is required for its induction. The list of activities and investments permitted under the automatic route, have been significant expanded in the fourth phase.

13. **'Conditionalities'** refer to the sectoral conditions that must be fulfilled. Such conditions are prescribed for sectors like insurance, telecom, NBFC, construction-development etc. In the construction-development sector, for example, the conditionalities prescribed *inter-alia* include a lock-in period on FDI, minimum investment and minimum built-up area to be developed.

II. RATIONALE OF EQUITY CAPS

14. The FDI equity caps in a sector essentially reflect the levels of control that a foreign direct Investor is permitted to exercise in a company operating within that sector. The FDI policy incorporates equity caps at broadly four levels- 26%, 49%, 51% and 74%[2]. These caps reflect the ownership/ control levels in a company, under the Companies Act, 1956. Thus, for example, any equity holding greater than 25% gives a right to block a 'special resolution'. 49% equity represents a level just short of ownership. 51% signifies ownership and a right to pass all ordinary resolutions. 74% equity cap on FDI means that the Indian equity holders, acting in unison, can block a special resolution.

III.FDI INFLOWS: 2000-2010

15. **Annexure 'A'** shows FDI inflows into 11 countries (including India) calendar-year wise, between 2000 and 2010. The total FDI flows into India have increased dramatically over the last ten years, from US $ 3.6 billion in the year 2000, to a peak of US $ 40.4 billion in the year 2008, despite the global recession. Countries like China, Russia and Turkey have witnessed similar growth. When compared to calendar year 2009, FDI during the calendar year 2010 grew by 6.3% in China, 2.6% in Russian Federation, 161.2% in Indonesia, 400% in Malaysia, 122.6 % in Singapore, 15.3% in Thailand, 16.6% in Brazil and 12.1% in Republic of Korea. Though the FDI base is small for some of these countries, the positive direction of growth is unambiguous. India, however, is the only major country in South Asia where FDI inflows have fallen during 2010. Why this has happened is the question that needs to be addressed[3].

16. A recent study[4] on the determinants of FDI has pointed to the strong correlation of secondary sector FDI with labour market flexibility, financial depth and infrastructure quality in developing countries. **Annexure 'B'** summarises the results of this study. The investment policy, fiscal and other

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[2] *Terrestrial/FM broadcasting constitutes an exception to this general principle, where the cap is 20%.There is a proposal to increase the same to 26%.*

[3] *During 2010, FDI has fallen in South Africa and Turkey.*

[4] *Determinants of Foreign Direct Investment: A Sectoral and Institutional Approach' by James P. Walsh and Jiangyan Yu; IMF Working Paper 10/187; July, 2010*

incentives, as well as the business and political environment in the host country are also identified as determinants of FDI. While these reasons could hold true in the Indian context as well, this Discussion Paper examines the policy relating to *'ownership and control'* and the relevance/role of the caps.

IV. REVISED DEFINITIONS OF 'OWNERSHIP' AND 'CONTROL'- IMPLICATION ON DOWNSTREAM INVESTMENTS

17. In February, 2009, Government issued Press Notes 2, 3 and 4. These instructions are now incorporated in Paragraphs 4.1, 4.2.2 and 4.6 of "*Circular 1 of 2011 – Consolidated FDI Policy"* respectively. In these policy amendments, Government has made a distinction, for the first time, between *'ownership'* and *'control'*. It is felt that, under FDI policy, while 'ownership' and 'control' could be interrelated, they need not be identical. Both need to be looked at separately to assess the extent of domestic/foreign 'influence' in a company. This distinction is relevant in the specific context of downstream investments made by Indian companies. As per the guidelines, the downstream investment of entities owned and controlled by resident Indian citizens shall not be counted as indirect FDI. This is a major deviation from the earlier method of calculation on proportionate basis. The change recognises the fact that FDI equity caps are structured along the premise of 'control' and that a 'proportionate' methodology, though less complex, is inadequate to accurately reflect the extent of control exercisable by foreign investors in an Indian company.

18. As a result, the downstream investment of a company, in which more than 50% of the beneficial equity, as well as the right to appoint the majority of the Board of Directors, are with resident Indian citizens, would be treated as domestic investment. As a corollary to this, these downstream companies are permitted to carry out activities in any sector, as long as they do not have any direct FDI. This effectively opens all sectors to 49% FDI indirectly, raising a question mark on the relevance of sectoral caps in FDI. It is logical to argue that *'what can be done indirectly, should as well be allowed to be done directly'*. Therefore, there is a clear case of abolishing all caps below 49%. In fact, through an inverted pyramid structure of downstream investments, the level of indirect FDI can be even more than 49%. What, therefore, becomes important is not the percentage of beneficial equity but the level of control in a company. Control, perhaps, can be better exercised by having sectoral regulations in sensitive sectors.

19. While, on the one hand, a foreign investor can easily breach the cap by a combination of direct and downstream investments, the caps also provide an opportunity for arbitrage to unscrupulous Indian partners, which certainly has a cost for the consumer and comes in the way of the country deriving optimal benefit of the FDI. This point has been very succinctly brought out by editorials in two leading business papers of India in April, 2011 **(Annexure 'C').**

20. The erstwhile proportionate method of calculation of FDI in downstream companies had its own anomalies. As per this method, no Indian company, having any FDI, howsoever insignificant, could either operate or make any downstream investment in a company operating in a prohibited sector. This stipulation was practically being violated by a large number of Indian companies, especially those who had accessed ADRs/GDRs/FII investments.

V. EQUITY AS A SOURCE OF FUNDING:

21. There is a need for Indian industry to be able to complement and supplement its available pool of domestic funds, through access to external funding. Access to external funding in the form of equity could also enable Indian industry to attract high-end technology and draw from managerial best practices globally. The revised methodology for calculation of aggregate foreign investment accords additional space to Indian corporates for meeting their funding requirements. As long as the ownership and control of an Indian company vests ultimately with resident Indian citizens, it is free to make downstream investments that would have no *'foreign'* component in them. The methodology, therefore, 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. As such, a number of Indian companies, including those operating in the prohibited sectors, can now supplement their funding requirements through FDI, apart from accessing FCCB/ADR/GDR, so long as they retain Indian ownership and control.

VI. RELEVANCE OF EQUITY CAPS

22. A clear distinction, therefore, now exists between 'controlling'/ 'strategic' interest and 'economic' interest. It is, accordingly, possible for a foreign investor to increase the levels of his economic interest in an Indian company, through a series of cascading/ multi-layered structures, as long as control and ownership vest with resident Indian citizens at each level. It could also be argued that, in the context of foreign investment, it may not be the 'colour' of

the money that is important but rather the context/circumstances within which it is permitted to function. As such, it needs to be considered whether it may be appropriate to lay more emphasis on sectoral regulatory conditions, as against equity caps. Such sectoral guidelines could *inter-alia* include conditions relating to appointment of resident Indian citizens on the Boards of Management/top level managerial positions. Sectors like defence manufacturing, telecommunication services, private security services etc. can have different suitable sector-specific conditions. Sector-specific conditions would cater to specific needs of a sector, keeping in view the strategic interest of the country. For example, if there is an apprehension that a particular acquisition through FDI is designed to kill competition or affect the capacity of the country to produce life-saving generic drugs, the Departments of Health & Family Welfare/ Pharmaceuticals can ask for certain commitments before permitting the acquisition. Such an approach would directly and explicitly secure an objective in a much better manner than caps.

23. With multinational companies getting listed on several stock exchanges, ownership is getting diversified. The requirements of listing agreements and the adoption of international financial & accounting standards have made companies increasingly accountable to general shareholders. As a result, ownership, control and management are emerging as distinct domains. Capital is, in fact, losing its nationality and managements are getting more professionalised. While we must strive to make Indian companies global, we must encourage MNCs to develop a long-term association with India. This can be achieved if they set up their core business in India, get listed on Indian stock-exchanges and also source their higher management positions from India. This will be the fastest way of making India a global manufacturing and financial hub and would further strengthen our presence in the services sector.

24. If the caps are at all felt necessary in a particular sector, the option of asking MNCs to list on Indian stock exchanges and offloading equity within a stipulated period could be explored. This would not only bring transparency in the system but would also reduce the scope for arbitrage by the Indian partner.

VII.COMPOSITE vs. SEPARATE CAPS

25. Another area where there is some lack of clarity is whether the caps specified are in respect of FDI alone, or whether they include both-FDI and FII.

This confusion arises because of differential treatment accorded to different sectors. For example, in respect of asset reconstruction companies; banks; commodity exchanges; credit information companies; infrastructure companies in securities markets; insurance companies; companies in the information and broadcasting (including those in the print media) and telecommunications sectors, it is specified that the equity caps include both FDI and FII investments. In other sectors, it has been specified that the equity caps are specifically for only FDI. The Lahiri Committee[5], which had examined this issue, had suggested that, *'in general, FII investment ceilings, if any, may be reckoned over and above prescribed FDI sectoral caps'*. It may be desirable to have a common approach on this issue for all sectors. In the case of the insurance sector, the legal position will, however, need to be kept in view.

VIII. ISSUES FOR CONSIDERATION

26. The following issues are for consideration in the context of the above:

1. *Do equity caps fulfil any purpose other than 'control'?*
2. *In the context of FDI Policy, should those activities that can now be done indirectly, through downstream investments, as well be allowed to be done directly?*
3. *If so, is there any relevance left for equity caps, especially below 49%?*
4. *Can the concerns supposed to be addressed by control through equity caps be addressed through sectoral conditions?*
5. *Do the caps create an unfair opportunity for arbitrage?*
6. *If at all it is necessary to have caps in certain sectors, is it a better option to ask MNCs to list on Indian stock exchanges and then offload equity within a stipulated period?*
7. *As long as sectoral caps exist, should it be specified that they are exclusive of FII?*

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5 *'Report of the Committee on Liberalisation of Foreign Institutional Investment'; Government of India, Ministry of Finance, Department of Economic Affairs (June, 2004)*

ANNEXURE A

FDI INFLOWS INTO ECONOMIES

(Amount in US $ billion)

YEAR	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	% change over 2009
ECONOMY												
India	3.6	5.5	5.6	4.3	5.8	7.6	20.3	25.0	40.4	34.6	23.7	-31.5
China	40.7	46.9	52.7	53.5	60.6	72.4	72.7	83.5	108.3	95.0	101.0	6.3
Russian Federation	2.7	2.7	3.5	8.0	15.4	12.9	29.7	55.1	75.5	38.7	39.7	2.6
Malaysia	3.8	0.6	3.2	2.5	4.6	4.1	6.1	8.5	7.3	1.4	7	400
Singapore	16.5	15.1	6.4	11.9	21.0	15.5	29.1	35.8	10.9	16.8	37.4	122.6
Thailand	3.4	5.1	3.4	5.2	5.9	8.1	9.5	11.4	8.5	5.9	6.8	15.3
Indonesia	--	--	--	-0.5	1.9	8.3	4.9	6.9	9.3	4.9	12.8	161.2
Brazil	32.8	22.5	16.6	10.1	18.1	15.1	18.8	34.6	45.1	25.9	30.2	16.6
South Africa	0.9	6.8	1.6	0.7	0.8	6.6	-0.5	5.7	9.0	5.7	1.3	-77.2
Turkey	1.0	3.4	1.1	1.7	2.8	10.0	20.2	22.0	18.1	7.6	7.0	-7.9
Korea, Republic of	9.0	4.1	3.4	4.4	9.0	7.1	4.9	2.6	8.4	5.8	NA	12.1**

Source: *UNCTAD Data and UNCTAD Global Investment Trends Monitor- 17th January, 2011*
*** (http://www.mofat.go.kr/english/press/speech/trade/index.jsp)*

ANNEXURE B

DETERMINANTS OF FDI

Summary of Qualitative Variables- Impact on FDI Flows			
	Primary FDI	Secondary FDI	Tertiary FDI
Macroeconomic Variables			
Openness	---	---	+
Real Exchange Rate	---	---	+
GDP Growth	---	---	+
FDI Stock	---	+	+
Average Inflation	---	---	---
GDP per capita	---	---	---
Qualitative/Institutional Variables			
Labor Market Flexibility	---	+(dev): +(adv)	-(adv)
Judiciary Independence	---	-(adv)	+(adv)
Legal System Efficiency	---	---	---
Financial Depth	---	+(dev): -(adv)	+(adv)
Infrastructure Quality	---	+(dev) : +(adv)	+(dev)
Primary Enrolment	---	---	---
Secondary Enrolment	---	-(adv)	---
Tertiary Enrolment	---	---	---
+ represents significantly positive, - represents significantly negative, (dev) represents developing countries, and (adv) represents advanced economies.			

ANNEXURE-C

...SS INFORMATION BUREAU
पत्र सूचना कार्यालय
...OVERNMENT OF INDIA
भारत सरकार

The Economic Times, Delhi
Saturday, 2nd April 2011, Page: 10
Width: 8.34 cms Height: 18.08 cms, Ref: pmin.2011-04-02.32.69

Passport to Riches

FDI caps allow businessmen to make fortunes only by virtue of citizenship

64-10

Ruia-controlled Essar has sold its 33% stake in Vodafone Essar, India's third largest mobile operator, to the British giant for $5 billion. This will be good for the company, which will now see a united management. In the past, relations between the Ruias and their overseas partners — first Hutchison Whampoa and then Vodafone — were less than cordial. It is also a massive windfall for Essar, which has received a fortune for being a sleeping local partner in a joint venture run entirely by overseas players. From 1995, when India's mobile telecom was just opening up, to 2006, when it was near its peak, Essar, which held licences but had little or no activities, was gradually bought out by Hutchison, which spread its operations across India. One year later, Hutchison sold its part of the business, now a highly lucrative one, to Vodafone. Essar tagged along, simply because Indian regulations say that at least 26% of any telecom business must be owned by Indians. And proved that tagging along can be worth a staggering ₹22,000 crore.

The Essar-Vodafone deal shows that sectoral caps are an ineffective way of controlling foreign investment in India. If it doesn't want foreign investment in some areas, it should have a complete ban. If FDI is allowed, it should be allowed without fetters. Sectoral FDI caps, varying between 26% and 74% across sectors as varied as insurance, banking, media and telecom, have created a policy maze. Worse, these caps have created a lucrative market for any Indian businessman to become a passive partner of overseas companies wanting to set up shop in India. Effectively, the local businessman becomes entitled to dividends — and more — in the joint venture by putting up only his passport as equity. In any case, Indian FDI rules have been changed and tweaked so much that some of the caps have become meaningless. In the case of telecom, for example, foreign companies can effectively own as much as 87% of the business and still comply with the law: they can own 74% directly, and own 49% in a company that holds the remaining 26%. They can control 100%, if obliging Indian partners surrender voting rights to the equity they hold. End this farce. Scrap the FDI limits.

THE FINANCIAL EXPRESS

FE Editorial: New ring to FDI tale

The Financial Express
Posted online: 2011-04-02 01 :09:26+05:30

For an FDI-starved nation, where people were beginning to argue policy-induced uncertainty was driving away investment, Vodafone's purchase of Essar's 33% stake is good news. The $5-bn deal, coming weeks after Reliance's $7.2-bn deal with BP for a 31% stake in the KG-D6 gas fields, would suggest the India story is back in the news. That the deal is in the scam-scarred telecom space is especially interesting since many argued, irresponsibly given the government mopped up over a lakh crore rupees in the 3G/BWA auction, the sector was not worth investing in anymore. Vodafone was, in fact, one of those making the most noises-about it having to shell out more than $2 bn on taxes for its original purchase of Hutch's shareholding in 2007 and about the spectrum shortage thanks to A Raja's favoritism. Given how Vodafone's global arm has $100 bn of annual revenues, the $5 bn may not be too difficult to absorb; in any case, given Vodafone India's $5.7 bn annual revenues, the amortization costs of the deal can be absorbed by even the Indian arm.

While Essar has got a great payoff-the $5-bn valuation is significantly higher than the market prices for telecom stocks today-it will be interesting to see what strategy Vodafone adopts to ensure the FDI limits of 74% are not breached. It has been helped in the past by FDI rules that allow foreign firms to disguise their economic interests in Indian firms. Under the rules introduced in 2009, if Indians have a 51% stake in a firm, any investments by this firm are considered Indian investments-never mind if a foreign firm has a 49% stake in the parent firm or whether the Indian partners have raised their equity on the basis of bank guarantees by the foreign partner. This is what happened in 2007, and while Vodafone never got into trouble, it came in for a lot of flak and adverse attention. Given how Essar's exit makes little difference to either Vodafone India's customers or to how the business is run, perhaps it is time to be more transparent and allow 100% FDI in telecom. All that the 74% rule does is to create regulatory opportunities for Indian partners who are willing to play ball. Call it coincidence if you will, but it is significant that Essar's exit came on the same day the government announced the scrapping of Press Note 1-which suggests Indian industry is mature enough that it doesn't need to hold partners to ransom any more.