India's Investment Environment – May 2009

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I. Introduction

According to UNCTAD's recent study, India achieved a spectacular 85.1 percent increase in FDI flows in 2008, the highest increase across all countries, even as global flows declined by 14.5 percent. The significant factor highlighted is that ratio of FDI to GDP in India now exceeds that of China, indicating its larger role in the Indian economy. As prospects continue to deteriorate more markedly in developed countries, investors are likely to favour the relatively more profitable options offered by India and it will continue to be a favourable destination for FDI.

II. Expected changes in FDI rules

The following changes in FDI rules are expected in the near future:
(i) Allowing higher FDI in insurance sector is on priority of the government
The Insurance Laws Amendment Bill, placed in Parliament last July, is likely to be passed at the earliest. The Bill provides for an increase in the foreign investment ceiling in the domestic insurance sector to 49 percent from the current level of 26 percent. The key element in the Bill is a package of proposals for dilution of government holding in public sector insurance companies on the lines adopted by public sector banks. In some of these banks, the government holding is already down to the threshold of 51 percent. The Bill also makes provisions to allow public sector insurers to raise capital directly from financial markets through equity, subordinate bonds or hybrid instruments.

(ii) Government may open up the legal sector for FDI
The Bar Council of India has decided to reconsider the issue of FDI in law firms. A nod by the council will pave the way for opening up of the legal sector to FDI, a decision it has kept in abeyance due to opposition from its members. If allowed, foreign law firms will be able to invest in Indian firms, and depending on reciprocity conditions, Indian lawyers will be able to take up cases abroad.

The Bar Council's decision to rethink this issue follows the recent backdoor entry of several foreign law firms into the country as partners of Indian law firms through 'best friend', 'referral' or 'non-financial' agreements.

(iii) India is renegotiating double tax avoidance agreements
India, like the OECD, has now decided to check the prevalent situation of tax avoidance and treaty shopping in tax havens. In countries with which it has Double Tax Avoidance Agreements (DTAA), it is renegotiating and amending the treaties to incorporate more stringent measures of tax assessment, a clearer idea of where the tax accrues and is payable, the criteria that need to be met to set up residency and permanent establishments, and the limitations of benefits/the

primary purpose clause. The primary purpose clause especially opens the door for greater scrutiny. A country like Mauritius which is the largest source of FDI in India does not have such a clause in its treaty with India.

Tax havens are a pervasive problem for most countries including India. Similarly, treaty shopping is for the most part discouraged, but in today's global scenario, it has become an unavoidable necessity for ensuring competitiveness, and preventing other countries from taking a first mover advantage.

(iv) Strict provisions for foreign companies manufacturing power equipments

To discourage non-serious players the government is expected to stipulate a strict process to monitor foreign companies. In addition to a three year lock-in period for MNCs setting up facilities to manufacture new generation power equipment, these companies may need to hold at least 75 percent of the land before bidding for a project. However, the land could be held by the joint venture company or the Indian subsidiary of the foreign player.

This move is likely to prevent wider participation from many foreign companies that do not have a footprint in India. As part of the monitoring process, the government has also mandated that prior to the submission of a bid, the concerned manufacturing company must have registered in India and should have obtained a certificate for commencement of business. These provisions are aimed at keeping a check on bidding companies and would rule out bids from foreign companies with an unsatisfactory track record. However, these would also prevent the entry of many Chinese and Russian firms which do not have a physical presence in India.

The government is planning to use large and fuel efficient super critical equipment in all new power projects. At present, these equipments are not manufactured in India. Current FDI guidelines governing power equipment manufacturing do not have any provision to stop fly-by-night operators. However, the sector is open to 100 percent FDI under the automatic route.

(v) Government is planning to put checks on FDI in trusts

FDI in trusts may be subjected to a minimum lock-in-period and capitalisation norms to promote long term capital investments in the trusts. The idea behind this move is to prevent the use of trusts registered as venture capital funds (VCs) for asset stripping and short term gains by foreign companies.

FDI is permitted in trusts which intend to carry out private equity investments, provided these register with the capital market regulator SEBI. The main objective of trusts is to achieve substantial long term capital appreciation, primarily through privately negotiated equity and equity linked investments. Most companies set up private equity funds as VC funds. The VC route is preferred by some foreign investors as it provides flexibility in terms of pricing of shares, lock-in and the SEBI takeover guidelines for open offer.

The Government is planning to put checks on FDI in trusts which have invested in companies, especially start ups, to ensure that the investments are used only for making long term capital gains. FDI in trusts would now be subject to FIPB's clearance.

(vi) Government plans to introduce comprehensive legislation to scan FDI in sensitive sectors

The government has once again revived the old proposal for a comprehensive legislation, The National Security Exception Act, to scan FDI in sensitive sectors such as telecom, aviation, ports and defence. The Act will be an umbrella legislation empowering the government to block mergers and acquisitions, and takeovers of Indian companies in sensitive sectors in the case of credible evidence of a threat to national security from the concerned investor. The legislation is modelled on the lines of Exon-Florio Act of the US.

III. News & Views

(i) India may not be affected much by global slowdown

India continues to rank as the second most attractive destination after China. This is a positive sign, and even the ratio of India's FDI flows to that of China has been consistently increasing over time. In the context of the present global economic crisis, it is being predicted that FDI inflows to developing economies would be vulnerable to the slowdown. Moreover, the fall is expected to be more widespread in the current year, as the worst impact of the crisis will get transmitted to these countries in the second half of this year.

It is being argued that FDI in India is expected to remain buoyant because of huge domestic demand and investor friendly policies, especially the expected relaxation of requirements for foreign ownership in sectors such as insurance, media, civil aviation, real estate etc

(ii) Will FDI in retail become a reality?

The organised retail sector is hoping that the government will give a fresh lease of life to FDI in retail. The opening of retail has been facing stiff resistance from various political outfits which claim that it may adversely impact more than 11 million retailers. However, sector experts contend that only a small portion of general trade, which is in close proximity to modern trade, would be partially affected by FDI. The share of unorganised retail will go down but volumes certainly will not decrease.

FDI in retail is also being supported on the grounds that India needs private investment in retail from both Indian and foreign sources for its modernisation. Private players have more access to investment and, hence, can install better storage and refrigeration systems for perishable items. Moreover, these can provide access to products from distant markets.

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