ESF11-06

Ms. Anjali Prasad
Joint Secretary (JS)
Department of Industrial Policy and Promotion (DIPP),
Ministry of Commerce & Industry
Udyog Bhawan,
New Delhi 110011
India

Brussels, 15 July 2011

RE: ESF comments on Discussion Paper: FDI Policy-Rationale and Relevance of Caps

Dear Joint Secretary Prasad,

The European Services Forum (ESF) is a network of high-level representatives of the European Services Sector committed to the liberalisation of services markets throughout the world through international trade in services and investment negotiations. Our organisation is closely following the EU-India trade and investment negotiations and fully supports the conclusion of an ambitious agreement.

Foreign direct investment has now come under the ambit of the exclusive competence of the European Union and we strongly encourage the negotiators to establish an effective investment policy framework that will offer strong mutual protection to the investments made by EU and Indian companies. We believe that such a framework is a necessary tool to foster and develop mutually beneficial investments by both EU and Indian companies engaged in supplying services in each jurisdiction.

On behalf of the business leaders of European services companies and our sector specific trade associations (see attached), I wish first to thank the Indian government, and your department in particular, for giving an opportunity to interested stakeholders to express their views on the very important issue of FDI policy rationale and the relevance of equity caps.

In this context, we have noted that the EU is the biggest receiver of FDI in the world, a factor which has undeniably contributed to the competitiveness of the EU economy. Two of the primary policies that have built this successful environment for attracting FDI are the openness of the EU economy to FDI and the generally transparent regulatory framework. It is also important to note that more than 90% of all FDI coming into the EU is invested in services sectors. The EU is also the biggest investor in the world, and more than 65% of all outward FDI is invested in services sectors.

The European Services Forum welcomes the efforts of the Government of India over the past decade to implement desirable economic reforms including consideration of measures to attract more FDI with a view to strengthening economic and social progress in India. We note that India is still a very modest recipient of European FDI (€3.4 billion in 2009 or 1.2% out of the total of €280.6 billion) and receives less EU FDI than other important emerging countries, *e.g.*, Brazil - €8.8bn, China - €5.8bn[1]. Given the right conditions, there is enormous potential to increase European FDI into India and thus to support the development objectives of the Government of India in such important areas as infrastructure. We also note the strong emergence of globally competitive Indian companies with specific expertise and know-how who are potential investors in the EU and we welcome their full participation in the EU economy on the same basis as EU companies.

Of course, investors, when taking their decision to invest in a foreign country, look not only at market access, existing protection mechanisms and treaties, and the potential market/profits, but also at the tax environment. Some EU-based companies active in India have reported great uncertainty concerning tax treatment, particularly concerning extra-territorial transactions, and we would therefore urge that measures to foster FDI should be accompanied by urgent efforts to end such uncertainty on tax treatment.

ESF members are strongly of the view that the effective functioning of a modern market economy requires that companies should be fully free to choose the form of corporate structure they consider most appropriate to their business, whether this be a wholly owned subsidiary, a branch or a joint venture. Mandated equity caps that inhibit such freedom create great distortions and inefficiencies and can undermine the purpose of investment policy by reducing the commitment required of investors to effectively implement the investment strategy. That is why in the context of the current EU-India FTA negotiations, the ESF is calling for the removal of all remaining equity caps that prevent EU businesses from fully controlling their investments and operations in India. To the extent that equity caps be retained in certain sectors, there should at least be the possibility of a foreign investor to exercise majority ownership in all services sectors, and requirement to maintain less than full ownership should be phased out progressively. The recent example of the telecom sector, as quoted in the annexes, is clear evidence that equity cap policy is inefficient and to the detriment of the Indian economy. The equity cap in place in the insurance sector (still 26% despite the long delayed intention to move it to 49%) means that FDI is constrained from flowing into that sector. It is worth noting that long-term infrastructure investments, which are a major objective of the Government of India, are often carried out through private investment by insurance companies that collect and manage life insurance and pension fund premiums. Equity caps which prevent these activities have therefore a doubly adverse effect on Indian development policy objectives.

India's WTO GATS Horizontal Offer (dated August 2005 and reiterated at the WTO Ministerial "signalling conference" in July 2008) of removing a Mode 3 requirement which required foreign acquisition of Indian shares to systematically receive FIPB (Foreign Investment Promotion Board) approval – in our view an unnecessarily burdensome administrative barrier - is most welcome and the opportunity should be taken to formalise that commitment in the FTA.

In the light of the foregoing, we are happy to provide a number of remarks on the questions raised in the consultation paper:

1. Do equity caps fulfil any purpose other than 'control'?

Foreign equity caps prevent the companies affected from effectively controlling and managing their assets. As such, they inevitably discourage investment and have the potential to reduce greatly the

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[1] *Source: Eurostat News Release 94/2011 - 27 June 2011*

positive impact of such investment that does flow into the economy. Policy that restricts a company from ownership and control based on the fact that it is foreign will therefore have a detrimental effect on the competitiveness of companies that operate in India. In the case of services sectors, the importance of control is particularly acute. The “software” of a services company is intangible by essence. It is factors such as know-how, management expertise and IT expertise that constitute the competitiveness of a company. If a forced joint venture structure inhibits a service company from having necessary control of its key operations, either it will decide not to invest at all, or it may decide not to bring the same level of experience or commitment to the joint-venture as it would to the optimal corporate structure for the business. Such a situation could see the company wait and see until it is eventually allowed to obtain full control before it brings such assets to the business.

Equity caps, particularly where they block majority ownership, will therefore ultimately reduce benefits to consumers within India and will also hinder India in its objective of becoming globally competitive; negatively affecting employment and employment conditions. An FDI Policy that prevents proper direct investment activities by maintaining equity caps is therefore not logical and highly negative for the Indian economy. The rationale of equity caps is to limit the control foreign investors have on a company operating in a specific sector; they serve no other direct purpose.

The ESF supports the right of Indian service suppliers active in the EU market to be fully free to choose the corporate structure they consider most appropriate to their business on a basis of equal treatment with EU service suppliers and wish to see the EU-India FTA give effect to the same freedoms for both EU and Indian services companies in both jurisdictions.

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?

The fact that some activities can be carried out indirectly through downstream investment merely creates an opaque business environment that forces competitive businesses through less efficient routes and also gives leverage to Indian companies or businesspersons that can profit from the discrimination without improving the quality of the business or services supplied. Such systems effectively reduce transparency, which increases uncertainty, and reduces the attractiveness of India as a base for business. It is clearly beneficial, as a result, to allow direct investments in the first instance.

3. If so, is there any relevance left for equity caps, especially below 49%?

In our view, there is no relevance for investment caps in a country that wishes to advance its economy through attracting investment and improving the competitiveness and quality of services and goods. Foreign companies that are not fully permitted to be in control of their investments and assets are far less likely to transfer know-how and technology into the Indian economy because their position is already compromised. A company needs certainty to know that it can direct its business operations in the best interests of creating higher quality and more efficient output. Foreign equity caps produce the opposite outcome, especially when they are below 49%. There is no doubt that when a European company does not have necessary control of its Indian subsidiary, it will not invest in the same way, if it invests at all, if the business model requires that the subsidiary be wholly owned.

4. Can the concerns supposed to be addressed by control through equity caps be addressed through sectoral conditions?

Creating economies that are healthy and beneficial to society is achievable through the creation of a framework that has clear rules and promotes fair competition and is applied equally to both domestic and foreign companies. Foreign companies do not ask anything more than being able to

compete on a fair, level playing field, and to be treated like all domestic companies and submitted to the same efficient regulation.

Sectoral conditions that do not meet this criterion run the very detrimental risk of creating the same distortions and damage as those created by equity caps. On the other hand, an open trade and investment policy and a regulatory regime that is transparent and inspires confidence that it will be applied consistently and without discrimination can create a business environment that inspires innovation and growth.

In addition, regulators should generally:

i. Be independent from any political influence;
ii. Propose regulations in draft form and provide interested parties the opportunity to comment on such draft regulations;
iii. Make publicly available the requirements that suppliers must meet in order to supply a service;
iv. Enforce laws and regulations according to fair and transparent criteria. Licensing or whatever authorisation process must be clear, subject to a specific timeframe, with right of appeal when necessary. Proper competition legislation must be in place, with an efficient and fast dispute settlement mechanism.

We do not share the view that any sectoral guidelines that would possibly include conditions relating to appointment of resident Indian or EU citizens on the Boards of Management/top level managerial positions would be an efficient policy. Nationality or residency requirements that apply to members of the board or to top management clearly act as impediments to control of the company and are therefore already considered as barriers to investment; at the same level as equity caps. The ESF calls the EU negotiators to remove all these requirements in all on-going bilateral trade and investment negotiations.

5. Do the caps create an unfair opportunity for arbitrage?

Yes, we believe that foreign equity caps do create an unfair opportunity for arbitrage as they allow the mandatory Indian partner to be valued solely based on the fact that it is Indian and not because it provides real benefits to a business or to consumers. Such a situation is not healthy as it creates a murky business climate and potentially non-productive business partners. We would oppose EU governments insisting on similar restrictions on Indian investors.

6. If it 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?

Some further clarification would be needed here to better understand the intention. Is it about allowing first the multinational companies to be allowed to create a wholly owned subsidiary that must be listed on the Indian stock exchange, and then forcing that incorporated company to offload/sell equity with the rationale of limiting foreign investor control? If so, such a rule will inevitably lead to some of the same problems as having foreign equity caps on pre-establishment investments. It will not only discourage foreign investment stocks but will reduce technology transfer into the Indian economy and thus reduce competitiveness. Forcing an offload of equity will also cause distortions in the real market due to the artificial nature of its application with potentially non-productive consequences. Such a rule could even be seen as an obligation to disinvest, and therefore would have a negative effect on the financial markets and reduce the attractiveness of India as a destination for FDI. We would oppose the introduction of a similar rule on Indian investors in the EU.

7. As long as sectoral caps exist, should it be specified that they are exclusive of FII?

Foreign institutional investments, like foreign direct investments, should not be restricted by foreign equity caps because such an artificial business restriction can reduce not only funding for the businesses concerned but also the quality of corporate governance. Institutional investors reduce information asymmetries by encouraging companies to increase information about their business operations in an effort to increase investment from large investors. In addition, institutional investors, due to their size and resources, are better able to exercise oversight over a company's board and therefore management, and therefore performance. FIIs can therefore not only provide investment where it is needed in India, but could also improve the competitiveness of the businesses into which they invest. Putting caps on this investment serves only to privilege a few to the detriment of the wider economy and the many. Equity caps should be completely removed for FIIs.

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Once again we thank DIPP for giving this opportunity for comments and we shall remain at your disposal for any further information you and your services would find useful on this issue.

Yours sincerely,

Christoffer Taxell
ESF Chairman