LEGAL REGIME OF FOREIGN DIRECT INVESTMENT IN INDIA: UNDERLYING ISSUES AND CONCERNS

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DECLARATION

I hereby declare that this dissertation entitled "Legal Regime of Foreign Direct Investment in India: Underlying issues and concerns" is the outcome of the study conducted by me at the National Law School of India University, Bangalore, as partial fulfillment of the LL.M. programme.

I also declare that this work is original, except for such help taken from such authorities as have been referred to at the respective places for which necessary acknowledgements have been made.

I further declare that this work has not been submitted either in part, or in whole, for any degree or diploma at any other University or Institution.

Namrta Sinha

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"THE INDIAN ECONOMY IS LIKE A SLEEPING GIANT WHICH, IF AWAKENED, COULD BY ITSELF TRANSFORM THE FACE OF THE GLOBAL ECONOMY. INDIA HAS THE POTENTIAL TO FORM AN INDEPENDENT ECONOMIC BLOC ON HER OWN, WITHOUT TOO MUCH DEPENDENCE ON ANYBODY ELSE"

Mr. Lee Kuan Yew,
Former Prime Minister of Singapore.

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GLOSSARY OF TERMS

American Depository Receipt (ADR)- "American Depository Receipt" means a security issued by a bank or a depository in United States of America against underlying rupee shares of a company incorporated in India

Arm's length concept- Arm's length concept implies that two companies, connected by financial equity and related by culture, will be treated in many instances as if they were independent of each other.

Arm's length price- Arm's length price is the price at which two unrelated and non-desperate parties would agree to a transaction.

Arm's length transaction- Arm's length transaction is a transaction between two related or affiliated parties that is conducted as if they were unrelated, so that there is no question of a conflict of interest.

Balance of payments- Balance of payments is a systematic recording of all international transactions that occur between residents of one nation and residents of all other nations. A nation's balance of payments position is the annual change in its international reserve assets and/or the annual changes in foreign claims on its own monetary assets (international reserves).

Corporate income tax- Corporate income tax is levied on the earnings of corporations. A corporation (or a company) is regarded as a separate entity for purposes of income-tax.

Direct Investment- Direct investment is net flows of investment to acquire a lasting management interest in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments.

Export Processing Zones (EPZs)- EPZs are special arrangements, often a distinct geographic area near a port, which are set up to promote export industries.

Foreign Currency Convertible Bond (FCCB)- "Foreign Currency Convertible Bond" (FCCB) means a bond issued by an Indian company expressed in foreign currency, and the principal and interest in respect of which is payable in foreign currency.

Foreign Direct Investments (FDIs)- Foreign direct investments are investment made by companies into foreign markets for the purpose of owning or co-owning, controlling and managing a business enterprise with market share and earnings objectives.

Global Depository Receipt (GDR)- "Global Depository Receipt" (GDR) means a security issued by a bank or a depository outside India against underlying rupee shares of a company incorporated in India.

Globalisation- Globalisation is a process of corporate enterprise that involves the procurement of resources from the best available source worldwide and the production and sale of goods and services in the widest possible markets.

Host country- Host country means the country in which the entity receiving the direct investment from a foreign party is registered or incorporated.

Internalization advantage- Internalization advantage refers to some aspect, such as incomplete contracts, that makes keeping transactions within the firm preferable to arms-length transactions between firms.

Investment incentives- Investment incentives are government actions or policies that are granted in order to increase the net cash flow or lower the risk of a venture over what would have been expected without incentives.

Joint venture- Joint venture is a highly structured and formal strategic alliance that involves two or more partners. Sometimes the alliance is strictly voluntary, but often it is mandated by the laws of the host country.

Local content requirements- Local content requirements require foreign investors to purchase a certain percentage of intermediate goods from the host country.

Location advantage- Location advantage refers to some aspect, such as transportations costs, that makes producing in the same location as consumption preferable to producing in one place and shipping to wherever the demand is located.

Most Favoured Nation (MFN)- MFN clause is at the heart of modern commercial diplomacy. Under it, parties give each other all of the concessions which they give to any other country. The nomenclature is somewhat misleading as it sounds like a promise of preferential treatment. Instead, it is a promise that no other country will be given preferential treatment. In other words, the partner will receive treatment no less favourable than that given to any other country.

Multinational Corporation (MNC)- A multinational may be defined as *a company that owns or controls production or service facilities in more than one country.* In other words, a multinational is not simply a company that trades internationally by exporting its product (or by licensing overseas producers). It actually owns (via a wholly or partly-owned subsidiary) or controls (via a branch plant, joint venture or minority shareholding) productive facilities outside its home country.

Organization for Economic Cooperation and Development (OECD)- The Organization for Economic Cooperation and Development describes itself as "an intergovernmental organization comprising 29 advanced economies from Europe, North America and the Pacific region". It's mainly known for gathering economic data and is often called the "think tank" of the rich countries of the world.

Ownership advantage- Ownership advantage refers to some aspect, such as a unique product design, that a firm does better than others.

Tax sparing- Tax sparing is a tax treaty provision whereby a contracting state agrees to grant relief from residence taxation with respect to source taxes that have not actually been paid (taxes that have been 'spared').

Transfer pricing- Transfer pricing the practice of either under-invoicing or over-invoicing transaction taking place between a parent company and its subsidiaries. The aim of under-invoicing is to lower the costs of the subsidiary so that its prices are reduced and it can eliminate its competitors from the market (disguised predatory pricing). The aim of over-invoicing is to increase costs artificially, in order to reduce profits and avoid taxation, or circumvent profit repatriation rules in the host country.

RESEARCH METHODOLOGY

OBJECTIVE

The primary objective of the study is to highlight the need for regulation of Foreign Direct Investment regime in India after an exploration of the law relating to foreign direct investment in India and on the basis of the underlying issues and factors that play a determining role in the volume and composition of foreign capital flows to the host country. The extent and the form of influence, which such factors exert on foreign direct investment, has been attempted to be established in the study. However, to substantiate the propositions made in the study, support has been taken from the primary investigation pursued by various researchers in the field owing to the near impossibility of primary data collection and formulation given the economic and statistical intricacies of the subject.

RELEVANCE OF STUDY

The study is relevant in the wake of the fact that foreign direct investment plays a substantial role in the economy of a country. However, unregulated or over regulated FDI cannot contribute to the economic development of the country to its maximum potential. This is the reason why FDI needs to be regulated in one form or other. The relevance of the study is because its tries to take certain concepts that play a vital role in investment decision by the investors and their relation and impact on the form and volume of the foreign direct investment so that the formulation of the foreign investment policy takes into consideration these factors.

MAIN OBJECTIVES

The following are the main objectives of the dissertation:-

a) To examine the regulation of foreign direct Investment in India
b) To identify the legal concepts and areas that have an impact on the investment decision
c) To find out the extent and form of impact these concept have on investment
d) To highlight the need for regulation of foreign investment policy keeping in mind the influence such concepts

GUIDING RESEARCH QUESTIONS

The questions that this dissertation has tried to answer are:-

a) How is FDI regulated in India?
b) What are the legal and procedural technicalities faced by the foreign direct investors during entry and at the time of exit?
c) What is the importance of FDI to the host country?
d) What is the impact of FDI on the host country?
e) Is there any need to regulate the flow of FDI?
f) What are factors and legal concerns to be taken into consideration while formulating an investment policy?
g) What is the extent to which such factors affect the volume and composition of FDI and the consequent impact on the country's economy and legal regulatory framework?

METHODOLOGY

The study relies both on primary as well as secondary sources of data. Apart from books, journal and Internet articles, guidance has also been taken from various notification and statutes. Since first hand collection of data was virtually impossible owing to the very nature of the subject under study, heavy reliance has been placed on discussion papers and studies conducted by international organizations and bodies such as International Monetary Fund, Organization for Economic Cooperation and Development, International Finance Cooperation etc. The nature of the study is descriptive as well as analytical. A uniform mode of footnoting is followed throughout the study.

LIMITATIONS

The limitation of the paper is that it does not give much statistical data regarding FDI. The reason for deliberately omitting to mention strictly economic concepts, theories and findings is to avoid too much of technicality. Moreover, the concept (FDI) is studied within the legal framework in isolation with any other aspect.

STRUCTURE OF THE STUDY

Chapter I gives an introduction of foreign direct investment and its relationship with issues like development, balance of payments etc. The remaining dissertation is divided into two parts. Part A concentrates on the legal regulatory framework of FDI in India. Chapter I of part A traces the development of FDI policy in India. Chapter II gives a brief preview of the routes available for FDI in India. Chapter III describes the entry strategies for the foreign investors. Chapter IV gives an overview of with the investment routes available for the NRIs. Chapter V discusses the sector specific guidelines for FDI in India. Chapter VI examines the FDI related Government bodies in India. Chapter VII is about the repatriation facilities available to the foreign investors. Chapter VIII discussed

the mode of taxation of foreign investment. Chapter IX highlights the prominent aspects in drafting of a foreign collaboration agreement. Chapter I of part B discusses the incentives that are offered by different economies in order to attract FDI towards their country. Chapter II explains the concept of tax incentives and their overall contribution to the host country. Chapter III is about competition among countries to attract FDI and its ramifications on their legal regulatory framework. Chapter IV examines the need of corporate governance in Foreign Direct Investment. Chapter V discusses how protection of Intellectual property rights in the host country acts as a determinant of flow of FDI. Chapter VI is a brief analysis of the impact of international bodies on FDI. This is followed by a summarized study of salient features of FDI in Singapore. The Conclusion follows the study.

INTRODUCTION

FOREIGN INVESTMENTS

Foreign Investment can be defined as the acquisition by governments, institutions or individuals in one country of assets in another. Total foreign investments, as an item in the capital account, can conceptually be divided into two components: (a) foreign direct investments (FDI); and (b) foreign portfolio investments (FPI).

Foreign Direct Investment refers to international investment in which the investor obtains a lasting interest[1] in an enterprise in another country. Most concretely, it may take the form of buying or constructing a factory in a foreign country or adding improvements to such a facility, in the form of property, plants or equipment. The IMF defines FDI as "direct investment reflecting the lasting interest of a resident entity in one economy (direct investor) in an entity resident in another economy (direct investment enterprise), ...and covers all transactions between direct investor and direct investment enterprise...".[2]An investor's earnings on FDI take the form of profits such as dividends, retained earnings, management fees and royalty payments.

On the other hand, FPI is a category of investment instruments that are more easily traded, may be less permanent, and do not represent a controlling stake in an enterprise. These include investments via equity instruments (stocks) or debt (bonds) of a foreign enterprise which does not necessarily represent a long-term interest. Although FDI, almost by definition, tends to be undertaken by multinational corporations, FPI comes from more diverse sources, and may originate, for example, from a small company's pension fund or through mutual funds held by individuals. The returns that an investor acquires on FPI usually take the form of interest payments or non-voting dividends.

[1] A lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise.
[2] World Investment Report, 1994.

FPIs are purely financial assets such as stocks and bonds denominated in a national currency. With bonds, the investor simply lends his capital to get fixed payments or a return at regular intervals and receive the face value of the bond at a pre-specified date. With stocks however, the investor purchases equity or a claim in the net worth of a firm. FDIs on the other hand are actual investments in factories, capital goods, land and inventories where both capital and management are involved and the investor retains control over use of the invested capital. FDI are usually undertaken by MNCs engaged in manufacturing resources extraction or services.

However, The definitions of these two forms of investment are not the same to all people, and hence a semantic problem may arise unless these are clarified at the very outset. Two definitions are in fairly wide currency today. These are :

a) FPI is the acquisition of domestic non-equity instruments; whereas FDI involves equity participation, whether in new or existing companies.
b) FPI involves the acquisition of existing financial assets, whether debt or equity; whereas FDI leads to an expansion of the equity base either in a new or an existing company.

Moreover, the acquisition of the asset becomes FDI when the non-resident investor intends to manage that asset. Hence, the management control distinguishes FDI from portfolio investments[3]. The level of ownership that accords control is hard to specify unambiguously: it depends on the legal framework of corporate governance, and the specific pattern of holding of voting stock of the firm. Another important distinction that exists between FDI and FPI is that in the present era of globalization, FPI can be much more volatile. Changes in the investment conditions in a country or region can lead to dramatic swings in portfolio investment. But because FDI implies a controlling stake in a business, and often connotes ownership of physical assets such as a equipment, buildings and real estate, FDI is more difficult to pull out or sell off. Consequently, direct investors may be more committed to managing their international investments, and less likely to pull out at the first sign of trouble. Moreover, FDI is undertaken by MNCs and is firm or

[3] Why Shouldn't We Hype Up FDI? Bibek Debroy, financial Express, , Tuesday, June 18th, 2002

Balance of payments accountants have defined foreign direct investment as "any flow of lending to, or purchase of ownership in, a foreign enterprise that is largely owned by residents of the investing country"[6]. The proportions of ownership that define "largely" vary from country to country. In the United States, 10 % ownership by the investing firm suffices as an official definition of direct investment[7].

Balance of payments accountants have also defined FDI as "direct investment and any lending in, or purchase of stock in, firms owned in greater proportion by parties in the investor's home country even if the individual investor does not own 10% of the firm being invested"[8].

FDI is normally undertaken by Multinational Enterprises (MNEs), which invest their normally huge capital in different nations. They can be market seeking, efficiency seeking or resource/ asset seeking. They take either the form of new investments, also known as green field investments or the form of acquisitions of existing projects through mergers and acquisitions (M&A).

In the process of globalization of economic activities, cross border transactions are carried out that at first glance may be regarded as foreign direct investment when in fact they do not meet the criteria. For example:

a) An enterprise undertakes to build for a foreign client, usually a Government, a complete manufacturing plant, to provide technical know how, and to manage and operate a plant for a number of years, without an ongoing on-site managerial presence and without other criteria for existence of a direct enterprise being met. It has complete control over day-to-day operations and receives a management fee, paid either in cash or goods produced by the plant. However, the enterprise has no equity stake in the plant and is performing a cross border service.

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[6] P.H.Lendert, *International Economics*, 562 (New Delhi: IRWIN, 1987).
[7] *Ibid* at 563.
[8] *Id.*

b) An enterprise has a long term contract with a foreign company, provides it with technical know-how and has considerable influence over the quality and quantity of output. The enterprise may provide a loan to the foreign company and sometimes will have a member on the company's board. However, there is no equity stake. It is once again a cross-border service.

c) Some host countries shave made agreements with a number of foreign enterprises where the host country supplies factory accommodation, electricity, staff accommodation, administration and labour. The foreign enterprise supplies all production machinery, fixtures and fittings for the building and production materials, and is responsible for the initial training of the labour force. The foreign enterprise then pays an agreed piecework rate for each item produced. When the production machinery and fixtures and fittings remain the property of the foreign enterprise, there is technically a direct investment branch, though the branch's profits will be zero. There is no direct investment interest if the machinery becomes the property of the host country.

d) Other cases might include foreign sales and representative offices, as well as foreign stations, terminal or fort facilities of domestic airlines or ship operators.

VERTICAL VERSUS HORIZONTAL FDI

Vertical FDI takes place when the multinational fragments the production process internationally, locating each stage of production in the country where it can be done at the least cost. Horizontal FDI occurs when the multinational undertakes the same production activities in multiple countries.

Firms should service foreign markets with horizontal FDI when the OLI conditions are satisfied:

a) Ownership advantage- The parent firm must have a product or process to which other firms don't have access.
    - Patent, blueprint, or trade secret

- reputation

b) Location advantage- It must be more profitable to produce the product abroad than at home.
   - shipping is costly,
   - there are advantages to being close to one's clients (e.g., custom products),
   - trade barriers,
   - there are special government-sponsored enticements in the host country,
   - labor is cheap in the host country,
   - plant-level scale economies are modest relative to firm-level scale economies

c) Internalization advantage- The parent company must be better able to extract the rents from its ownership advantage by producing the product itself than by licensing.
   - Potential licensees may not sign up unless they know the details of what they're getting. Once they are told, however, they don't need a license to produce that product. More generally, contract enforcement is problematic.
   - Even if a licensing agreement is reached, turnover among skilled workers, technicians, etc. may diffuse the proprietary knowledge to competitors.

ESSENTIALS FOR INVITING FDI

The United Nations Economic Commission for Asia and Far East (ECAFE) have summarized the essential requirements of foreign investors to invest in developing countries[9]. The essential elements that constitute a favourable climate from investing country's point of view may be briefly indicated below:

a) Political stability and freedom from external aggression.
b) Security of life and property.

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[9] United Nations Economic Commission for Asia and Far East (ECAFE), Committee on Industry and Trade, Second Session, "Foreign Investment Laws and Regulation in the ECAFE Region", Bangkok, March 1950, pp.4-5.

c) Availability of opportunities for earning profits.

d) Prompt payment of fair compensation and its remittance to the country of origin in the event of compulsory acquisition of a foreign enterprise.

e) Facilities for the remittances of profits, dividends, interests, etc.

f) Facilities for the immigration and employment of foreign technical and administrative personnel.

g) A system of taxation that does not impose a crushing burden on private enterprise.

h) Freedom from double taxation.

i) Absence of various controls.

j) Non-discriminatory treatment of foreigners in the administration of controls.

k) Absence of competition of state owned enterprises with private capital.

l) A general spirit of friendliness for foreign investors.

MOTIVES FOR FDI

The two basic motives for FDI are to earn higher returns, and to diversify risk. However, it is quite pertinent to know how and why the developed nations want to make huge investment in developing countries through foreign direct investment when they know that developing economies are expected to be more familiar with the local conditions and thus to be at a comparative advantage as compared to the foreign investors. There are several possible factors for this trend. Firstly, large corporations often have some unique production knowledge or managerial skills that could easily and profitably be utilized abroad and over which the corporation wants to retain direct control. This involves "horizontal integration" or the production abroad of a decentralized product that is also produced at home. Secondly, to obtain control of needed raw material and thus ensure an uninterrupted supply at the lowest possible cost. This is referred to as "vertical integration" and is the form of most direct foreign investments in developing countries and in some mineral rich developed countries. Vertical integration involving multinational corporations can also go forward into the ownership of sales or distribution networks abroad, as is the case with most of the world's major automobile producers[10].

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[10] Dominick Salvalore, *International Economics*, 351 (New York: Macmillan Publishing Co., 1987).

According to Dunning's OLI theory, there are three aspects that motivated the firms towards choosing FDI as a mode of entry to foreign markets[11]. These are: -

- Ownership Advantage: the firm must have a product or a production process such that the firm enjoys some market power advantage in foreign markets.
- Location Advantage: the firm must have a reason to want to locate production abroad rather than concentrate it in the home country, especially if there are scale economies at the plant level.
- Internalization Advantage: the firm must have a reason to want to exploit its ownership advantage internally, rather than license or sell its product/process to a foreign firm.

He also identified four primary reasons for corporate foreign investments:

a) Market seeking- Firms may go overseas to find new buyers for goods and services. The top executives or owners of a company may realize that their product is unique or superior to the competition in foreign markets and seek to take advantage of this opportunity. So market seeking may happen when producers have saturated sales in their home market, or when they believe investments overseas will bring higher returns than additional investments at home. This is often the case with high technology goods.
b) Resource seeking- A company may find it cheaper to produce its product in a foreign subsidiary for the purpose of selling it either at home or in foreign markets. The foreign facility may be able to obtain superior or less costly access to the inputs of production (land, labor, capital and natural resources) than at home.
c) Strategic asset seeking - Firms may seek to invest in other companies abroad to help build strategic assets, such as distribution networks or new technology. This

[11] Dunning, J.H. (ed). *Globalisation, Trade and Foreign Direct Investment*. 194-203 (Amsterdam: Elsevier. 1998).

may involve the establishment of partnerships with other existing foreign firms that specialize in certain aspects of production.

d) Efficiency seeking- Multinational companies may also seek to reorganize their overseas holdings in response to broader economic changes. For example, the creation of a new free trade agreement among a group of countries may suddenly make a facility located in one of those countries more competitive, because of access for the facility to lower tariff rates within the group. Fluctuations in exchange rates may also change the profit calculations of a firm, leading the firm to shift the allocation of its resources.

ARGUMENTS IN FAVOUR OF FDI

The pro-foreign investment arguments grow largely out of the traditional analysis of the determinants of economic growth. Foreign direct investment is typically seen as a way of filling the gaps between the domestically available supplies of savings, foreign exchange, Government revenue, and management skills and the desired level of these resources essential to attain growth and development targets. Hence the most vital and well cited contribution of FDI to a country's economy has been its role in filling the resource gap between targeted or desired investment and locally mobilized savings.

Another noteworthy contribution, that is analogous to the first, has been the FDI contribution to filling the gaps between targeted foreign exchange requirements and these derive from net export earnings plus net public foreign aid. This is also known as "foreign exchange or trade gap".

Third favourable argument has been that FDI could overcome the gap between targeted governmental tax revenues and locally raised taxes. By taxing FDI profits and participating financially in their local operation, developing countries' governments are thought to be better able to mobilize public financial resources for development project. Fourth pros of FDI has been that FDI inflows not only provide financial resources but also supply a "package" of required non-financial resources including management

experience, entrepreneurial abilities, and technological skills to bridge the gap in management, entrepreneurship, technology and skill of the host country's firm(s).

Fifthly, FDI brings with it the most sophisticated technological knowledge about production processes while transferring the modern machinery and equipment to capital poor developing countries. Such transfer of knowledge, skills and technology are assumed to be both desirable and productive for the recipient nations.

ARGUMENTS AGAINST FDI

There have been two basic arguments against FDI in general and the activities of MNC's in particular- the strictly economic and the more philosophical and the ideological. Economic arguments that are against the FDI are as under:

a) Though FDI provides capital, it may also lower domestic savings and investment rates stifling competition through exclusive production agreements with host governments, failing to reinvest much of their profits, generating domestic incomes for those segments with lower savings propensities, inhibiting the expansion of indigenous firms that might supply them with intermediate goods by instead importing these products from foreign affiliates, and imposing high interest cost.on capital borrowed by host governments.

b) The initial impact of FDI is to bring improvement in the foreign reserve of the host country. However, it is argued that its long-run impact might be to reduce foreign exchange earnings on both capital and current accounts. The current account may deteriorate due to considerable imports of intermediate goods and capital goods. Similarly the capita account may worsen due to the overseas repatriation of profits, interest, royalties, and management fees.

c) FDI inflows do contribute to public revenue in the form of corporate taxes. However, it is believed that their contribution is always considerably less than what it should be. This is due to liberal tax structure, excessive investment allowances, disguised public subsidies, and tariff protection available to foreign investors by the host countries.

d) It is also argued that the management, entrepreneurial skills, technology, and foreign contracts available through FDI might have little impact on the development of local resources of these deficient skills and resources and might in fact inhibit their development by stifling the growth and development of indigenous enterpreneurship as a result of the FDI's dominance in local markets.

The Third World countries have specifically raised the following objectionsr regarding FDI:-

a) The impact of FDI on the host country's economic development is very uneven. As a result, in some situations, it leads to dualistic economic structure which in turn generates income inequalities. It is also seen that, it tends to promote the interests of the small number of well paid modern sector workers against the interests of the remaining by the creation of differential wage structure within the firm(s) affecting its workers and efficiency.
b) Secondly, the inflow of FDI produces or manufactures inappropriate goods meant for elite class, stimulate inappropriate consumption patterns through advertisement and also their monopolistic market power, and to do this all with inappropriate technologies of production.
c) Thirdly, the local resources tend to be allocated for socially unwanted projects. This further aggravates the existing magnitude of inequalities between rich and poor and in turn leads to serious regional imbalances and intra-regional imbalances in the host country.
d) FDI uses its economic dominance to influence Government decisions in regard to various development policies protecting or favouring its interests that may have far reaching effects on growth and development process. It possess an ability to derive sizeable economic and political benefits from the host countries Governments in regard to excessive protection, tax rebates, investment allowances and factory site at a comparatively cheaper price and certain vital social services Theses benefits in turn lead to a situation wherein private profits

always have an edge over social benefits that should not be there from the host country's point of view.

e) Another criticism has been that FDI inflows may damage host country by suppressing entrepreneurship and using their superior knowledge, worldwide contracts, much superior advertising skills, and range of vital support services to drive out local competitors and inhibit the possibility of emerging new and potential small scale enterprise.

f) It is also feared that higher dominance of FDI in a host country take control over the local assets and job market and makes the working of the host country's government difficult and also exerts influence on political decisions from top to bottom levels.

It is clear from the above discussion that there has only been a difference of ideology and value judgments between pro-FDI economists and against FDI-economists in regard to the nature, sources and meaning of economic growth and development. Pro-economists advocates that FDI brings "free-market, private enterprise, *laissez faire*" in an economy. Whereas economists against FDI inflow believe that FDI leads to "lack of national control over domestic economic activity and minimization of dominance, dependence of relationship between MNCs and the Third World Countries' Governments".

EFFECTS OF FDI

FDI inflows have tremendous impact on the host country. The host country faces the problem of balance of payments. In short run, the host country may have normal balance of payments as well as favourable terms of trade. However, in the long run the trends may be different. The transfer of profits will lead to a negative term in its balance of payments[12].

Secondly, FDI inflows have direct bearing on the quality of employment. Some economists believe that FDI "ignores local employment practices". It is also pointed out

[12] It is believed that FDI is beneficial as long as its positive effect on the host country's economic development, is more than the negative effect on its balance of payments.

that FDI could shift the quality of employment in an unfavourable way reducing the "number of good jobs and replacing them with bad jobs". This shows a difference of human capital-good workers versus bad workers, not good jobs versus bad jobs. Under such conditions the investing country reduces higher wage jobs in a host country, leaving the host country with lower wage jobs on a increasing scale. This situation creates imbalance in the labour market of a host country.

Lastly, FDI inflows in the host countries some times make the national planning difficult and have far reaching effect on the host country's fiscal and monetary policies. As a result, it could also have negative effect on research and industrial development in the host country.

FDI AND BALANCE OF PAYMENTS

The balance of payments is a comprehensive statement of a country's economic transactions with the rest of the world for a given period of time - normally a quarter or a year. It is an account of all transactions between one country and all other countries - transactions that are measured in terms of receipts and payments[13]. *Any transaction that causes money to flow into a country is a credit to its BOP account, and any transaction that causes money to flow out is a debit.*

The three main components of the Balance of Payments are:

- The Current Account measuring transactions associated with goods and services (Exports Imports), Investment income and transfers (rents, profits, interest). The current account measures flow of real resources including exports and imports of goods and services, income receivable and payable abroad, and current transfers from and to abroad. The standard components covering goods, services, and income are to reflect the provision and acquisition of real resources by an economy to and from other economies.

[13] The balance of payments should not be confused with the balance of trade, which is a narrower concept that measures only trade in goods and services.

Flows recorded as credit measure the economy's domestic output (exports of goods and services) provided to other economies, as well as receipt of factor incomes arising from its factors of production (compensation of employees and investment income) used in the productive process in other economies. Conversely, flows recorded as debit measure the acquisition of output of other economies (imports of goods and services) and payment of factor incomes to other economies for the use of the latter's factors of production

- The Capital Account measuring financial flows such as purchases of bonds and equities or direct investment activities. The capital account measures external transactions in capital transfers[14] (mainly debt forgiveness and migrant transfers) and non-produced / non-financial assets (such as patents and copyrights). The financial account shows how an economy's external transactions are financed. Transactions in this account are classified into direct investment[15], portfolio investment[16], financial derivatives[17], other investment[18] and reserve assets[19].
- The Balancing Account allowing for changes in official reserve assets.

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[14] A capital transfer is a transfer of ownership of a fixed asset or forgiveness of a liability. For example, Economy A extends a loan to Economy B in a given period, and later on agrees to write off the loan. The forgiveness of such a loan is recorded under capital transfers.

[15] Direct investment refers to external investment in which an investor of an economy acquires a lasting interest and a degree of influence or control over the management of an enterprise located in another economy.

[16] Portfolio investment refers to investment in non-resident equities (i.e. stocks and shares) and debt securities (e.g. bonds, notes, negotiable certificates of deposits). Compared with direct investors, portfolio investors in equity and debt securities of non-resident enterprises have no lasting interest or influence in the management of the companies they invest. A holding of less than 10% equity in an enterprise is regarded as portfolio investment.

[17] Financial derivatives are financial instruments that are linked to a specific financial instrument or indicator or commodity, and through which specific financial risks can be traded in financial markets in their own right (e.g. options, warrants).

[18] Other investment refers to other financial claims on and liabilities to non-residents that are not classified as direct investment, portfolio investment, financial derivatives, or reserve assets. Examples of these financial claims and liabilities include short-term and long-term non-marketable loans, deposits, financial leases and trade credits.

[19] Reserve assets consist of external assets that are readily available to and controlled by monetary authorities of an economy for directly financing payment imbalances and for indirectly regulating the magnitude of such imbalances through intervention in the exchange markets to affect the currency exchange rate of that economy.

While the initial impact of an inflow of FDI on the host country's balance of payments may be positive[20], the medium-term impact is often negative[21], as the MNC increases imports of intermediate goods and services, and begins to repatriate profits.

FOREIGN DIRECT INVESTMENT AND DEVELOPMENT

The essence of FDI is control as opposed to ownership-control in the managerial sense. On the first glance foreign direct investment would seem to be uniquely beneficial for developing countries. It provides a vehicle for the transfer of scarce resources, and may provide both needed capital and foreign exchange.

The list of potential benefits is impressive. Foreign investment may help transfer technology and skills, provide management and training of local workers, aid in the creation of indigenous skills in administration, marketing and other business techniques, and "with appropriate safeguards" it can contribute to the growth of local enterpreneurship. It may make for more competitive markets, provide access to international markets, contribute to tax revenues and help fill foreign exchange gaps. Foreign investment may also create employment opportunities and may raise domestic wages.

The role of FDI in the development process may be enumerated as follows:

1) Injection of real capital.
2) Transfer of "embodied" technology (foreign firms training ground).
3) A way of adapting to changing comparative advantages. (A reason for FDI, instead of selling off the machinery or technology, is complementary know-how of marketing channels, management etc.)

[20] FDI can have a beneficial effect on a country's balance of payments by (i) the initial capital investment, (ii) substituting for imports that contribute to a current account deficit, and (iii) the current account surplus that results from exporting the products produced from a facility built with the initial FDI.
[21] The negative impact may be due to increase in import of inputs and payments of dividends and royalties abroad.

4) Means to circumvent trade barriers gain market access. It may have negative effect in the form of outcompeting inefficient domestic firms.
5) Increases competition, enhances efficiency of domestic firms.

Thus foreign direct investment would seem to have the potential to contribute much needed resources to developing countries. Yet, it is by no means certain that the net results from a given investment will be positive. The situation is complex with foreign investment bringing simultaneous costs and benefits to the host countries. It is obvious that foreign direct investment is viewed as less than universally beneficial by many in the developing countries.

The list of potential negatives of foreign investment is lengthy and well known. Arguments range from excessive cost of resources transferred, decrease in competitive ness of domestic markets and inappropriate technology transfers to increased dependence on industrialized countries, a loss of political and economic sovereignty and a strengthening of imperial or exploitative relationships. Many feel that in spite of its potential, foreign investment actually hinders development by suppression of the growth of local entrepreneurs. Foreign investment is also accused of undermining indigenous societies by imposing Western values and lifestyles.

The answer to the question whether FDI contributes to development is by no means determinate. Foreign direct investment has the potential to contribute much needed resources to developing countries. Yet resources are not so transferred in the abstract; they come as a part of a business enterprise responsible to an authority in an industrialized country interested in maximizing a global objective which may or may not relate positively to the development goals of the host economy.

WHY INVEST IN INDIA

India's economic reforms have played a critical role in the performance of the economy since 1991. Structural reforms, removal of controls on private and foreign direct

investment, opening the economy to foreign trade, dismantling of quantitative restrictions, liberalizing imports and reducing tariffs, exchange rate flexibility, public sector reforms and disinvestment, private investment in infrastructure, banking and insurance sector reforms - all these symbolize a great move forwards. Demographic trends, specially a slightly declining population growth rate and a rising share of working population, contribute to higher per capita income.

Changes in the policy regarding foreign investment have been more radical. These reforms have involved a total reorientation of foreign investment policy with foreign investment being actively sought not as a preferred means of financing balance-of-payments deficits compared with external borrowing, but also because it provides access to closely held technology and global marketing linkages.

The policy environment in India provides clear guidelines for entry, freedom of location, choice of technology, production, repatriation of capital, dividends, etc., which is specifically aimed of enhancing the flow of FDI. There is also a package of excellent fiscal incentives.

- India allows full and free repatriation of capital, technical fee, royalty and dividends. There is no Income Tax on profits derived from export of goods
- There is complete exemption from Custom Duty on industrial inputs, and Corporate Tax holiday for five years for 100% export oriented units and units in Export Processing Zones. The Corporate Tax applicable to foreign companies of a country for which agreement for avoidance of Double Taxation exists is lower than the rates prevailing in any of the two countries and the treaty rates.
- India has a sophisticated legal and accounting system, and a long history of stable parliamentary democracy.
- India has a rich base of mineral and agricultural resources.
- India has a long history of market economy infrastructure and a sophisticated financial sector.

- The economy has also been opened to portfolio investment. More than 500 Foreign Institutional Investors are already registered with the Securities and Exchange Board of India.
- India has a sprawling and rapidly growing consumer market. The middle class of about 300 million people constitutes the market for branded consumer goods. This is growing at 8% per annum. The demand for several consumer products is growing at over 12% every year.
- India has about 50 million English-speakers, a good 20 million more than the population of Canada.
- India has one of the largest manufacturing sectors in the world.
- India has one of the cheapest skilled and semi-skilled work force of over 150 million. Skilled manpower and professional managers are available at highly competitive cost.
- As opposed to China, where skills in marketing and human resources are in short supply, and a huge deficit in qualified managers is already visible, India has one of the largest pool of scientists, engineers, technicians and managers in the world.
- Although services in India are growing faster than any other sector, it is the Information Technology that has produced the best results. India's IT sector has grown at an annual average rate of 50%, from almost nothing in 1991 to sales of US $ 8.3 billion in 2000, employing about half a million people, and constituting 15% of India's exports.
- India is a signatory to TRIMS. Among other things it means that investors should not be subject to export obligations and domestic content requirements. The adherence to TRIMS is believed to lower transaction costs in investment

WHY REGULATE FDI

Most countries presently accept the importance of foreign investment and are trying their best to attract foreign investments. However, there is evidence that foreign investment can have both positive and negative effects, and a major objective of development policy is to maximise the positive aspects whilst minimising the negative ones, so that, on

balance, there is a significant benefit. Experience shows that for foreign investment to play a positive role, the government must have the right and powers to regulated its entry, terms of condition and operations[22].

The potential reasons for regulating foreign direct investments are:-

a) In certain areas of economic activity, regulation of FDI is used by the governments to correct market failures, protection of property rights etc. For example, access to fisheries resources might be restricted in order to protect the resource in the face of incentives to over-fish. Where it proves difficult to devise a tax or regulatory regime that fully removes the "excess profits" earned by those with access to the resource, it may be desirable to ensure that any excesses are appropriated by the host country rather than by the foreign investors.
b) Owing to strategic considerations certain areas of national defense might desirably be closed to foreign participation on strategic grounds.
c) FDI is one of several methods of financing a deficit on the current account of the balance of payments. Restricting FDI will only alter the amount to which the host country becomes indebted to foreigners to the extent that restricting FDI changes the current account deficit. For the most part, a decision to regulate FDI implies a decision about the relative merits of balance of payments financing by FDI or by borrowing abroad in other ways.
d) Controls over FDI have often also been motivated by concerns not directly related to foreign ownership such as resource management purposes.

POLICY ISSUES

There are certain policy issues that must be incorporated within the investment policy of any host country:-

a) Most favoured nation[23] - The principle implies that foreign investors from different countries are treated the same so that there is no discrimination between

[22] Martin Khor, The need to regulate foreign investment, available at http://www.twnside.org.sg/title/mai1-cn.htm (May 17, 2002).

countries. To ensure that nations do not disadvantage foreign investment from certain nations in favor of investment from other ones, this basic concept of international trade agreements - and now the key provision in international agreements on investment - seeks to prevent discrimination among investors from different countries. The phrase "most favored nation" refers to the obligation of the country receiving the investment to give that investment the same treatment as it gives to investments from its "most favored" trading partner.

b) National treatment[24] - This means that foreign investors are treated the same as domestic investors. This has been a core element of most agreements on trade in goods and services, and is also a critical issue pertaining to international investment. Typically, this principle ensures that foreign investors and their subsidiary companies are "treated at least as well as their domestic counterparts", or "no less favorably" than domestic industries. A law which taxed foreign-owned entities at a higher rate than domestically owned entities would therefore violate this principle. However, if a government wishes to give foreign-owned companies an incentive to invest such as tax-free treatment of manufacturing in an export processing zone (EPZ's), this would not generally constitute a violation of these agreements.

c) Right of establishment- This principle implies that foreign investors have the right to establish their presence in a foreign country.

d) Transparency - All laws and regulations of a country are posted so that everyone can see them and have access to them.

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[23] Most Favoured Nation (Article I of GATT) refers to the non-discriminatory principle that a GATT member country must offer the same treatment to exports from any other GATT member as the most favourable terms that it offers to any specific member.

[24] National Treatment (Article III of GATT) gives GATT members the same market access and other rights as the domestic producers of any other member.

PART A

CHAPTER 1 : DEVELOPMENT OF FDI POLICY IN INDIA

INDUSTRIAL POLICY, 1948

The first ever statement of industrial policy by the Government of India was on April 6, 1948. The government of India recognized in the statement that though the participation of foreign capital and enterprise particularly as regards industrial technique and knowledge, will be of value to the rapid industrialization of the country, it is necessary that the conditions under which they may participate in Indian industry should be carefully regulated in the national interest. Thus while foreign participation, particularly in industries requiring technology was allowed liberally, the policy made it very clear that conditions will be imposed through suitable legislation in order to ensure that the operations of the foreign enterprises conform to national interest- legislation that will provide for the scrutiny and approval by the Central Government of every individual case of participation of foreign capital and management in industry; that will provide that as a rule, the major interest in ownership and effective control, should always be in Indian hands, but power will be taken to deal with exceptional cases in a manner calculated to serve national interest. The policy statement further provided that even in such cases, the training of suitable Indian personnel for the purpose of eventually replacing foreign experts will be insisted upon[25]. However, by and large, the role of foreign capital and foreign technology was set out to be very liberal[26]. The policy made a bold front in regard to placing the foreign enterprise on par with the Indian companies. Foreign interests were permitted to earn profits and allowed to have the facility of remittances abroad. While no restrictions were placed on withdrawal of foreign capital in India, the remittance facility was to be governed by foreign exchange considerations.

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[25] 1948 Industrial Policy Resolution, No. 1(3) 44(13)/(48).
[26] R. Krishnan, *Handbook on Foreign Collaborations and Investments in India* 2 (New Delhi: Commercial law publishers, 2001).

On 6th April 1949, the then Prime Minister Pandit Jawaharlal Nehru made an important statement in the parliament on the participation of foreign capital in industries. The statement highlighted the importance of utilization of foreign in a manner most advantageous to the country. The statement recognized the low level of national savings, which in turn hampered capital formation. The statement called upon foreign undertakings to generally conform to the requirements of the industrial policy in the country. The statement assured that if ever foreign enterprises were compulsorily acquired, Government would provide reasonable facilities for the remittance of the proceeds and also payment of compensation on a fair and equitable basis. The statement clarified that while major interest in the ownership and effective control of the undertaking was sought to be in India's hands, the industrial policy had provided for exceptions from this rule in national interest. Similarly, there was no restriction on non-Indians occupying posts in Indian companies requiring technical skill and knowledge. At the same time, the statement underlined the importance of training and employment to Indians even for such posts in the quickest possible manner.

THE INDUSTRIAL (DEVELOPMENT AND REGULATION) ACT, 1951

In 1951, the Industrial (Development and Regulation) Act, (IDRA) was promulgated to regulate the method and manner of issue of an industrial licence[27] as well as the terms and conditions upon which the licence can be granted.

OBJECTIVE OF THE ACT

The Act seeks to develop and regulate certain types of industries listed in the First Schedule to the Act. These industries are called the scheduled industries. The developmental objective of the Act is sought to be achieved by two nodal authorities

[27] In the pure legal sense, licence is a kind of permission for doing an act, which otherwise would be unlawful and illegal. Industrial licence confers legality to the undertaking of a manufacturing activity in respect of which such licensing has been stipulated.

under the Act, called the Central Advisory Council and the Development Council. Both these authorities are created by notification issued by the Government of India and have the status of a corporate body. While the former functions purely as an advisory body the latter has well defined functions, enumerated in the second schedule to the Act[28]. The regulatory objective is sought to be achieved by various methods namely, requiring registration of exiting industrial undertakings, licensing of certain activities, conducting of investigation into the working of scheduled industries, takeover of management and control of scheduled industrial undertakings, disposal of the undertakings so taken as per the alternatives specified in the Act.

SCOPE OF THE ACT

The Act applies only to those industries carried on in a factory, i.e., the manufacturing[29] activity pertaining to the scheduled industries only are covered under the act. But not all manufacturing activities would be subject to the provisions of the Act. To come within the purview of the Act, the manufacturing activity should be carried on in a factory[30], i.e.-

a) where the manufacturing activity is carried on with the aid of power if fifty or more workers are working or were working thereon on any day of the preceding twelve months;
b) where the manufacturing activity is carried on without the aid of power if one hundred or more workers are working or were working thereon any day of the receding twelve months.

The idea of exempting the above type of factories is that they are too insignificant to be controlled or regulated and their production may not matter in overall context of regulation. Moreover service industries are totally outside the purview of the Act.

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[28] Section 5 & 6 of theAct.
[29] "Manufacturing" would mean bringing into existence a commodity with a distinctive name, character or use.
[30] Section 3 (c) of the Act

REGISTRATION OF EXISTING INDUSTRIAL UNDERTAKINGS

The Act provides for the registration of existing industrial undertakings[31]. "Existing Industrial Undertakings" has been defined to mean an industrial undertaking which is in existence or for the establishment of which effective steps have been taken on the date on which the activity has been brought within the purview of the Act by a statutory amendment. For example, a new industry is added to the First Schedule to the Act by a statutory amendment from say 1st December 2001, then all the industrial undertakings which are already in existence on 1st December, or all undertakings through not in existence, but for the establishment of which effective steps have been taken, would be deemed to be "existing industrial undertaking" and they would required to be registered under the Act. Since they are already in existence, they are not required to take out a licence, but offer themselves for registration under the Act and thus be subject to all regulations under the Act.

LICENSING REQUIREMENTS UNDER THE ACT

The Act requires the owner of an industrial undertaking to apply for an industrial licence for the following purpose:

a) for establishment of a new industrial undertaking[32]
b) for manufacture of a new article[33]
c) for effecting substantial expansion of its activities
d) for effecting change of location of the factory

In addition to the above, under the following circumstances also an industrial licence has to be applied for:

[31] Section 10
[32] Section 11
[33] Section 11A

a) where a certificate of registration earlier granted has been revoked and the business of the undertaking is required to be carried on
b) where the industrial undertaking was required to be registered but the undertaking did not get itself registered within the time stipulated for the purpose and it wants to carry on the business of the undertaking nevertheless
c) where the provisions of the Act did not originally apply to the undertaking, but became applicable subsequently for any reason whatsoever, and the undertaking desires to carry on its activity beyond a period of three months
d) where the undertaking has been exempt from licensing by a notification under tha Act and later exemption has been withdrawn, such an undertaking desires to carry on its activities further

In the above four cases, the undertakings apply for what is known as the "carry on business licence".

REGULATORY POWERS

The Act contains the following regulatory powers, namely:-

a) conducting of investigation into the working of scheduled undertakings
b) issuing directions after such investigations
c) taking over the management and control of scheduled industrial undertakings
d) managing the undertakings taken over
e) disposal of the undertakings so taken over by
   - giving the management back to the owners
   - selling it as a running concern
   - ordering reconstruction of the undertaking

Nowadays, as a matter of principle, the Government of India does not take over management of any industrial undertaking under the Act in view of the fact that the

experience in this regard in the past has had a serious implication of Government funding the units and dealing with labour related issues.

INDUSTRIES REQUIRING COMPULSORY LICENSING UNDER THE ACT

There are effectively only 6 industries which require licensing compulsorily, namely:-

a) Distillation and brewing of alcoholic drinks
b) Cigars and cigarettes of tobacco and manufactured tobacco substitutes
c) Electronic Aerospace and defence equipment: all types
d) Industrial explosives including detonating fuses, safety fuses, gun powder, nitrocellulose and matches.
e) Hazardous chemicals
f) Drugs and Pharmaceuticals

INDUSTRIAL POLICY, 1956

This policy was announced at a time when the Government had launched upon a policy of planned economic development and the First Five year plan had come to a close by then. The policy has also to be seen in the context of the fact that the Constitution of India had declared securing justice, liberty, equality and fraternity and further in the context of the fact that the Constitution provided for a set of Directive Principles of State Policy for ensuring social, economic and political justice. The highlights of this policy are:-

a) It recognized the concept of mixed economy where both the state and the private sector would have defined roles in the industrial development of the country.
b) A list of industries, which would be the exclusive responsibility of the State, was drawn up specifying 17 industries.

c) A second category of industries consisting of 12 industries in all was also specified wherein the state was to increasingly establish new undertakings. At the same time, the private enterprise was also to have equal opportunity to develop in this field either on its own or with State participation.

d) All the remaining industries were to fall in the third category in which the initiative and enterprise will be entirely left to the private sector. At the same time, it was open to the State to start any industry even in this category.

The policy reinforced its faith in the mixed economy and embraced the approach of planned economic development in the efforts towards setting up a modern industrial economy.

INDUSTRIAL LICENSING GUIDELINES, 1970

The Cabinet, in the year 1970, announced certain guidelines which were by and large in the context of the new law which was enacted to regulate monopolies and regulate the activities of large industrial enterprises, namely the Monopolies and Restrictive Trade Practices Act, 1969. The MRTP Act sought to define monopoly and large industrial houses in terms of the control over assets and control over market power. The whole exercise that preceded the enactment of the MRTP Act was intended to ensure that there was no concentration of economic power to the common detriment and that the material resources of the country were so distributes as to subserve the common good. Therefore the 1970 Industrial licensing guidelines laid special importance to exports, promotion of small scale industries and drew up scheme of export obligations in certain cases. The highlights of the policy were:-

a) Exports from small-scale industries to be developed to the maximum extent.

b) MRTP undertakings to participate mainly in core, heavy investment sectors

c) Minimum export obligations in the case of MRTP undertakings to be 60% of the additional production.

d) MRTP undertakings to undertake 75% export commitment in case they enter areas where the products are reserved for the small-scale sector.

e) High priority to be accorded to export oriented units.

FOREIGN EXCHANGE REGULATION ACT, 1973

Exchange control regulations in India have come a long way since they were first introduced in 1939 under the Defence of India Rules. They were enacted into a statute in 1947 known as Foreign Exchange Regulation Act, 1947 (FERA, 1947). The Act was completely overhauled in 1973 and replaced by a brand new Act known as Foreign Exchange Regulation Act, 1973(FERA 1973). The Foreign Exchange Management Act, (FERA) 1973 was an act to regulate dealings in foreign exchange and foreign securities with the objective of conservation of foreign exchange resources of India and its proper utilization in the economic development of India. It was a very stringent act. Unlike other laws where everything is permitted unless specifically prohibited, under FERA nothing is permitted unless specifically permitted. Hence the tenor and tone of the Act is very drastic. It provided for imprisonment for violation of even a very minor offense. Under this act, a person was to be presumed guilty unless he proves himself innocent whereas under other laws, a person is presumed innocent unless he is proven guilty. Therefore one had to be very careful while dealing in foreign exchange and ensure that all legal compliances are carried out.

FERA imposed restriction on every dealing involving foreign exchange. No dealing in foreign exchange was permitted unless allowed by the RBI. Under section 8, except with the previous general or special permission of the reserve bank, no person, other than an authorized dealer, could deal in India and no person resident in India, other than an authorized dealer, could outside India purchase or otherwise acquire, borrow from, or sell, or otherwise transfer or exchange with any person not being an authorized dealer, any foreign exchange. Except with the previous general or special permission of the reserve bank, no person, whether an authorized dealer or a money changer or otherwise, could enter into any transaction which provided for the conversion of Indian currency

into foreign currency or foreign currency into Indian currency at rates of exchange other than the rates of exchange for the time being authorized by the reserve bank.

FERA imposed restrictions on the dealing and investing outside India of Indian securities. It also imposed restrictions on dealing and investing in foreign securities in India and overrode the provisions of the Companies Act also in this connection. The Act imposed certain restrictions on the appointment of certain persons and companies and agents of technical or management advisers in India[34]. A person resident outside India, whether a citizen of India or not, or person who not a citizen of India but is resident in India or company (other than banking company) which is not incorporated under any law in force in India or any branch of such company could not, except with the general or special permission of the Reserve Bank, act or accept appointment as agent in India of any person or company in trading or commercial transactions of such person or company.

Where any such person or company acted or accepted appointment as such agent without permission of Reserve Bank, such acting or appointment was to be void[35].

FERA restricted the establishment of business of place in India.[36] A person resident outside India, whether a citizen or not, or a person who is not citizen of India but is resident in India or company (other than banking company) which is not incorporated under law in force in India or any branch of such company couldnot except with general or special permission of the Reserve Bank :

1) Carry on in India or establish in India a branch office or other place of business for carrying the activities of a trading, commercial and industrial nature other than activity for carry of which permission of the Reserve Bank has been obtained

2)Acquire the whole or any part of any undertaking in India of any person or the company carrying on such trade, commerce or industry or purchase the share of such company in India.

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[34] Section 28
[35] *Id*
[36] Section 29 of the Act.

It was only in the 1980s that the attitude to foreign collaborations and investment began to change, along with the change in the attitude to domestic industry. Illustratively, in the mid-80s, some liberalization of policies and procedures pertaining to new FDI, technology transfer etc. was attempted. Still, the restriction on the foreign equity ownership (to a maximum of 40%) continued, thereby implying that effective control of such joint ventures would be with the Indian hands. The value of FDI approved as well as accrued in the pre-1991 period, was miniscule and negligible not only relative to the FDI in other developing countries, but also relative to that in the post- 1991 period.

The principal factors which were responsible for the indifferent attitude of the foreign investors and (hence) for the very limited role of FDI, were- the 40% ceiling on foreign equity- which also acted as a disincentive for obtaining latest, sophisticated technology, the stringent FERA provisions and procedural rigidities, constraints in foreign technology agreements (in the form of: contractual provisions, low royalty rates, higher tax liability, inappropriate norms for lump sum payments etc.).

It is here that the Industrial Policy of 1991 and its subsequent revisions and modifications, made radical departures from the past, especially in formulating a policy-environment conducive to FDI.

INDUSTRIAL LICENSING POLICY, 1991

The 1991 Policy is a watershed in the economic history of the country. This policy again was formulated in the backdrop of a political crisis in the country, which led to more than one and a half years of policy instability and political uncertainty. The policy was announced in the context of the fact that a deep and pervasive economic crisis had over-taken the country, the credit rating of the country was at its lowest ebb, the country committed defaults in repayment of loans from international agencies for the first time ever after Independence and that the foreign exchange resources were hardly sufficient to meet import bills for barely a period of 14 days. The situation was worsened by the Gulf war in so far as it led to increased petroleum prices and caused the virtual stoppage of remittances from Indian workers in the Gulf. These developments brought the country

almost to the verge of default in respect of external payments liability which could only be averted by borrowing from the IMF under standby arrangements and other emergence measuers taken by the Government to restrict imports. In June 1991, a new government headed by Mr. P.V. Narasimha Rao came into power following the mid term elections. This government initiated a programme of macro-economic stabilization and structural adjustment supported by the IMF and the World Bank. As a part of this programme the Indian rupee was devalued and a New Industrial Policy (NIP) was announced on 24th July 1991 in the parliament. It carried conviction and determination to go ahead with a host of reforms in industrial, trade and fiscal policies. For the first time, the new industrial policy questioned the role of the Public sector which had become a heavy burden on the national exchequer, enlarging the fiscal deficit year after year. The ideological shackles were for once sought to be broken and complete incline towards establishment of a market-driven economy rather than a State-regulated economy (Command economy) was sought to be experimented. The shift in the policy was necessitated in the context of the fact that a command economy did not, over a period of four decades of Independence, prove sufficiently successful and that a shift towards market-driven economy would perhaps bring about more desirable results. The salient feature of the 1991 policy are as under :

(i) Industrial licensing was abolished for all industries other than 18 industries (now reduced to 15).

(ii) The role of Public Sector was reduced from 17 to only 8 categories of industries (now reduced to 6).

(iii) 34 categories of industries (now raised to 36) were identified as high priority industries wherein foreign investment up to 51% was permitted.

(iv) Location policy was relaxed in non-polluting industries.

(v) The concept of phased manufacturing programme was given a go by.

(vi) Foreign technology agreements and foreign investments were allowed in high priority industries subject to certain limits under the automatic permission route of the Reserve Bank.

(vii) Sick companies in the Public Sector were to be either wound up or referred to the Board for Industrial and Financial Reconstruction (BIFR).

(viii) Regulation over large industrial houses and dominant undertakings were abolished insofar as they came in the way of expansion, growth and further development. Greater emphasis was laid on control of monopolistic, restrictive and unfair trade practices.

(ix) Free permission of repatriation of earnings and remittances of profits, except in the case of some specified consumer goods industries and

(x) Liberalization of technical know how fees, royalty on domestic sales and royalty on exports

The New Industrial policy implemented in the regime characterized by dramatically reduced public sector dominance, abolition of MRTP and dilution of FERA, virtual delicensing of all major industries, financial and monetary deregulation etc., doubtlessly, added a qualitatively distinct dimension to the economy. Thus, the new industrial policy of 1991 broke new grounds and put the matrix of industrial growth on a bold experimental plane.

ACTUAL FDI FLOWS (IN RS MILLIONS)

CATEGORY	1991	1992	1993	1994 (first quarter)
1. Direct Investment[37]	3,514.3	6,752.2	17,860.0	5,939.1
2. *Of which* NRI Investment	1,602.5	1,496.9	1,817.4	1,817.4
3. FDI (1-2)	1,911.8	5,255.3	12,264.0	4,121.7
4. Monthly average of 3	159.3	437.9	1,022.0	1,373.9

Source: Reserve Bank of India

[37] Excluding Portfolio Investment

FOREIGN EXCHANGE MANAGEMENT ACT, 1999

On the face of it, the replacement of the Foreign Exchange Regulation Act (FERA) by the Foreign Exchange Management Act (FEMA) represented the logical culmination of the process of relaxation of controls over foreign exchange transactions in the country which was initiated with amendments to FERA in 1993, as a part of the ongoing process of economic liberalization. Thus, in keeping with the perceived needs of the present times, foreign exchange dealings in the country were to be "managed" rather than "regulated". Justification for the introduction of FEMA has been sought primarily on the grounds that the external payments position of the country has shown a marked improvement since the amendment to FERA was brought about in 1993, which is reflected in the growing levels of foreign exchange reserves and the confidence that the country has displayed in moving towards greater openness vis-à-vis the external sector.

FEMA represented major departure from the past policies in two important aspects. First, it is an initial step towards capital account convertibility. Secondly, by removing the FERA from the statute book and replacing it with FEMA, the government seemed to have finally decided to give up even the bare intention of regulating foreign capital in the country. The FEMA seeks to take two significant steps towards diluting existing restrictions of foreign exchange dealings. In the first place, the relatively more punitive provisions of the FERA have been diluted. Two such provisions need particular mentioning. One, unlike in case of the FERA, violations of the FEMA would not attract criminal proceedings. And, two, any contravention of the provisions of the proposed Act would attract a penalty, after the process of adjudication is gone through, up to twice the amount involved in such contravention. Where the mount involved is not quantifiable, the penalty would be up to two lakh rupees[38]. This makes a departure from the FERA, where the penalty was five times the amount involved in the contravention and simultaneous initiation of criminal proceedings. At the same time, the Central Government has been

[38] Section 13 of Foreign Exchange Management Act, 1999

given the discretionary power to suspend the operation of the Act if it considers it necessary to do so in public interest[39].

Under the FEMA, the Reserve Bank of India is authorized to make, by notification, regulations to carry out the provisions of the Act and the rules made thereunder. The Foreign Direct Investment in India continues to be governed by the Industrial Policy, FEMA and the rules and regulations notified thereunder.

[39] Section 40

CHAPTER II: GENERAL OUTLINE OF THE POLICY REGARDING FOREIGN DIRECT INVESTMENT

There are essentially two types of foreign collaborations which involve direct investment in shares of Indian companies:

a) Financial collaboration (foreign equity participation) where foreign equity alone is involved:
b) Technical collaboration (technology transfer) which involves licensing of technology by the foreign collaborator with due compensation for the same.

Whether it is technical collaboration or financial collaboration, there are two approving authorities:

a) the Reserve Bank of India
b) the Government of India.

ROUTES FOR FDI IN INDIA

The Government of India's policy on foreign private investment is based mainly on the approach adopted in 1949. The basic policy is to welcome foreign private investment on a selective basis in areas advantageous to the Indian economy. The conditions under which foreign capital is welcome are as follows:

a) All undertakings (Indian or foreign) have to confirm to the general requirements of the Government's Industrial Policy.
b) Foreign enterprises are to be treated at par with their Indian counterparts.
c) Foreign enterprises would have the freedom to remit profits and repatriate capital, subject to foreign exchange considerations.

Foreign direct investment is freely allowed in all sectors including the services sector, except where the existing and notified sectoral policy does not permit FDI beyond a ceiling. FDI for virtually all items/activities can be brought in through the automatic route under powers delegated to the Reserve Bank of India (RBI), and for the remaining items/activities through Government Approval. Government approvals are accorded on the recommendation of the Foreign Investment Promotion Board (FIPB), chaired by the Secretary, Department of Industrial Policy and Promotion (Ministry of Commerce and Industry) with the Union Finance Secretary, Commerce Secretary, and other key Secretaries of the Government as its members.

The Foreign Exchange Management (Transfer or Issue of security by a person resident outside India) Regulation, 2000[40] provide that a person resident outside India (other than a citizen of Bangladesh or Pakistan or Sri Lanka) or an entity outside India, whether incorporated or not, (other than an entity in Bangladesh or Pakistan), may purchase shares or convertible debentures of an Indian company under Foreign Direct Investment Scheme, subject to the terms and conditions specified in Schedule 1[41] to the notification.

AUTOMATIC ROUTE

An Indian company which is not engaged in any activity, or in any manufacturing of items included in annexure[42], may issue shares or convertible debentures to a person resident outside India, referred to in paragraph 1 of the schedule upto the extent specified, subject to the compliance with the provisions of Industrial Policy and Procedures as notified by the Secretariat for Industrial Assistance (SIA) in the Ministry of Commerce and Industry, Government of India, from time to time, provided-

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[40] Para 5(1), Notification No. FEMA 19/2000-RB, dated 3rd May, 2000.

[41] Hereinafter referred to as schedule.

[42] Annexure A to Schedule 1 of Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000.

a) the activity of the issuer company does not require an industrial licence under the provisions of the Industrial (Development & Regulation) Act, 1951 or under the locational policy[43] notified by Government of India under the Industrial Policy of 1991 as amended from time to time.
b) The shares or convertible debentures are not being issued by the Indian company with a view to acquiring existing shares of any Indian company.

A company which proposes to embark on expansion programme to undertake activities or manufacture items included in annexure B to the schedule may issue shares or debentures out of fresh capital proposed to be issued by it for the purpose of financing expansion programme, upto the extent indicated in annexure B[44].

According to the "Manual on Industrial Policy and Procedures in India", February 2000, issued by SIA, all new ventures regarding items/ activities for FDI/NRI/OCB investment up to 100% fall under the Automatic Route except: -

a) all proposals that require an Industrial Licence which includes (i) the item requiring an Industrial Licence under the Industries (Development and Regulation) Act, 1951; (ii) foreign investment being more than 24% in the equity capital of units manufacturing items reserved for small scale industries; and (iii) all items which require an Industrial Licence in terms of the locational policy notified by Government under the New Industrial Policy of 1991.

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[43] The locational policy provides that, "Industrial undertakings are free to select the location of a project. In the case of cities with population of more than a million (as per the 1991 census), however, the proposed location should be at least 25 KM away from the Standard Urban Area limits of that city unless, it is to be located in an area designated as an "industrial area" before the 25th July, 1991. Electronics, Computer software and Printing (and any other industry which may be notified in future as "non polluting industry") are exempt from such locational restriction. Relaxation in the aforesaid locational restriction is possible if an industrial license is obtained as per the notified procedure". It further provides that, "the location of industrial units is further regulated by the local zoning and land use regulations as also the environmental regulations. Hence, even if the requirement of the locational policy is fulfilled, if the local zoning and land use regulations of a State Government, or the regulations of the Ministry of Environment do not permit setting up of an industry at a location, the entrepreneur would be required to abide by that decision.

[44] Annexure at the end regarding sectoral cap on investment by persons resident outside India.

b) all proposals in which the foreign collaborator has a previous venture/tieup in India.

c) all proposals relating to acquisition of shares in an existing Indian company in favour of a foreign/NRI/OCB investor.

d) all proposals falling outside notified sectoral policy/caps or under sectors in which FDI is not permitted.

Whenever any investor chooses to make an application to the FIPB and not to avail of the automatic route, he or she may do so.

Investment in Public Sector Units as also for EOU/EPZ/SEZ/EHTP/STP units would also qualify for the Automaic Route. Investment under the Automatic Route is governed by the notified sectoral policy and equity caps and RBI ensures compliance of the same.

Besides new companies, automatic route for FDI/NRI/OCB investment is also available to the existing companies to induct foreign equity. For existing companies with an expansion programme, the additional requirement are that (I) the increase in equity level must result from the expansion of the equity base of the existing company without acquisition of existing shares by NRI/OCB/foreign investors, (ii) the money to be remitted should be in the sector(s) under the automatic route. Otherwise the proposal would need Government approval through the FIPB. For this, the proposal must be supported by a Board Resolution of the existing Indian company as well as a consent letter from the Indian partner and the foreign collaborator.

For existing companies without an expansion programme, the additional requirements for eligibility for automatic route are (I) that they are engaged in the industries under automatic route (including additional activities covered under the automatic route regardless of whether the original activities were undertaken with Government approval or by accessing the automatic route), (ii) the increase in equity level must be from expansion of the equity base and (iii) the foreign equity must be in foreign currency.

The automatic route[45] for FDI and/or technology collaboration would not be available to those who have or had any previous joint venture or technology transfer/trade mark agreement in the same or allied field in India.

Equity participation by international financial institutions such as ADB[46], IFC[47], CDC[48], DEG[49], etc. in domestic companies is permitted through automatic route subject to SEBI/RBI regulations and sector specific caps on FDI.

In a major drive to simplify procedures for foreign direct investment under the "automatic route", RBI has given permission to Indian Companies to accept investment under this route without obtaining prior approval from RBI. Investors are required to notify the Regional Office concerned of the RBI of receipt of inward remittances within 30 days of such receipt and file required documentation within 30 days of issue of shares to Foreign Investors. This facility is available to NRI/OCB investment also.

A company which is a small scale industrial unit[50] and which is not engaged in any activity or in manufacture of items included in annexure A[51], may issue shares or convertible debentures to person referred to in paragraph one of the schedule, to the extent of 24% of its paid up capital. Such a company may issue shares in excess of 24% of its paid up capital if-

a) it has given up its small scale status;
b) it is not engaged or does not propose to engage in manufacture of items reserved of small scale sector, and

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[45] Automatic Route is only for issue of fresh shares by the Indian company. Transfer of existing shares from residents to non-residents needs approval from Government of India followed by an approval from Reserve Bank of India.
[46] Asian Development Bank.
[47] International Finance Corporation.
[48] Commonwealth Development Corporation.
[49] Deustche Entwicklungs Gescelschaft.
[50] An industrial undertaking is defined as a small scale unit if the investment in fixed assets in plant and machinery does not exceed Rs 10 million
[51] Annexure A to Schedule 1 of Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000.

c) it complies with the ceilings specified in annexure B to the schedule.

An Export Oriented Unit or a unit in free trade zone or in Export Processing Zone or in a Software Technology Park or in an electronic hardware technology park may issue shares or convertible debentures to a person resident outside India referred to in paragraph 1 of the schedule in excess of 24% provided it complies with the ceilings specified in annexure B to the schedule.

GOVERNMENT APPROVAL

For the following categories, Government approval for FDI/NRI/OCB through the FIPB shall be necessary:-

a) All proposals that require an Industrial Licence which includes (i) the item requiring an Industrial Licence under the Industries (Development and Regulation) Act, 1951; (ii) foreign investment being more than 24% in the equity capital of units manufacturing items reserved for small scale industries; and (iii) all items which require an Industrial Licence in terms of the locational policy notified by Government under the New Industrial Policy of 1991.
b) All proposals in which the foreign collaborator has a previous venture/tieup in India. The modalities prescribed in Press Note No. 18 dated 14.12.98 of 1998 series, shall apply in such cases. However, this shall not apply to investment made by multilateral financial institutions such as ADB, IFC, CDC, DEG, etc. as also investment made in IT sector.
c) All proposals relating to acquisition of shares in an existing Indian company in favour of a foreign/NRI/OCB investor.
d) All proposals falling outside notified sectoral policy/caps or under sectors in which FDI is not permitted.

Areas/Sectors/Activities hitherto not open to FDI/NRI/OCB investment shall continue to be so unless otherwise decided and notified by Government.

For greater transparency in the approval process, Government have announced guidelines for consideration of FDI proposals by the FIPB. The sector specific guidelines for FDI and Foreign Technology Collaborations are also stated.

FDI APPROVALS (IN CRORES)

PERIOD	AMOUNT	MONTHLY AVERAGE	%CHANGE
Jan 1981-Dec 1990	1,1,51	9.6	-
Aug 1991-July 1992	1,950	162.5	159.2
Aug 1992-July 1993	7,220	601.6	270.2
Aug 1993-March 1994	5,170	646.2	(-7.41)

Source: Secretariat For Industrial Approvals

FOREIGN INVESTMENT POLICY FOR TRADING ACTIVITIES

Foreign investment for trading can be approved through the automatic route up to 51% foreign equity, and beyond this by the Government through FIPB. For approval through the automatic route, the requirement would be that it is primarily export activities and the undertaking concerned is an export house/trading house/ super trading house/star trading house registered under the provisions of the Export and Import policy in force. However, under the Government route:

i) 100% FDI is permitted in case of trading companies for the following activities:

a) exports;

b) bulk imports with export/ex-bonded warehouse sales;

c) cash and carry wholesale trading;

d) other imports of goods or services provided at least 75% is for procurement and sale of goods and services among the companies of the same group and for the third party use or onward transfer/distribution/sales.

ii) the following kinds of trading are also permitted, subject to the provisions of EXIM policy:

a) Companies for providing after sales services (that is not trading per se).

b) Domestic trading of products is permitted at the wholesale level by such trading companies who wish to market manufactured products o behalf of their joint ventures in which they have equity participation in India

c) Trading of hi-tech items/items requiring specialized after sales service.

d) Trading of items for social sector

e) Trading of hi-tech/medical and diagnostic items.

f) Trading of items sourced from the small scale sector under which based on technology provided and laid down quality specifications, a company can market that item under its brand name.

g) Domestic sourcing of products for export.

h) Test marketing of such items for which a company has approval for manufacture provided such test marketing facility will be for a period of two years, and investment in setting up manufacturing facilities commences simultaneously with test marketing.

i) FDI upto 100% permitted for E-commerce activities subject to the condition that such companies would divest 26% of their equity in favour of the Indian public in five years, if these companies are listed in other parts of the world. Such companies would engage only in business to business e-commerce and not in retail trading.

ISSUE AND VALUATION OF SHARES IN CASE OF EXISTING COMPANIES

On receipt of the approval (either through the automatic route or by Government) an existing company needs to propose allotment of preferential allocation of the required amount of equity to the foreign investor by a special resolution. The company can make the issue at market prices of the shares either at

a) the average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the six months preceding the relevant date or
b) the average of the weekly high and low of the closing prices of the related shares quoted on a stock exchange during the two weeks preceding the relevant date.

The stock exchange referred to is the one at which the highest trading volume in respect of the share of the company has been recorded during the preceding six months prior to the relevant date. The relevant date is the date thirty days prior to the date on which the meeting of the General Body of the shareholders is convened.

OTHER MODES OF FDI IN INDIA

ADR/GDR/FCCB

Foreign Investment through GDRs/ADRs, Foreign Currency Convertible Bonds (FCCBs) are treated as Foreign Direct Investment. Indian companies are allowed to raise equity capital in the international market through the issue of GDR/ADRs/FCCBs. These are not subject to any ceilings on investment. An applicant company seeking Government's approval in this regard should have a consistent track record for good performance (financial or otherwise) for a minimum period of 3 years. This condition can be relaxed for infrastructure projects such as power generation, telecommunication, petroleum exploration and refining, ports, airports and roads.

An Indian company may issue its rupee denominated shares to a person resident outside India being a depository for the purpose of issuing Global Depository Receipts (GDRs) and/or American Depository Receipts (ADRs), provided the Indian company issuing such shares: -

a) has an approval from the Ministry of Finance, Government of India to issue such ADRs and/or GDRs or is eligible to issue ADRs/GDRs in terms of the relevant schemes in force or notifications issued by the Ministry of Finance, and
b) is not otherwise ineligible to issue shares to persons resident outside India in terms of these regulations, and
c) the ADRs/GDRs are issued in accordance with the scheme for issue of Foreign Currency Convertible bonds and Ordinary Shares (Through Depository Receipt Mechanism)Scheme 1993 and guidelines issued by the Central Government thereunder from time to time.

There is no restriction on the number of GDRs/ADRs/FCCBs to be floated by a company or a group of companies in a financial year. A company engaged in the manufacture of items covered under Automatic Route that likely to exceed the percentage limits under the Automatic Route or whose direct foreign investment after a proposed GDR/ADR/FCCBs issue is likely to exceed 50 per cent/51 per cent/74 per cent as the case may be, or which is implementing a project not contained in project falling under Government Approval route, would need to obtain prior Government clearance through FIPB before seeking final approval from the Ministry of Finance.

PREFERENCE SHARES

Foreign investment through preference shares is treated as foreign direct investment. Proposals are processed either through the automatic route or FIPB as the case may be. The following guidelines apply to issue of such shares: -

a) Foreign investment in preference share are considered as part of share capital and fall outside the External Commercial Borrowing (ECB) guidelines/cap
b) Preference shares to be treated as foreign direct equity for purpose of sectoral caps on foreign equity, where such caps are prescribed; provided they carry a conversion option. If the preference shares are structured without such conversion option, they would fall outside the foreign direct equity cap.

CHAPTER III: ENTRY STRATEGIES FOR FOREIGN INVESTORS

There are several strategies by which a foreign enterprise can set - up Indian operations. Broadly, entry strategies may be classified into two major types: -

1. A foreign investor may directly set up its operations in India through a branch office or a representative office or liaison office or project office of the foreign Company; or
2. It may do so through an Indian arm i.e. through a subsidiary company set - up in India under Indian laws.

AS A FOREIGN COMPANY

A foreign company is a company, which has been incorporated outside India. Such companies, for conducting business in India, have to comply with the following formalities:-

a) Compliance with the Indian Companies Act, 1956
b) Compliance with the Reserve Bank of India's rules and regulations

COMPLIANCE UNDER THE COMPANIES ACT, 1956

Sections 591 to 602 of the Companies Act contain the provisions regarding the foreign companies. According to section 592, foreign companies are required to file certain documents with the Registrar of Companies. The list of documents to be filed is given in section 591. Foreign companies that establish a place of business in India shall, within 30 days of establishment of the place of business, file with the Registrar of Companies the following documents:-

a) Certified copy of the Charter or Memorandum and Articles of Association of the company and if the instrument is not in English language, a certified translation thereof in English.
b) Full address of the registered office or principal office of the company abroad.
c) List of Directors and Secretary of the company
d) The name and address of one or more persons resident in India who is or are authorized to accept, on behalf of the company, service of any notice served on the company.
e) The full address of the office of the company in India which is its place of business.

Several sections of the Companies Act (sections 594, 209, 600) provide for maintenance of accounts books by a foreign company and submission of its Balance Sheet and Profit and Loss Account to the prescribed authorities. A foreign company is required to compile its Balance Sheet and Profit and Loss Account relating to its business carried on in India. This compilation is in addition to the normal Balance sheet and Profit and Loss account such a company would prepare for its global operations which are popularly called as "world accounts" in India. The Balance Sheet and Profit and Loss account for Indian operations are to compiled separately and independently as per the requirements of the schedule VI of the Companies Act. Balance Sheet and Profit and Loss account are also required to be filed with Registrar of Companies in India.

COMPLIANCE WITH THE RESERVE BANK OF INDIA RULES AND REGULATIONS

Under Foreign Exchange Management Act, 1999 (FEMA), RBI can issue rules regulating foreign investment. The following are the entry strategies for a foreign enterprise in case the Indian operations are to be run directly by a foreign company[53] through a branch

[53] Foreign Companies means a company incorporated in a country outside India under the law of that other country and has established the place of business in India.

office or a representative office or liaison office or project office of the foreign company:-

LIAISON OFFICE

A foreign company can set up a liaison or representative office in India to test the Indian Market. It can enter with much greater investment later if it is convinced about the potential of the Indian market. There are however certain limitations regarding the type of work which can be done through a liaison or representative office. A liaison office[54] is not allowed to undertake any business activity in India and cannot therefore, earn any income in India. The role of such offices is, therefore, limited to collecting information about possible market opportunities and providing information about the company and its products to the prospective Indian customers. Expenses of such offices are to be met entirely through inward remittances of foreign exchange from the Head Office abroad.

PROJECT OFFICE

Foreign companies planning to execute specific projects in India can set up project office[55] or site offices[56] in India. Specific approval from the RBI is required for setting up a project office. Such approval is generally accorded in respect of projects approved by appropriate authorities or where the projects are financed by Indian bank/Financial Institution or a multilateral/bilateral international financial institution.

[54] "Liaison Office" means a place of business to act as a channel of communication between the principal place of business or head office by whatever name called and entities in India but which does not undertake any commercial/trading/industrial activity, directly or indirectly, and maintains itself out of inward remittances received from abroad through normal banking channel". Clause 2(e), Foreign Exchange Management (Establishment in India of Branch or Office or other Place of Business) Regulations, 2000.

[55] "Project office" means a place of business to represent the interests of the foreign company executing a project in India but excludes a liaison office.

[56] "Site office" means a sub-office of the project office established at the site of a project but does not include a liaison office.

BRANCH OFFICE

Foreign companies wishing to establish a branch office or other place of business for their activities of trading, commercial or industrial nature are required to take permission of Reserve Bank to carry on such activities. Reserve Bank permits companies engaged in manufacturing and trading activities abroad to set up Branch Offices in India for the following purposes:

- To represent the parent company/other foreign companies in various matters in India e.g. acting as buying/selling agents in India
- To conduct research work in the area in which the parent company is engaged
- To undertake export and import trading activities
- To promote possible technical and financial collaborations between the Indian companies and overseas companies.
- Rendering professional or consultancy services
- Rendering services in Information technology and development of software in India
- Rendering technical support to the products supplied by the parent/Group companies.
- Acting as a communication channel between the parent company and Indian companies.

A branch office is not allowed to carry out manufacturing, processing activities directly/indirectly. Branch office will have to submit activity certificate from a Chartered Accountant on an annual basis to Reserve Bank of India. For annual remittance of profit Branch Office may submit required documents to an authorised dealer.

Permission for setting up branch offices is granted by the Reserve Bank of India. RBI considers the track record of the applicant company, existing trade relations with India and financial position of the company while scrutinising the application.

specific permission of the Reserve Bank of India with full benefits of repatriation such permission would constitute necessary approval to the company. It may also be noted that the Foreign Exchange Management (Investment in Firm or Proprietary Concern in India) Regulations, 2000 constitute the complete code o investments in the capital of a firm or proprietary concern in India.

INVESTMENT BY NRIs/OCB IN SHARES/CONVERTIBLE DEBENTURES ON NON-REPATRIATION BASIS

Non-resident Indians (NRIs) and Overseas Corporate Bodies (OCBs)[58] have been permitted to make investments in the share/convertible debentures of an Indian company under the Portfolio Investment Scheme. Investments under the scheme would have to be made in the form of purchase from the open market, that is, through recognized Stock Exchange and not in the initial issued by an Indian company. The rules governing such investments are specified in the Schedule-3 to the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulation, 2000.

CONDITIONS FOR PURCHASE OF SHARES BY NRIS/OCBS UNDER THE SCHEME

The following conditions apply for purchase of shares under the scheme:-

(a) The shares/convertible debentures can be purchased only through a registered Broker on a recognized Stock Exchange.
(b) The NRI/OCB should designate a branch of an authorized dealer for routing of the investment transactions.

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[58] The term "overseas corporate body" means a company, partnership firm, society or other corporate body owned directly or indirectly to the extent to at least 60% by non-resident Indians and includes overseas trust in which not less than 60% of the beneficial interest is held by non-resident Indians directly or indirectly but irrevocably.

(c) The total investments by each NRI/OCB under the scheme shall not exceed 5% of the paid-up value of the shares of the Indian company concerned.

(d) The investment in regard to the convertible debentures shall not exceed 5% of each series of convertible debentures issued by the Indian company.

(e) The total aggregate paid-up shares of any company purchased by all NRIs/OCB shall not exceed 10% of the paid-up capital of the company and in the case of purchase of convertible debentures the aggregate paid-up value of each series of debentures purchased by all NRIs/OCBs shall not exceed 10% of the paid-up capital of the company and in the case of purchase of convertible debentures the aggregate paid-up value of each series of debentures purchased by all NRIs/OCBs shall not exceed 10% of the paid-up value of each series of convertible debentures. However, the aggregate ceiling of 10% may be raised to 24% if a special Resolution to this effect is passed under the Companies Act, 1956 by the General Body of the Members of the Indian Company concerned.

The investment must involve taking deliveries of the shares purchased and giving deliveries of shares sold. In other words, there must be actual purchase and actual sale under the scheme. The idea is to curb speculative purchase and sales not involving actual delivery of securities.

PAYMENT FOR PURCHASE OF SECURITIES

The OCB/NRI shall make the payment for purchase of shares/convertible debentures by inward remittance in Foreign Exchange through Normal Banking Channels or out of funds held in NRE/FCNR account maintained in India if the shares are purchased on Repatriation basis; if the purchase is on non-repatriation basis, there must be actual inward remittance of funds or the payment must be made out of the funds held in NRE/FCNR/NRO/NRNR/NRSR account of the NRI/OCB concerned maintained in India.

OBLIGATIONS OF OCBs REGARDING THEIR STATUS

It is essential that the OCB concerned informs the designated authorized dealer in India immediately on the holding/interest of NRIs under the OCB becoming less than 60%. This a voluntary compliance expected of OCBs.

REPORT TO BE SUBMITTED TO RESERVE BANK BY AUTHORIZED DEALER

The designated branch through whom purchase/sale is taking place is under obligation to furnish to the Chief General Manager of the Reserve Bank of India (ECD), Central Office Mumbai, to send report on daily basis giving the following details: -

(a) Name of non-resident Indians or OCB
(b) Company-wise number of shares and debentures and paid-up value thereto purchased/sold by each NRI/OCB. This is for the purpose centralized monitoring and control by RBI.

REMITTANCE OF SALE PROCEEDS OF SHARES BY NRIs/OCBs

Where the NRI/OCB who or which has invested under the scheme desires to sell shares/convertible debentures as the case may be, acquired under the scheme, the same is permitted, the net sale proceeds will also be allowed by the designated branch of the bank to be credited:-

(a) To NRSR Account of the NRI/OCB investor if the funds for purchase of the time of initial investment were from the NRSR Account or to be credited;
(b) To his/its NRO/NRSR Account, where the shares/debentures were purchased on non-repatriation basis or

(c) At the NRI or OCB investors option, to be remitted abroad or credited to his/its NRE/FCNR/NRO/NRSR account if the shares/debentures had initially been purchased on repatriation basis.

CHAPTER V: SECTOR SPECIFIC GUIDELINES FOR FOREIGN DIRECT INVESTMENT IN INDIA

In June 2000, India revised the foreign investment guidelines substantially, retaining a very small list of areas that require prior approval, while specifying detailed sector wise guidelines to remove any ambiguity or discretion in the system of specific approvals. The sector wise guidelines are as follows:

BANKING

NRI holding may be upto 40%, inclusive of equity participation by other investors. Foreign investment of upto 20% is permitted by foreign banking companies or finance companies including multilateral financial institutions. Multilateral institutions are allowed to invest within the overall foreign direct investment cap of 40% in case of shortfall in foreign direct investment contribution by NRIs.

Non Banking Financial Companies (NBFC): FDI /NRI/OCB investments allowed in the following 17 NBFC activities: merchant banking; underwriting, Portfolio Management Services,Investment advisory services, Financial consultancy, Stock Broking, Asset Management, Venture Capital, Custodial Services, Factoring, Credit Reference agencies,Credit Rating Agencies,Leasing and Finance,Housing Finance, Forex Broking, Credit card business, Money changing Business.

The minimum capitalization norms are:: For permitted non-fund based activities: US$ 0.5 million, to be brought upfront.

For fund-based NBFCs:

1. For FDI upto 51% - US$ 0.5 million to be brought upfront
2. For FDI above 51% and upto 75% - US$ 5 million to be brought upfront
3. For FDI above 75% and upto 100% - US$ 50 million out of which US$ 7.5 million is to be brought upfront and the balance within 24 months.

In case of 100% foreign holding, the entity is to act only as holding company and specific activities to be undertaken by step down subsidiaries with minimum 25% domestic equity.

CIVIL AVIATION

FDI upto 40% permitted in domestic airlines; however, no direct or indirect equity participation by foreign airlines is allowed. Upto 100% investment by NRIs /OCBs is allowed in domestic airlines.

TELECOMMUNICATIONS

FDI up to 100% is allowed with some conditions for the following activities in the Telecom sector :

1) ISPs not providing gateways (both for satellite and submarine cables);
2) Infrastructure providers providing dark fibre (IP Category 1)
3) Electronic Mail and
4) Voice Mail.

FDI upto 74% is permitted for the following telecom services subject to licencing and security requirements:-

1) Internet service providers with gateways
2) radio paging
3) End-to-end bandwidth.

PETROLEUM

1. Under the exploration policy FDI upto 100% is allowed for small fields through competitive bidding; upto 60% for unincorporated JV and upto 51% for incorporated JV with No Objection Certificate for medium size fields.
2. For refining, FDI is permitted upto 26% (PSU holding of 26% and balance 48% public). In case of private Indian company, FDI is permitted upto 49%
3. For petroleum products and pipeline sector, FDI is permitted upto 51%.
4. FDI is permitted upto 74% in infrastructure related to marketing and marketing of petroleum products.
5. 100% wholly owned subsidiary (WOS) is permitted for the purpose of market study and formulation of business plans.
6. 100% wholly owned subsidiary is permitted for investment/financing.
7. For actual trading and marketing, minimum 26% Indian equity is required to be brought in over 5 years.

All approvals are under the Specific Approval Route only.

HOUSING & REAL ESTATE

No foreign investment is permitted in this sector. However, NRIs/OCBs are allowed to invest in the following:

1. Development of serviced plots and construction of built up residential premises.
2. Investment in real estate covering construction of residential and commercial premises including business centres and offices.
3. Development of townships.
4. City and regional level urban infrastructure facilities, including both roads and bridges.
5. Investment in manufacture of building materials
6. Investment in participatory ventures in (1) to (5) above

7. Investment in housing finance institutions.

COAL AND LIGNITE

1. Private Indian companies setting up or operating power projects as well as coal or lignite mines for captive consumption are allowed FDI upto 100%.
2. 100% FDI is allowed for setting up coal processing plants subject to the condition that the company shall not do coal mining and shall not sell washed coal or sized coal from its coal processing plants in the open market and shall supply the washed sized coal to those parties who are supplying raw coal to coal processing plants for washing or sizing.
3. FDI upto 74% is allowed for exploration or mining of coal or lignite for captive consumption.
4. In all the above cases, FDI is allowed upto 50% under the automatic route subject to the condition that such investment shall not exceed 49% of the equity of a PSU.

VENTURE CAPITAL FUND (VCF) AND VENTURE CAPITAL COMPANY (VCC)

An offshore venture capital company may contribute upto 100% of the capital of a domestic venture capital fund and may also set up a domestic asset management company to manage the fund. VCF and VCC are permitted upto 40% of the paid up corpus of the domestic unlisted companies. This ceiling would be subject to relevant equity investment limit in force in relation to industries reserved for the small-scale sector. A domestic VCF/VCC may not invest in excess of 5% of its paid up corpus, in any single venture.

TRADING

Trading is permitted under automatic route with FDI upto 51% provided it is primarily for export activities, and the undertaking is a recognized export house/trading house/ super trading house, star trading house. However, under the FIPB route:

1. 100% FDI is permitted in case of trading companies for the following activities: exports; bulk imports will export /expanded warehouses sales; cash and carry wholesale trading; other import goods or services provided at least 75% is for procurement and sale of goods and services among the companies of the same group and for third party use or onward transfer / distribution/sales.
2. The following kinds of trading are also permitted, subject to provisions of EXIM policy. Companies for providing after sales services (that is not trading per se) Domestic trading of products of JVs is permitted at the wholesale level for such trading companies who wish to market manufactured products on behalf of their joint ventures in which they have equity participation in India. Trading of hi-tech items /items requiring specialized after sale service Trading of items for social sectors. Trading of hi-tech, medical and diagnostic items. Trading of items sourced from the small scale sector under which, based on technology provided and laid down quality specifications, a company can market that item under its brand name. Domestic sourcing of products for exports. Test marketing of such items for which a company has approval for manufacture provided such test marketing facility will be for a period of two years, and investment in setting up manufacturing facilities commences simultaneously with test marketing.

INVESTING COMPANIES IN INFRASTRUCTURE /SERVICE SECTOR

In respect of companies in the infrastructure/service sector, where there is a prescribed cap for foreign investment, only the direct investment will be considered for the

prescribed cap and foreign investment in an investing company will not be set off against this cap provided the foreign direct investment in such investing company does not exceed 49% and the management of the investing company is with the Indian owners.

ATOMIC ENERGY

The following three activities are permitted to receive FDI/NRI/OCB investment through FIPB:

1. Mining and mineral separation.
2. Value addition per se to the products of (a) above.
3. Integrated activities (comprising of both (a) and (b) above.

The following FDI participation is permitted:

1. Upto 74% in both pure value addition and integrated projects.
2. For pure value addition projects as well as integrated projects with value addition upto any intermediate stage, FDI is permitted upto 74% through joint venture companies with Central / State PSUs which equity holding of at least one PSU is not less than 26%
3. In exceptional cases, FDI beyond 74% will be permitted subject to clearance of the Atomic Energy Commission before FIPB approval.

DRUGS & PHARMACEUTICALS

1. FDI upto 74% in the case of bulk drugs, their intermediates and formulations (except those produced by the use of recombinant DNA technology) would be covered under automatic route.
2. FDI above 74% for manufacture of bulk drugs will be considered by the Government on case to case basis for manufacture of bulk drugs from basic stages and their intermediates and bulk drugs produced by the use of recombinant DNA

technology as well as the specific cell/tissue targeted formulations provided it involves manufacturing from basic stage.

ROADS & HIGHWAYS. PORTS AND HARBOURS

FDI upto 100% under automatic route is permitted in projects for construction and maintenance of roads, highways, vehicular bridges, toll roads, vehicular tunnels, ports and harbours.

HOTELS & TOURISM

100% FDI is permissible in the sector. The term hotels include restaurants, beach, resorts and other tourist complexes providing accommodation and/or catering and food facilities to tourists. Tourism related industry includes travel agencies, tour operating agencies and tourist transport agencies, units providing facilities for cultural, adventure and wild life experience to tourists, surface, air and water transport facilities to tourists, leisure, entertainment, amusement, sports, and health units for tourists and convention / Seminar units and organizations.

Automatic route is available upto 51% subject to the following parameters. For foreign technology agreements, automatic approval is granted if:

1. upto 3% of the capital cost of the project is proposed to be paid for technical and consultancy services including fees for architects, design, supervision etc.
2. Upto 3% of the net turnover is payable for franchising and marketing/publicity support fee, and
3. upto 10% of gross operating profit is payable for management fee, including incentive fee.

MINING

1. For exploration and mining of diamonds and precious stones FDI is allowed upto 74% under automatic route.
2. For exploration and mining of gold and silver and minerals other than diamonds and precious stones, metallurgy and processing FDI is allowed upto 100% under automatic route.

POLLUTION CONTROL AND MANAGEMENT

FDI upto 100% in manufacture of pollution control equipment and consultancy for integration of pollution control systems is permitted under automatic route

ADVERTISING AND FILMS

Automatic approval is available for the following:

1. Upto 74% FDI in advertising sector.
2. Upto 100% FDI in film industry (i.e., film, financing, production, distribution, exhibition, marketing and associated activities relating to film industry), subject to the following:

1. Companies with an established track record in films, TV, music, finance and insurance would be permitted.
2. The company should have a minimum paid up capital of US$ 10 million if it is the single largest equity shareholder and at least US$ 5 million in the other cases.

3. Minimum level of foreign equity investment would be US$ 2.5 million for the single largest equity shareholder and US$ 1 million in other cases.
4. Debt equity ratio of not more than 1:1, i.e., domestic borrowings shall not exceed equity

Provisions of dividend balancing would apply. In all other sectors/ activities, there is no upper limit on the foreign equity percentage or the requirement of specific approvals, in general. However, all proposals that do not qualify under the automatic route guidelines for reasons other than sector ceilings shall continue to be covered by the specific approval process.

POWER

Foreign Investment in power can either be in the form joint venture with an Indian Partner or as fully owned operation with 100% foreign equity.

PRINT MEDIA

The government has opened up the print media to FDI, allowing 26% /foreign stake in newspapers and current affairs periodicals and 74% in other forms of print media.

DEFENCE AND STRATEGIC INDUSTRIES

The defence industry sector is opened up to 100% for Indian Private sector participation with FDI permitted upto 26%, both subject to licensing.

CHAPTER VI: FDI RELATED GOVERNMENT BODIES IN INDIA

SECRETARIAT FOR INDUSTRIAL APPLICATION

SIA was set up by the Government of India in the Department of Industrial Policy and Promotion in the Ministry of Commerce and Industry to provide a single window for entrepreneurial assistance, investor facilitation, receiving and processing all applications that require Government approval, conveying Government decisions on applications filed, assisting entrepreneurs and investors in setting up projects, (including liaison with other organizations and state governments) and in monitoring implementation of projects. As a matter of procedure, all industrial license applications are submitted to the SIA. The SIA processes the application through the concerned approval levels as per the prevailing powers of delegation among various authorities in the Ministry of Industry.

The SIA also notifies all Government policy relating to investment and technology, and collects and publishes monthly production data for 213 select industry groups. As an investor friendly agency, it provides information and assistance to Indian and foreign companies in setting up industry and making investments. It guides prospective entrepreneurs and disseminates information and data on a regular basis through its monthly newsletters. It also assists potential investors in finding joint venture partners and provides complete information on relevant policies and procedures, including those, which are specific to sectors and the state governments.

ISSUE OF LETTER OF INTENT

Cases where an industrial licence is issued straightaway are rare. In all other cases, the SIA initially issues a Letter of Intent. The Letter of Intent is nothing but a letter indicating the intention of the government to issue an industrial licence to the applicant if the terms and conditions specified therein are fulfilled by the applicant.

From the year 1988, the validity period of the Letter of Intent has been raised to three years in order to enable the applicant to take steps to finalize foreign collaborations, tie-up imports and arrange for finance with the institutions[59].

Within the period of validity of the Letter of Intent, the applicant has to apply for conversion of it into an industrial licence. If for any reason, there is delay, the applicant has to apply for extension of the validity period to the Administrative Ministry with a copy to the SIA. On the recommendations of the Administrative Ministry, the Department of Industrial Development will extend the validity period of a Letter of Intent. In any case, the validity of Letter of Intent cannot be extended beyond five years from the date of issue.

ENTERPRENEURIAL ASSISTENCE UNIT

The Entrepreneurial Assistance Unit (EAU) functioning under the Secretariat for Industrial Assistance, Department of Industrial Policy and Promotion provides assistance to entrepreneurs on various subjects concerning investment decisions. The Unit receives all papers/ applications related to industrial approvals and immediately issues a computerized acknowledgement, which also has an identity/reference number. All correspondence with the SIA has to quote this number. The Unit extends this facility to all papers/applications relating to Industrial licences, Foreign Investment, Foreign Technology Agreements, 100 per cent EOUs, STP schemes etc.

The Unit also attends to enquiries for entrepreneurs relating to a wide range of subjects concerning investment decisions. It furnishes clarifications and arranges meetings with nodal officers in concerned Ministries/Organizations. The Unit also provides information regarding the current status of application filled for various industrial approvals.

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[59] Licensing Procedure Simplification-Increase in initial validity period of Letters of Intent under IDRA. Press note no. 15 (1988 Series) dt. 10.6.1988 issued by the Department Industrial Development.

INVESTMENT PROMOTION AND INFRASTRUCTURE DEVELOPMENT CELL

In order to give further impetus to facilitation and monitoring of investment, as well as for better coordination of infrastructural requirements for industry, a new cell called the "Investment Promotion and Infrastructure Development Cell" has been created. The functions of the cell include.

a) Dissemination of information about investment climate in India;
b) Investment facilitation;
c) Developing and distributing multimedia presentation material and other publications;
d) Organizing symposiums, seminars etc on investment promotion;
e) Liaison with State Governments regarding investment promotion;
f) Documentation of single window systems followed by various states;
g) Match-making service for investment promotion;
h) Coordination of progress of infrastructure sectors approved for investment/technology transfer, power, telecom, ports, roads etc.;
i) Facilitating Industrial Model Town Projects, and Industrial Parks;
j) Promotion of Private Investment including Foreign Investment in the infrastructure sector;
k) Compilation of sectoral policies, strategies and guidelines of infrastructure sectors, both in India and abroad; and
l) Facilitating preparation of a perspective plan on infrastructure requirements for industry.

PROJECT MONITORING WING

The Project Monitoring Wing has been created with the Investment Promotion and Infrastructure Development Cell with a view to monitoring the implementation of

projects approved and for facilitating solutions to investors problems. The functions of the Project Monitoring Wing are:-

a) Coordination with Central and State level Ministries/Departments concerned and related agencies for tracking and monitoring approved projects, and compilation and analyses such information;
b) Direct contact, wherever necessary, with entrepreneurs and updation of the information on projects, and provision of necessary assistance.

NODAL OFFICERS

The Department of Industrial Policy and Promotion has identified offices at the Depute Secretary/Director level as Nodal Officers for facilitation of all matters relating to the industrial projects pertaining to a state. For large projects involving sizeable amount of FDI, officers have been identified in the Department of Industrial Policy and Promotion and other departments concerned (e.g. the ministry to which the investment proposal pertains) and the State Government to act as contact officers so that these projects can be implemented within the time schedule. The officers of the Project Monitoring Wing are in touch with the contact officers.

FOCUS WINDOWS

The Department of Industrial Policy and Promotion also has opened Country Focus Windows for countries with sizeable investment interest in India. At present, the Focus Window covers countries such as USA, Germany, France, Switzerland, Australia, Japan and Korea. For each focus window a senior officer in the Department provides facilitation and assistance.

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automatically by the RBI. The aim is to bring only selected large or sensitive projects for clearance to the FIPB. The role of FIPB is being altered from merely issuing clearances to carrying out policy reviews and promotion.

The effort now being made is to ensure firstly, that proposals already in the pipeline are quickly cleared and secondly that step should be taken to attract investment in selected thrust areas of the economy. The FIPB may thus become a more pro-active institution in terms of trying to seek out foreign investment rather than just approving projects.

FOREIGN INVESTMENT PROMOTION COUNCIL

CONSTITUTION

The Government has constituted a Foreign Investment Promotion Council (FIPC) under the chairmanship of Chairman ICICI, to undertake vigorous investment promotion and marketing activities. The Presidents of the three apex business associations such as ASSOCHAM, CII and FICCI will be members of the Council. A Ministry of Industry personnel is Member-Secretary.

BOOST TO FDI

Setting up of the Council follows the Governments's decision to strengthen the institutional mechanism relating to the consideration and approval of Foreign Direct Investment proposals. The Common Minimum Programme (CMP) which states that the nation needs and has the capacity to absorb at least US $ 10 billion a year as FDI will require considerable promotional efforts apart from facilitating foreign investment approvals.

SUPPORT TO FIPB

The strategy adopted is a two-pronged one with one relating to the approvals and clearance required as per the transparent guidelines and other relating to full time investment promotion and marketing. Accordingly a revamped Foreign Investment Promotion Board fresh guidelines was put under the direct control of the Industry Minister thereby reducing one level in the decision making. As a secondary and supporting measure Foreign Investment Promotion Council was conceived.

FUNCTIONS

The Foreign Investment Promotion Council undertakes the investment promotional activity which entails making extensive contact with potential investors, lobbying and interacting with individual companies etc. The Council with distinguished and well known experts as the members capitalises, manages and coordinates investment promotion and marketing efforts.

PROMOTIONAL WORKS

The promotional efforts have been mostly centred on addressing general investment promotion seminars and conferences. Besides that a more target-oriented approach is now required, both to identify the sectors/projects within the country requiring foreign direct investment and targetting the specific regions and countries of the world from which FDI would be brought in through special efforts.

WHAT MORE IS TO BE DONE

It will be necessary to analyse the requirements of various sectors and industries in India which are in need of modernisation, technology upgradation and capital requirement. Sectoral profiles and projects proposals for these industries will need to be prepared for

presentation to the selected international companies and foreign investors.

It will also be necessary to undertake one-to-one dialogue with individual foreign investors at the Board-room level in order to motivate them to invest in the specified industries and sectors.

FOREIGN INVESTMENT IMPLEMENTATION AUTHORITY (FIIA)

Government has set up the Foreign Investment Implementation Authority (FIIA) in the Ministry of Commerce & Industry. The FIIA facilitates quick translation of Foreign Director Investment (FDI) approvals into implementations, provides a pro-active one stop after care service to foreign investors by helping them obtain necessary approvals, sorts out operational problems and meet with various Government Agencies to find solutions to problems and maximizes opportunities through a partnership approach. The FIIA is headed by the Secretary (Deptt. Of Industrial Policy & Promotion) and is serviced by the SIA

ROLE OF FIIA

The FIIA takes steps to:

- Understand and address concerns of investors;
- Understand and address concerns of approving authorities;
- Initiate multi agency consultations; and
- Refer matters not resolved at the FIIA level to high levels on a quarterly basis, including cases of projects slippage on account of implementation bottlenecks.

FUNCTIONS OF FIIA

The functions of the FIIA are as under:

- Expediting various approvals/permissions;
- Fostering partnership between investors and government agencies concerned;
- Resolve difference in perceptions;
- Enhance overall credibility;
- Review policy framework; and
- Liaise with the Ministry of External Affairs for keeping India's diplomatic missions abroad informed about translation of FDI approvals into actual investment and implementation.

MODALITIES OF FUNCTIONING OF FIIA

The modalities of functioning of FIIA are as under:

a) The FIIA shall set up a Fast Track Committee (FTC) to review and monitor mega projects. It will nominate members of the FTC from representatives of various Ministries/agencies/State Government at the working level. The representative of the AM concerned shall act as the project coordinator and shall head the FTC. The FTC shall prescribe the time frame within which various approvals/permissions are to be given on a project to project basis. FTC shall also flag issues that need to be resolved by FIIA. Based on the inputs provided by FTC, the FIIA will give its recommendations on each project on the basis of which Administrative Ministries/State Government shall take action under their own laws and regulations.

b) The FIIA will initiate inter Ministerial consultations and make appropriate recommendations to the competent authority, i.e. Ministry/Department concerned at the Central Government level and the State Government, as the case may be, on issues requiring policy intervention.

c) The FIIA will act as a single point interface between the investor and Government agencies including Administrative Ministries/State Governments/Pollution Control Board/DGFT/Regulatory Authorities/Tax Authorities/Company Law Board, etc.

d) The FIIA shall meet once every month to review cases involving investment of Rs. 100 crore or more, consider references received from the FTC, and monitor the functioning of various FTCs. It would also entertain any complaint regarding implementation bottlenecks from FDI approval holders regardless of the quantum of investment.

e) The FIIA shall also make recommendations from time to time on any issue relating to the speedy implementation of FDI projects and also to provide transparency in government functioning with respect to FDI projects.

CHAPTER VII: REPATRIATION OF INVESTMENT AND RETURN ON INVESTMENT

An important factor, which could influence the inflow of investment into the Indian economy by foreign investors, is the repatriation possibility of the investment and the returns thereon. Keeping this in mind, the Government of India has tried to ensure that the process of repatriation is as hassle-free as possible.

Application for making remittance out of India has to be made to the authorized dealer of Reserve Bank of India. The Reserve Bank of India has now prescribed Form A-2[60] for making application for effective remittances abroad on account of various transactions. This form is applicable not only for the remittances arising out of collaboration agreement but also applies to expatriate employees for repatriating their salaries abroad.

REPATRIATION OF CAPITAL INVESTMENT

Capital Investment in India can be fully repatriated along with profits after completing certain formalities. Foreign investors desiring to receive back the value of their investment will necessarily have to first sell their shares in Indian companies to some resident in India. For this purpose the foreign investor will require Reserve Bank of India's permission for which an application has to be made in Form TS-1 to the Chief General Manager, Exchange Control Department of the Reserve Bank of India. After approval for disinvestments by the Reserve Bank of India, repatriation can be made through an authorized dealer after fulfillment of certain formalities including no-objection/ Tax clearance certificate from the Indian Income Tax authorities.

REMITTANCE OF DIVIDEND

[60] Circular No. 51, dated 5-12-1997.

Dividend on shares held by foreign investors is fully repatriable subject to certain conditions on dividend balancing[61], wherever applicable. Interim dividend is also allowed to be fully repatriated.

Indian companies paying dividend have to make an application to an authorized dealer of Reserve Bank of India supported by a copy of Company's Balance Sheet and Profit and Loss account, resolution of the company passed at the Annual General Meeting declaring the dividend, details of the non-resident shareholders and a copy of Reserve Banks' approval for holding of shares by the non-residents. The application is to be made by the Indian company in a form prescribed by the Reserve Bank of India, namely RCD-1. The form contains the full details of all the documents which are required to be submitted along with the form. This form is to be submitted along with another form namely, RCD-2 giving particulars of non-resident shareholders to whom dividend is to be remitted, details of their shareholding and the amount of dividend to be remitted to each one of them. The authorized dealer shall scrutinize the application and the documents attached with the form to ensure that the form is complete in all respects. They are allowed to make remittances of dividend, in case of non-resident shareholder, after making the following verifications:-

a) that the non-resident shareholders to whom dividend has become remittable are holding shares in the company in accordance with the necessary permission given by the Reserve Bank of India either under section 19 or section 29 of the then FERA, or the FEMA and the Regulations framed thereunder,as the case may be;
b) that the certificate given in Part B of the RCD 1 has been properly completed by the company's auditors
c) one copy of the application in Form RCD 1 should be forwarded to the Reserve Bank within whose jurisdiction the Head/Registered Office of the company is situated.

[61] The condition of dividend balancing has been removed with effect from 14th July, 2000.

Where interim dividend is to be remitted, the application to the authorized dealer may be made in the form of a letter in duplicate enclosing only Form RCD 2 along with a copy of the Board's resolution approving payment of the interim dividend.

DIVIDEND BALANCING

Provisions of dividend balancing are applicable in case of 22 specified industries in the consumer goods sector. In such cases, the outflow on account of dividend payments should be balanced with the inflow on account of export earnings. The balancing is required to be done for a period of 7 years from the date of commencement of commercial production. Thereafter no balancing is required. *However, with effect from 14th July, 2000 the condition of dividend balancing has been removed vide Press Notification No. 7 dated 14th July, 2000 issued by the Ministry of Commerce and Industry, Government of India.*

REMITTANCE OF ROYALTY

The payment for royalty to be made to foreign entrepreneurs is approved along with the approval of the collaboration agreement whether under automatic route of Approval or through Secretariat of Industrial Assistance. Since the amount of royalty and the installments in which royalty is to be paid are approved before the collaboration agreement is implemented, the remittance of royalty to the foreign collaborator is fully allowed subject to nominal formalities.

The royalty has to be calculated in accordance with the formula laid down in the approval laid down in the approval letter of the foreign collaboration agreement. The Indian company has to ensure that the royalty has been calculated strictly as per the terms of the collaboration agreement and any subsequent amendments thereto which have been filed with the Reserve Bank of India/authorized dealer, as the case may be.

For the purpose of remittance of royalty, an application has to be made to the authorized dealer of Reserve Bank of India. The application is to be supported by a certificate from a Chartered Accountant. The amount of income-tax payable on the royalty is to be deducted at source by the remitter of royalty. Separate format is provided for remittance of royalty on software and copyright music produced in India.

REMITTANCE OF TECHNICAL KNOW-HOW FEE

The policy and procedure for remittance of technical know-how fee is similar to that applicable in case of remittance of royalty. Collaboration agreements provide for such remittances to be made by the Indian company under the Foreign Exchange Management (Current Account Transactions) Rules, 2000. Approval of Government of India (Ministry of Industry and Commerce) is necessary for remittance of royalty exceeding 5% on local sales and 8% on exports and lumpsum payments exceeding US $ 2million. Similarly approval of RBI is necessary for remittance of royalty and payment of lumpsum fee under a technical collaboration agreement which has not been registered with Reserve Bank of India.

The Indian company is required to make an application to the authorized dealer in foreign exchange along with a certificate from the auditors of the company in Form TCK, which has to be signed by a Chartered Accountant/ Chartered Engineer.

Since the authorized dealers are under obligation to ensure that the remittances are in accordance with the terms of the collaboration agreement, the Indian company itself should ensure the following and also satisfy the authorized dealer in respect of the following so that the remittance is made easily to the collaborator :-

a) the Indian company should ensure that the know how fee is strictly in accordance with the collaboration agreement.
b) If there has been any subsequent amendment to the collaboration agreement providing for any change in the lumpsum amount payable, such supplemental

agreement or amendment letters must have been filed with the authorized dealer and the Reserve Bank of India.

c) The payment of technical know how fee is always net of taxes.

d) It should be made clear as to whether the lumpsum payment is towards the first installment or second installment or the third installment, as the case may be. In case the installment is not the first installment, reference to remittances made earlier should be given; particularly the reference to the date of remittance and the balance amount of technical know how fee yet to be remitted must also be indicated

e) The company should have paid the cess payable under the Research and Development Cess Act due on the technical know how fee.

f) The Chartered Accountant/Chartered Engineer who gives the certificate in Form TCK will also call for the collaboration agreement and examine the terms thereof before giving the certificate. Therefore, the Indian company should keep all the relevant documents ready for the verification by the Chartered Accountant so that the latter is enabled to give the certificate and based on that, application is made to the authorized dealer for payment of the technical know how.

REMITTANCE FACILITIES FOR FOREIGN NATIONALS

For the purpose of remittance of their earnings in India, the foreigners[62] may be divided in the following two categories: -

a) Not permanently resident in India;

b) Permanently resident in India.

Foreign nationals are considered "permanently resident in India" if their stay on account of employment, or for a specific job or for any assignment is three years or more. This

[62] The expression "foreigners" does not include the foreign diplomats, the officials and staff (by whatever name called) of an Embassy, High Commission, Legation, Commission, Consulate, or a Trade Representation of a foreign state.

category of foreigners is treated at par with Indian nationals resident in India. Remittance of earning out of India for this category requires a specific approval from Reserve Bank of India. Foreigners who take up a temporary residence in India on account of their employment, profession or other activity with the intention of eventually retiring to their own country or some other foreign country are considered as "not permanently resident in India". The facilities of repatriation from India are easily available to this category of foreign nationals.

The foreign nationals not permanently resident in India can, for the purpose of remittance out of India, be divided in the following categories:

a) short term engagement by Indian firms or companies

Indian firms and companies may engage the services of foreign nationals on short-term assignment without prior approval of the Reserve Bank of India. The period of engagement in India is again divided into two categories-

- Upto three months
- Exceeding three months

When the period of engagement of a foreign national is upto three months, remittance of remuneration will be permitted for which the Indian firm/company making the payment should apply to an authorized dealer designated by the Reserve Bank of India. The Indian firm/ company also has to give an undertaking/certificate regarding payment of Income Tax by the foreign national. Before allowing remittance, the authorized dealer would verify the documents submitted and will also satisfy that-

- The amount of remittance sought for is in accordance with the terms of contract entered into by the applicant firm/ company with the foreign national/ foreign company.
- The services of foreign national are not covered by any foreign collaboration agreement.

agreement or amendment letters must have been filed with the authorized dealer and the Reserve Bank of India.

c) The payment of technical know how fee is always net of taxes.

d) It should be made clear as to whether the lumpsum payment is towards the first installment or second installment or the third installment, as the case may be. In case the installment is not the first installment, reference to remittances made earlier should be given; particularly the reference to the date of remittance and the balance amount of technical know how fee yet to be remitted must also be indicated

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   - The amount of remittance sought for is in accordance with the terms of contract entered into by the applicant firm/ company with the foreign national/ foreign company.
   - The services of foreign national are not covered by any foreign collaboration agreement.

100% repatriation of savings out of remuneration etc. would be permitted for this category of foreign nationals. Where however the period of engagement in India exceeds three months, besides the abovementioned formalities, the authorized dealer would also ensure that the concerned foreign national holds a valid employment visa.

Where the foreign nationals come to India under any foreign collaboration agreement, they would generally be covered under the category of foreign nationals who are in regular employment in India

b) Regular employment in India

Foreigners who are in regular employment in India may be divided in following two categories:

- Employees of Indian firms/companies
- Employees deputed by foreign companies to their office, branch, subsidiaries, joint ventures etc.

Foreign nationals (who are not permanently resident in India) who are in regular employment with Indian firms/companies are allowed to remit up to 75% of their net salary out of India. The net salary is calculated after deduction of contribution to provident fund etc and taxes payable. Such foreigners should hold a valid employment visa. On special request, remittances in excess of 75% of net salary may also be allowed provided the foreign national is in receipt of perquisites in India such as free housing, conveyance and medical facilities and his family is resident outside India.

For employees deputed by foreign companies, remuneration to the extent of 75% of the net salary is allowed to be paid outside India. The balance amount of salary

total income, the income is classified and is chargeable under various heads, namely, "Salaries", "Income from House Property", "Profits and Gains from Business or Profession", "Capital Gains" and "Income from Other Sources". Section 5 of the Indian Income Tax Act defines the scope of total income chargeable to tax. Tax is determined with reference to the following criteria:

(i) residence in India;
(ii) receipt of income in India;
(iii) accrual of income in India; and
(iv) deemed accrual of income in India.

RESIDENCE IN INDIA.

The first criterion for chargeability of taxes the residential status of a person i.e. whether he is a 'resident' or a 'non-resident'.

The Direct Tax Laws (Second Amendment) Act, 1989 has modified the definition of 'resident' with effect from Assessment Year 1990-91. According to this definition, an individual is considered to be resident in India if he fulfils any of the following conditions:

(a) is in India in that year for a period amounting in all to one hundred and eighty-two days or more; or
(b) having within the four years preceding that year been in India for a period or periods amounting in all to three hundred and sixty-five days jor more, is in India for a period or periods amounting in all to sixty days or more in that year.

Explanation – In the case of an individual,-

(a) being a citizen of India, who leaves India in any previous year as a member of the crew of an Indian Ship as defined in clause (18) of section 3 of the Merchant Shipping Act, 1958 (44 of 1958), or for the purposes of employment outside

India, the provisions of sub-clause (b) shall apply in relation to that year as if for the words "sixty days", occurring therein, the words "one hundred and eighty-two days" had been substituted;

(b) being a citizen of India, or a person of Indian origin within the meaning of Explanation to clause (e) of section 115C, who, being outside India, comes on a visit to India in any previous year, the provisions of sub-clause (b) shall apply in relation to that year as if for the words "sixty days", occurring therein, the words "one hundred and eighty-two days" had been substituted.

The Indian income-tax law charges tax from such a person on his *total world income,* This, however, is subject to an exception: in the case where the foreigner is a person who is 'resident' but *'not ordinarily resident'* during the year of evaluation, he will not be charged to tax on the income which accrued or arose to him outside India, unless that income is derived from a business controlled, or a profession set up, in India. A person is said to be 'not ordinarily resident' in India if he is basically a 'resident' in the year of evaluation and

(i) his total stay in India in the last 7 years preceding the year of evaluation was less than 730 days, or

(ii) was not, 'resident' in 9 out of 10 years preceding the year of evaluation.

In other words, the status of an individual is *'resident and ordinarily resident'* in India in a previous year only-(a) if he has been resident in India in 9 out of 10 previous years preceding to that year, and (b) during the seven previous years preceding to that year he has been in India for a total period of seven hundred and thirty days or more. The legal position has also been clarified by the Income-tax Department in an old Circular, which is reproduced below:

Therefore, generally speaking, the status of Foreigners in India will be that of 'not ordinarily resident'.

A *corporate body* would be a 'resident' when

(i) it is registered in India; or

(ii) the control and management of its affairs is situated *wholly* in India.

The expression "Control and Management" means *defacto* control and management and not merely the right or power to control and manage. The word 'affairs' means affairs which are relevant for the purpose of Income-tax Act and which have some relation to the income sought to be assessed. Calcutta High Court in the case *CIT v. Bank of China*[63], has held that a company in liquidation which had income from interest and rent in India had to be deemed resident in India as its affairs relating to earning of interest and rent income were being controlled and managed in India by the official liquidator as it is the liquidator who is empowered to do all acts and deeds for winding up subject to sanction and control of the Court.

Non-resident: A non-resident is defined as a person who is not "resident" in India as defined above. The income chargeable to tax in the case of a non-resident is his total income during the year of evaluation, to the following extent only:

(i) the income which is received or deemed to have been received in India in the year of evaluation, either by him or on his behalf; and

(ii) the income which accrued or arises or is deemed to accrue or arise to him in India.

RECEIPT OF INCOME IN INDIA

Where the income is received in India, it is wholly taxed in India, irrespective of the fact that it accrues or arises outside India, or had accrued or arisen to a person not resident in India[64]. A receipt may be in money or money's worth; i.e. a receipt may be in kind as well as in cash. It may be an actual receipt or a constructive receipt (a constructive

[63] (1985) 154 ITR 617 (Cal)
[64] *CIT v. Mathias*, (1939) 7 ITR 48 (PC).

receipt is made by an adjustment of cross-claims or by an adjustment of the books, or through an agent, trustee or other authorized person of the non-resident). What is taxed is the first receipt; that is, the receipt at the earliest point in time. *Thus, when a payment is received outside India, and then the receipt is remitted to India, it would not be treated as income received in India because it was first received outside India.*

ACCRUAL OF INCOME IN INDIA

Income, which accrued or arises in India, is chargeable to tax for all categories of persons, whether "resident" or "non-resident". The two words "accrues" and "arises" denote the same idea, or very similar ideas, and the difference only lies in that one is more appropriate than the other when applied to a particular case. In the case of foreigners, the *place* of accrual is very significant, as their tax liability depends mainly upon whether the income accrued in India or not. In the determination of the place of accrual, different considerations apply to different kinds of income. Some of them, which are of common importance in the case of foreigners, are discussed below.

Contract of Sale: In the case of a sale-contract, the profits accrue at the place where the title to the goods passes on from the seller to the purchaser. The title to the goods passes from the seller to the purchaser under the following conditions:

(i) where the contract of sale is unconditional and is for goods ready for dispatch, *at the place where the purchase order is accepted;*

(ii) where something material is to be done by either party, then, at the place where that something is done. For example, where the payment is the essence of the contract, the profit accrues at the place where the payment is made against delivery of documents of titles [*Mysore Glass Enamel Works Ltd. v. CIT*[65]]; and

[65] (1963) 47 ITR 841 (Mad)

c) income through or from any money lent on interest and brought into India
d) income through or from any asset or transfer of capital asset situated in India
e) income payable as dividend by an Indian company outside India
f) income payable by way of royalty or technical fee by an Indian company or from an Indian source; and
g) income by way of salary, if it is earned in India.

The income which is deemed to accrue or arise in India is wholly taxed in India. In respect of such income, it is immaterial whether the income is earned in India or received in India or not.

CATEGORIES OF INCOME CHARGEABLE TO TAX

	Where tax incidence arises in the case of		
	Resident or resident and ordinarily resident	Resident but not ordinarily resident	Non resident
Income received in India (whether accrued in or outside India)	Yes	Yes	Yes
Income deemed to be received in India (whether accrued in or outside India)	Yes	Yes	Yes
Income accruing or arising in India (whether received in India or outside India)	Yes	Yes	Yes
Income deemed to accrue or arise in India (whether received in India or outside India)	Yes	Yes	Yes

h) Operating industrial park
i) Commercial production and refining of mineral oil
j) Construction and development of housing project
k) Generation of power, or generation and distribution of power.

SET OFF OF LOSSES

As a general proposition of law, where the net result under any head of income is a loss, the taxpayer is entitled to have the amount of such loss set-off against his income under any other head. The Income tax Act contains provisions for carry forward of business losses. If business loss cannot be set off or is not wholly set off against the income under any other head of income in the same year, such loss shall be carried forward to be set off against the profits from business in future. The Finance act 2001, provided that unabsorbed depreciation that cannot be set off against the income of the year in which it arises will henceforth be carried forward without any restriction on the number of years.

INCOME EXEMPT FROM TAX

Certain types of income are not at all chargeable to tax in India and are not to be included in the computation of total income.

INCOME TAX PAYABLE BY FOREIGN COLLABORATORS IN INDIA

In order to ascertain the tax liability of foreign collaborators, the foreign collaboration agreements can be broadly divided into the following two categories:

(1) Collaboration agreements made before 1 April, 1976; i.e. up to 31 March, 1976
(2) Collaboration agreements made on or after 1 April, 1976

AGREEMENTS MADE BEFORE 1st APRIL 1976

INITIAL LUMP SUM

Section 9(1)(vi)[69] of the Income-tax Act provides for charging of royalty to Indian income-tax by creating a fiction that when royalty is paid to a non-resident it is deemed to accrue or arise in India and hence, charged to tax in India. The proviso to section 9(1)(vi) contains an important provision regarding the taxability of the initial lump sum paid to a foreign participant under a collaboration agreement made before 1st April, 1976.

The proviso provides that royalty consisting of lump-sum consideration for the transfer outside India of, or the imparting of information outside India in respect of, any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process or trademark or similar property, will not be taxable in India provided the collaboration agreement is made before 1st April, 1976. In this context, where the agreement was entered into on 16th December, 1975 but the same was modified on 24 August, 1976, it was held that agreement would be taken as entered into before 1st April, 1976, and the royalty will not be taxable in India if the prescribed conditions of the proviso are fulfilled[70].

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[69] The provisions of section 9(1)(vi) are reproduced below:
"The following incomes shall be deemed to accrue or arise in India-
Income by way of royalty payable by-

a) the Government; or
b) a person who is a resident, except where the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or
c) a person who is a non-resident, where the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India.

Provided that nothing contained in this clause shall apply in relation to so much of the income by way of royalty as consists of lump sum consideration for the transfer outside India of, or the imparting of information outside India in respect of, any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process or trade mark or similar property, if such income is payable in pursuance of any agreement made before the 1st day of April, 1976, and the agreement is approved by the Central Government."

[70] *CIT v. Shri Krishna Oil Complex Ltd.*, (2000) 242 ITR 48 (AP)

A combined reading of section 9(1)(vi) and the proviso to that section clarifies that no income shall be deemed to accrue or arise in India by way of royalty as consists of a lump sum consideration for the transfer outside India of, or the imparting of information outside India in respect of any data, documentation, drawing or specification relating to any patent, innovation, model, design, secret formula or process or trademark or similar property, if such income is payable under an agreement made before 1st April, 1976, and the agreement is approved by the Central Government[71].

ROYALTY AND TECHNICAL FEES

Fee for technical services is defined in Explanation 2 to section 9(1)(vii) as under:
"For the purposes of this clause, 'fees for technical services' means any consideration (including any lump sum consideration) for the rendering of any managerial, technical or consultancy services (including the provision of services of technical or other personnel) but does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head 'Salaries'".

Finance Act (2) of 1977 has inserted a new Proviso to section 9(1)(vii) providing that the fees for technical services shall be deemed to accrue or arise in India only if they are payable in pursuance of an agreement made on or after 1st April, 1976, and approved by the Central Government. For this purpose, an agreement made on or after 1st April, 1976, shall be deemed to have been made before that date if the agreement is made in accordance with the proposals approved by the Central Government before that date. This new amendment seeks to provide that income by way of fees for technical services payable in pursuance of an agreement made before 1st April, 1976, and approved by the Central Government shall not be deemed to accrue or arise in India under section 9(1)(vii) of the Income-tax Act.

[71] *CIT v. Koya Seiko Co. Ltd.*, (1998) 233 ITR 421 (AP)

Therefore, in order to tax fees for technical services payable in pursuance of an agreement made before 1st April, 1976, the said fees should accrue or arise in India by virtue of a provision other than section 9(1)(vii) of the Income-tax Act. In other words, the fees for technical services shall not be subject to tax in India merely because the same has been paid to the foreign participant by an Indian concern. The fees shall be taxable only if income in respect thereof accrues or arises, directly or indirectly, through or from any business connection in India.

Regarding taxability of royalty, if the foreign participants are involved in some activities in India, royalty will be taxed on the basis of accrual of income in India. But in a case where no services whatsoever are performed by the foreign participants in India and the payment is also received by them outside India, royalty would not be taxed in India[72].

PAYMENTS FOR SUPPLY OF MACHINERY AND OTHER EQUIPMENT

There is no distinction in the law relating to the levy of tax, in respect of supply of machinery and other equipment by a foreign participant under a collaboration agreement, between the case of an agreement entered into before 1st April, 1976, and the case of an agreement entered into after that date. Thus, profits relating to the supply of any machinery or equipment in India shall be taxable in India only if there is a business connection[73] between the foreign participant and the Indian counterpart. Generally speaking, if the equipment is supplied outside India and the payment for which is also made outside India and the transaction is on a principal-to-principal basis, there is no business connection, no profit would be taxable in India for supplying the equipment. A

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[72] *CIT v. Ruti Machinery Works Ltd.*, (2000) 243 ITR 442 (Mad)

[73] "Business connection" is not defined in the Indian Income Tax Act. However, broadly speaking, a business connection exists where there exists a relation between a business carried on by a non-resident, which yields profits or gains, and some activity in India, which contributes directly or indirectly to the earning of those profits of gains. It predicates an element of continuity between the business of the non-resident and the activity in India-a stray or isolated transaction is normally not regarded as business connection. The term business connection normally contemplate-

a) a business in India
b) a connection between the non-resident person and that business, and
c) a direct or indirect earning of income by virtue of or through that connection.

provision of technical personnel in India for the erection of the equipment would not be of much consequence in establishing any business connection.

Where, however, the supply of machinery is made in such a manner that a business connection is established and, for that reason, profit out of such supply is taxable in India, the foreign participant shall be liable to pay tax on the profit made by him on the supply of the equipment to India. It may be noted here that the entire amount of profit will not be taxable in India. The income of the non-resident shall be only such part of the income as is reasonably attributable to the operations carried out in India.

AGREEMENTS MADE ON OR AFTER 1st APRIL, 1976

ROYALTY

The term "royalty" is defined in *Explanation* 2 *to section 9(1)(vi)* of the Income-tax Act as follows:

"For the purposes of this clause, "royalty" means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipients chargeable under the head "capital gains")for –

(i) the transfer of all or any rights (including the granting of a licence) ink respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;

(ii) the imparting of any information concerning the working of, or the use of , a patent, invention, model, design, secret formula or process or trade mark or similar property;

(iii) the use of any patent, invention, model design, secret formula or process or trade mark or similar property;

(iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;

(iva) *the use or right to use, any industrial, commercial or scientific equipment;*

(v) the transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films; or

(vi) the rendering of any services in connection with the activities referred to in sub-clause (i) to (v)."

Furthermore, the royalty which is taxable in India should be payable by any of the following persons:

(a) the Government; or

(b) a person who is a resident, except where the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or

(c) a person who is non-resident, where the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India.

Where however the payment is not for the use of the technical know-how but for detailed engineering to enable the party to the contract to adopt the modified design in the existing furnace so as to make them workable under the know-how already made available under the agreement, it would be a case of "fee for technical or professional services" rather than "royalty"[74].

[74] *Hindusthan Electrographites Ltd. v. I.A.C.*, (1984) 145 ITR 84 (MP).

Rates of Tax : Section 115-A of the Income-tax Act prescribes the rate of income-tax in respect of royalty.

The rate of tax on royalty is 20% in case of agreements made after 31st May, 1997. For agreements made on or before 31st May, 1997, the rate of tax was 30%. This rate of 30% was introduced with effect from 1st April, 1987. Upto 31st March, 1987, the rate was 40% but in case of lump-sum payment the rate was 20%. The uniform rate of 30% (on all types of royalty) was introduced w.e.f. 1st April, 1987.

FEES FOR TECHNICAL SERVICES

Section 9 seeks to tax income byway of fee for technical services rendered by the non-resident if they are payable by:

(a) the Government; or
(b) a person who is a resident, except where the fees are payable in respect of services utilized in a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or
(c) a person who is a non-resident, where the fees are payable in respect of services utilized in a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India.

Where the foreign participant in the agreement receives the fees for such technical services outside India and in pursuance of a contract executed outside India, there will be no charge to tax provided no business connection is established.

Even where a business connection exists, only that part of income will be deemed to accrue or arise in India as is reasonably attributable to the operations carried out in India.

The scope of the term "fees for technical services" is very wide and almost every service rendered by foreigners, whether in India or outside India, is caught in the net of tax.

Section 115-A of the Income-tax Act prescribes the rate of the tax in respect of technical fees received by a foreign company as 20% in case of agreement made after 31stMay, 1997 and 30% in case of agreements made on or before 31st May, 1997. The rate of 30% was introduced from 1st April, 1987. Prior to this the rate was 40% of the gross amount of fees received by a foreign company.

DIVIDEND/SHARE OF PROFIT

In some cases, the collaboration agreements are entered into with an arrangement for sharing profits. In the case of companies, sharing may be by way of acquiring shares in the Indian company. Shares are also allotted in consideration of equipment supplied by a foreign participant or for supplying technical know-how. In the case of non-corporate bodies, the non-resident may become a participant in the Indian business by entering into a partnership.

In the former case, the profits are paid to the non-resident by way of dividends and, in the other case, byway of share of profit in the partnership/joint venture.

When shares are allotted to the foreign collaborator in consideration for technical know-how or otherwise, the value of the shares allotted will be taxed in India on the same basis as would apply to the consideration received otherwise than by way of shares. The value of the shares will be taxed only where the consideration is liable to tax. Where the consideration is not taxable, the value of shares will not be taxed merely on the ground that since the situs of shares is in India, the receipt of shares mounts to 'receipt of income' in India.

THE TAX IMPLICATIONS ON THE INDIAN COLLABORATORS

Collaboration agreements generally provide for the following types of payments to the foreign collaborators:

(a) Payment in consideration of "technical know-how". This payment could be a regular payment by way of royalty and other services, or an initial lump sum payment, or partly an initial lump sum payment and partly a regular payment.
(b) Allotment of shares in consideration for 'technical know-how'.
(c) Payment for acquisition of plant and machinery and/or other equipment.
(d) Payment for the foreign personnel in India for technical services like erection and installation of plant and machinery, etc.

PAYMENT IN CONSIDERATION FOR TECHNICAL KNOW-HOW

The question which arises for consideration is whether the payment made by the Indian collaborator is an allowable expenditure, i.e. an expenditure which is deducted from the gross income in order to arrive at the taxable income. The test which is applied for determining the allowbility of the expense is whether the expenditure in question is revenue expenditure or a capital expenditure. Broadly speaking, when expenditure is incurred in order to bring into existence an asset or an advantage for the enduring benefit of a trade, such an expenditure is properly attributable to capital and not to revenue. If it is a revenue expenditure, it will be allowed as deduction from the income of the Indian collaborator, but if it is a capital expenditure, it will not be allowed as a deduction from income. However where the expense is in the nature of a capital expenditure, a further question arises as to whether depreciation, etc, is permissible on such capital expenditure or not. Where the capital expenditure is of a type that could be termed as "plant and machinery", it would be entitled to the claim of depreciation. If, however, the capital expenditure is such that it does not fall in the category of plant and machinery or some other depreciable asset, neither will it be allowed as a revenue expense nor will any depreciation be permitted. Such an expenditure would be a dead capital expense.

TECHNICAL KNOW-HOW FEE HELD AS REVENUE EXPENDITURE

Where the payment for technical know how is made for the purpose of running the business more profitable and effectively, it has been held that payment would be revenue

in nature because no advantage of enduring value is derived by the assessee[75]. The Supreme Court in *Jonas Woodhead and Sons (India) Ltd. v. CIT*[76], has laid the following tests to determine the question when an expenditure can be regarded as a capital or revenue expenditure:

"The question whether a particular payment made by an assessee under the terms of the agreement forms a part of capital expenditure or revenue expenditure would depend upon several factors, namely, whether the assessee obtained a completely new plan with a completely new process and completely new technology for manufacture of the product or the payment was made for technical know-how which was for the betterment of the product in question which was already being produced; whether the improvisation made, is part and parcel of the existing business or a new business was set up with so-called technical know-how for which payments were made; whether on expiry of the period of agreement the assessee is required to give back plans and designs which were obtained, but the assessee could manufacture the product in the factory that has been set up with the collaboration of the foreign firm; the cumulative effect on a construction of the various terms and conditions of the agreement; ;whether the assessee derived benefits coming to its capital for which payment was made. This court in the Alemic Chemical Works Co. Ltd. v. CIT, (1989) 177 ITR 377 has indicated that 'in the infinite variety of situational diversities in which the concept of what is capital expenditure and what is revenue arises, it is not possible to form any general rule even in the generality of cases, sufficiently accurate and reasonable comprehensive, draw any clear line of demarcation'. This court further held that there is no single definitive criterion which, by itself, is demarcative, whether a particular outlay is capital or revenue. And, therefore, the 'once for all' test as well as the test of 'enduring benefit' may not be conclusive. Consequently, the various terms and conditions of the agreement, the advantage derived by an assessee under the agreement, the payment made by the assessee under the agreement are all to be taken into account and then it has to be decided whether the whole or a part of the payment thus made is capital expenditure or revenue expenditure."

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[75] *CIT v. Simpson and Co. Ltd.*, (1999) 239 ITR 83 (Mad)
[76] (1997) 224 ITR 342

In *CIT v I.A.E.C. (Pumps) Ltd.*[77], where a payment was made to a foreign company for granting a licence to use its patents and designs exclusively in India under an agreement the duration of which was ten years, the apex court held that the expenditure was revenue in nature because what was obtained by the assessee was only a licence and what was paid by the assessee to the foreign company was only a licence fee and not the price for acquisition of any capital assets

The land mark case on the question of allowability of the technical know-how fees in the hands of Indian collaborators in the case of *CIT v Ciba of India Ltd*[78]. In this case, the Indian company, in consideration of the right to receive scientific and technical assistance, agreed with the Swiss company to make contributions of 5%, 3% and 2%, respectively, of the net sale price of the products sold by the Indian company, towards

a) technical consultancy and technical services rendered, and research work done;
b) cost of raw material used for experimental work; and
c) royalties on trademarks used by the Indian Company.

The Indian company had further agreed-

a) not to divulge to any third party, without the consent of the foreign company, any confidential information received under the agreement;
b) not to assign benefit of the agreement or grant sub-licences of the patents and trade-marks without the consent of the foreign company; and
c) to return to the foreign company all copies of information, scientific data or material after the termination of the agreement and to refrain from communicating any such information, scientific data or material to any other person. The agreement was to be enforced for a period of 5 years but could be terminated earlier by giving three months' notice if either party failed to act according to the terms of the agreement.

[77] (1998) 232 ITR 316 (SC)
[78] (1968) 69 ITR 692 (SC)

The Supreme Court held that the contribution made by the Indian Collaborator is an allowable business expenditure and it was not a case of sale of technical know-how as such, as is evident from the following summarized facts:-

a) the licence was for a period of 5 years liable to be terminated in certain eventualities even before the expiry of the period.
b) The object of the agreement was to obtain the benefit of the technical assistance for running the business.
c) The licence was granted to the assessee subject to the rights actually granted or which may be granted after the date of the agreement to other person.
d) The assessee was expressly prohibited from divulging confidential information to the third parties without the consent of the Swiss company.
e) There was no transfer of the fruits of research once for all.
f) The stipulated payment was recurrent dependent upon the sales, and only for the period of the agreement.

Broadly speaking, therefore, one of the primary rules determining whether a particular expenditure is a revenue or capital expenditure is to ascertain the purpose for which it is being incurred. The purpose can be ascertained from the terms of the agreement between the parties and from the surrounding circumstances. If the purpose is related to the carrying on or the working of the business, the expenditure may be regarded as an integral part of the profit earning process and it should be held to be a revenue expenditure. Should, however, the purpose be the acquisition of an assets or the right of a permanent character or a benefit of an enduring nature, the expenditure would be a capital expenditure.

In a recent case, Delhi High Court has held that where there is no absolute transfer or sale of know-how, all that the assessee acquires is a licence for manufacturing or access to the technical knowledge, the payments made by the Indian Collaborators will be revenue in nature. It was held that in such cases the actual period of agreement, being 5 or 10 or 15

years, or the fact that payment was by way of lump sum or that the know-how was for a new business was not of much significance. It was further observed that even if the drawings and documents, etc., are not to be returned by the Indian party to his foreign counterpart, it will not change the revenue nature of expenditure because in this age of fast technological development and scientific research drawings, design, etc., become obsolete and mere scraps of paper very soon unless updated [*Triveni Engineering Works Ltd. v. CIT.* (1982) 136 ITR 340 (DEL); *CIT v. Power Build Ltd.,(2000) 244 ITR19(GUJ)]*. In the present day's condition of rapid scientific development, technological know-how which changes fast can not be treated as a capital asset and even where technological know-how is a capital asset, amounts paid for its use are allowable as 'revenue' expenditure. (See Electo Medical s v. CIT. (1987) 163 ITR 807 (MP); CIT. v. Sudarshan Chemical Industries (P.) Ltd., (1986) 159 ITR 629(BOM).

In all the cases where the technical know-how has been provided for use in India without a permanent transfer of the know-how and the rights therein, the courts have held that the payments is of the nature of revenue and is therefore deductible from the income of the assessee. In the recent case an Indian Co. incurred expenditure to obtain benefit of research and development made by the foreign company. The technical information given to the Indian company was 'non exclusive' and 'non transferable'. In other words this was not a case of outright sale of technical know-how. The Indian company was merely given a non-exclusive and non-transferable right of a user of technical information. The expenditure was held as revenue expenditure[79].

THE YEAR OF ALLOWABILITY OF EXPENSES:

Where collaboration agreements are made particularly for setting up a new business, a question often arises as to the year in which the expenditure is deducible. The problem assumes importance because a part payment to the foreign collaborator is generally made prior to commencement of production. The Delhi High Court in Shri Ram Refrigerators Industries Ltd., v. CIT[80], considered this issue at length. In the said case, payment to the

[79] *CIT v. Wavin India Ltd.*, (1999) 236 ITR 314 (SC)
[80] (181) 127 ITR 746

foreign collaborators had been made in the years 1962, 1963 and 1964 but the commercial production started and the business was set up in the year relevant to Assessment Year 1966-67. The Tribunal held that the expenditure, though incurred prior to the setting up of the business, was in the nature of prepaid expenditure which would be considered only in the first assessment of the company for the assessment year 1966-67. The High Court upheld the view of the Tribunal and allowed the entire expenditure as a deduction in Assessment Year 1966-67.

TECHNICAL KNOW-HOW FEES HELD AS CAPITAL EXPENDITURE

Where the fees for technical know-how are paid in such a manner that they amount to the acquisition of an asset or a right of a permanent nature, the payment would not be allowed as a revenue expense but would be treated as capital expenditure, and would be disallowed as expense in the hand of the Indian counterparts to a collaboration agreement.

In the case of *Fenner Woodroffe & Co. Ltd. v. CIT*[81], the Madras High Court laid down the following principles to determine the character of an expenditure- whether it is a revenue or capital expenditure:

(a) It's the aim of and object of the expenditure that would determine the character of the sum whether it is a capital or revenue expenditure and neither the source nor the manner of the payment may be of any consequence. The fact, therefore, that the agreement did not fix any lump sum consideration but referred to a periodical payment linked to the production or sale of the article does not in any way take it out of the category of a capital expenditure.

(b) If the fact and circumstances of the case and the nature of the contract are such as to warrant a finding that there was a sale of the know-how it could safely be inferred that even in the transferee's hand it is capital asset

[81] (1976) 102 ITR 665

unless the same is considered as a trading asset of the transferee. If on the other hand, it is considered to be an exploitation of its know-how by a trader without any diminution or destruction in the value to him there may not be a sale but still the knowledge acquired by the transferee by the disclosure of the know-how will be an asset or an advantage of an enduring nature unless there are any limitations in the agreement on its endurability or otherwise pointing to the contrary.

However, these principles are neither exhaustive, nor intend to be. They only serve as guidelines to solve the problems that are before the court.

In another case of *CIT v. Southern Structurals Ltd.*[82], the Madras High Court held that in a case where technical know-how was acquired in relation to the design and manufacture of railway wagons and where the agreement clearly provided that after the expiry of the agreement the assessee would be free from any further obligation to pay any amount to the foreign company, would have the continued use, free of charge, of all the information made available by the foreign company during the validity of the agreement, it amounted to the acquisition of an enduring benefit and therefore the payment was held to be of capital nature.

In the case where the foreign collaborators provided services for setting up factories, payment of royalty related to such services was held to be a capital expenditure[83]. Where a technical know-how fees paid by an Indian company to a foreign company is treated as capital expenditure, the assessee would be entitled to depreciation[84].

<u>TECHNICAL KNOW-HOW FEES HELD AS A PLANT</u>

[82] (1977) 110 ITR 890

[83] *Jonas Woodhead & Sons (India) Ltd. v. CIT*, (1979) 117 ITR 55 (MAD- FB) and *M.R. Electronic Components Ltd. v. CIT*, (1982) 139 ITR 305 (MAD)

[84] *CIT v. Warner Hindustan Ltd.*, (1999) 239 ITR 566 (SC)

In *CIT v. Elcon Engineering Co. Ltd.*[85], an interesting question arose as to whether the know-how is an asset and if it is, whether it would come under the definition of "plant and machinery". The case was is approved by Supreme Court in the case of *Scientific Engineering House Pvt. Ltd. v. CIT*[86]. According to the Supreme Court "the test for determining whether technical know-how in the shape of drawings, designs, charts, plans, processing data and other literature falls within the definition of plant would be: Does the article fulfill the function of the plant in the assessee's trading activity? Is the tool of his trade with which he carries on his business? If the answer is in the affirmative, it will be a plant".

Following the above case, the Bombay High Court in *Mahindra Ugine Steel Co. Ltd.*[87], held that the know-how provided in the form of books, manual etc. constitute "plant" entitled to depreciation.

In *CIT v. Sudarshan Chemical Industries (P.) Ltd.*[88], it was observed that where the technical know-how was in the form of printed literature giving technical informations, such technical know-how would be covered under the definition of "Plant". The High Court further observed that there is no reason to exclude from the wide meaning of the term "Plant" objects such as drawings, patterns, designs, etc., which like books are the embodiments of the know-how and serve the purpose of teaching at long range.

After considering all the above cases, it appears that know-how could be capitalized to 'Plant' only under the following circumstances:-

(i) Know-how relating to design and engineering of the plant or its erection and commissioning may be capitalized to "plant". But the technology related to items like workshop drawings, manufacturing instructions, etc., will clearly be in the nature of revenue expenditure.

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[85] (1974) 96 ITR 672 (Guj.)
[86] (1986) 157 ITR 86 (SC)
[87] (1993) 203 ITR 383
[88] (1986) 159 ITR 629(BOM)

(ii) Where know how is claimed as "plant" on the plea that the same is like a book, then only that part of technical know how can be capitalized to plant which is in the form of "bound sheets of papers or made into a roll". Such cost will not cover payments for acquiring rights to the use of technical know how.

(iii) to claim manufacturing or process know how as "plant" even as a "book" may not be correct because in a very large number of decided cases payment for such technical know how has been held as revenue expenditure as neither the know how has transferable property rights in it nor the same provides any enduring benefit.

(iv) Even in cases where technical know how is composite and the entire technical know how is in the form of "manuals", the correct view appears to be that only that part of fee which represents the "cost of manuals" can be capitalized to "books" and the other part of the fee (even if entire know how is in the shape of manual) which is paid to obtain the right of the know-how with its connected services cannot be taken as the cost of the book.

ALLOTMENT OF SHARES IN CONSIDERATION FOR TECHNICAL KNOW-HOW

In *Eimco-K.C.P.Ltd. v. CIT*[89], an Indian company allotted its shares to a foreign company in consideration for supply of technical know how and claimed the value of shares as revenue expenditure. It was held that the subscription for shares otherwise than for cash could not have the effect of making the non-cash consideration an item of the company's expenditures. Even otherwise, the admissibility of expenditure as a deduction would rise only where the company after formation gets going with its business. On the allotment of shares to the foreign company, the assessee company could not be treated as having incurred or laid out any expenditure for the purpose of its business. As no expenditure in the trading sense of the term had arisen in the instant case, there was no question of the further issue as to whether it would be a capital or revenue expenditure. Further, the offer of the know-how by the foreign company to the assessee only represented its way of

[89] (2000) 242 ITR 659 (SC)

discharging its capital contribution for the floating of the assessee-company and in that sense it could involve no expenditure.

In *CIT v. Protein Products Ltd.*[90], the Indian company issued shares to the foreign collaborator and capitalized their value and claimed depreciation on it. The High Court held that shares were allotted by the assessee in consideration of technical know-how provided by the foreign collaborators in the form of drawings, designs, charts, etc., and without technical assistance, it would not have been possible for the assessee to erect the plant. The expenditure incurred to obtain such expertise was closely and directly related to the erection of the plant and such expenditure was capital expenditure whereby a capital asset within the meaning of "plant" was acquired by the assessee and such asset was a depreciable asset. Therefore, depreciation was to be allowed on the total value of the shares capitalized and apportioned to various assets.

PAYMENT FOR ACQUISITION OF PLANT AND MACHINERY

The payment for acquisition of plant and machinery is undoubtedly a capital expense on which depreciation, etc. would be allowable to the Indian collaborator. The material received as technical know how may also fall in the category of plant and machinery. Similarly the amount paid for the erections, installation and commissioning of the plant and the machinery can also be regarded as the acquisition of plant and machinery. Where however the plant and machinery is an item for trading by the Indian importer, payment made for it would be normal business expense like that for the purchase of a merchandise for resale.

PAYMENT FOR FOREIGN PERSONNEL IN INDIA FOR TECHNICAL SERVICES

A payment may be made to the foreign personnel for any one or more of the following services:

[90] (1987) 167 ITR 157 (Ker)

a) for rendering assistance in imparting of technical know-how;
b) for installation, erection or commissioning of the plant and machinery;
c) as employees of the Indian collaborator for technical services;

Payment to foreign personnel for rendering technical know-how would normally be treated as a revenue expenditure. But where the payment for technical know-how as such is a capital expenditure, payment for the services of foreign personnel may also fall in the category of capital expense depending upon the facts and circumstances of each case.

The payment for installation or erection or commissioning of plant and machinery would be in the nature of capital expenditure.

TAXATION OF FOREIGN PERSONNEL IN INDIA

A foreigner is liable to pay income tax in India on all the income which he receives in India or which accrues or arised to him in India or which is deemed to accrue or arise in India. However, the foreign income of a foreigner is not ordinarily taxable in India because of his status being that of "not ordinarily resident".

INCOME FROM SALARY

Income from salary stands in a peculiar position under Indian Income-tax Law. Section 9(1)(ii) of the Income tax dealing with accrual of salary income provides:

" The following income shall be deemed to accrue or arise in India :

(ii) income which falls under the head "salaries" if it is earned in India.

Explanation:

For the removal of doubts, it is hereby declared that the income of the nature referred to in this clause payable for –

(a) service rendered in India; and

(b) the rest period or leave period which is preceded and succeeded by services rendered in India and forms part of the service contract of employment,

shall be regarded as income earned in India."

Because of this provision, the salary-income of a foreigner would be taxable in India if such salary is "earned" in India, irrespective of the fact whether it is received in India or outside. The implication of this provision is that a foreigner who receives his salary-income wholly outside India, or partly in his home country and partly in India is liable to pay tax in India on his entire salary income, including that portion of the salary which is received by him outside India.

What is to be taxed under section 9(1)(ii) is the income which falls under the head "Salaries". Therefore, when the income received by the foreigner or earned by him outside India is not "salary", it cannot be taxed in India merely because the services have been rendered in India. Thus, for example, where a foreigner receives professional charges outside India and also receives a salary in India, the professional charges which are accrued and received outside India would not be taxed in India on the ground that the foreigner is rendering services in India and earning his salary in India. It should, however, be ensured that the income earned by him outside India should not be related to the real and intimate connection amounting to "business connection" in India[91]. Furthermore, such income should be received outside India in pursuance to agreements, etc., entered into outside India.

ALLOWANCES AND BENEFITS

Any special allowance or benefit paid to employees by their employers are exempt under section 10(14) of the Income-tax Act which has been amended from time to time.

[91] *B.P. Ray v. ITO*, (1981) 129 ITR 295 (SC)

EXEMPTION FROM TAX AVAILABLE WITH EFFECT FROM 1ST JULY, 1995

An amendment was made in section 10(14) by the Finance Act, 1995, w.e.f. 1st July, 1995, providing that the exemption under section 10(14) will be available as maybe prescribed in place of "as the Central Government may, by notification in the official Gazette, specify". In view of this amendment, after 30th June 1995, the limit and extent of exemption is to be prescribed by the Government. Accordingly, the Government has made Rule 2BB under the Income-tax Rules 1962 providing for exemptions from various allowances which could be claimed as exempt under section 10(14) of the Income tax Act. Rule 2BB generally covers the following allowances which could be exempted from tax under section 10(14)(i) of the Income-tax Act.

(a) any allowance granted to meet the cost of travel on tour or on transfer;

(b) any allowance, whether granted on tour or for the period of journey in connection with transfer, to met the ordinary daily charges incurred by an employee on account of absence from his normal place of duty;

(c) any allowance granted to meet the expenditure incurred on conveyance in performance of duties of an office or employment or profits: Provided that free conveyance is not provided by the employer;

(d) any allowance granted to meet the expenditure incurred on a helper where such helper is engaged for the performance of the duties of an office or employment of profit;

(e) any allowance granted for encouraging the academic research and training pursuits in educational and research institutions;

(f) any allowance granted to meet the expenditure incurred on the purchase or maintenance of uniform for wear during the performance of the duties of an office or employment of profit.

Explanation : For the purpose of clause (a), "allowance granted to meet the cost of travel on transfer" includes any sum paid in connection with transfer, packing and transportation of personal effect on such transfer.

DOUBLE TAXATION AVOIDANCE AGREEMENTS

A foreign investor or company planning to have business operations in India has to deliberate on the likelihood of it being double taxed on its income from abroad. First on the basis of its accrual or receipt in foreign currency and then on the basis of residence on its own country where its entire income might be taxable.

Keeping this in mind section 90 of the Income-tax Act of 1961 of India, has empowered the Central Government to enter into agreements with the Government of any other country for the following purposes:

(a) for the granting of relief in respect of income on which taxes have been paid both income-tax under this Act and income-tax in that country, or
(b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country, or
(c) for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country, or investigation of cases of such evasion or avoidance, or
(d) for recovery of income-tax under this Act and under the corresponding law in force in that country.

The Central Government may, by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement made by it with the Government of any country outside India.

Whereas clauses (a) and (b) above both provide relief from double taxation, the next two clauses cover two distinct circumstances. Clause (a) provides for relief in the case where

income tax has already been paid both in India and in the foreign country on the same income, Clause (b), on the other hand, provides fork avoidance of double taxation. Thus, in the case of clause (a) the tax has first to be paid and only then does the right to relief arise. In the case of clause (b), tax shall not be paid in either country and thus double taxation is completely avoided[92]. Clause (c) provides for tackling the problem of tax evasion and tax avoidance by restoring to unwarranted means by the taxpayers. Clause (d) provides for the recovery of tax. The object of the provisions in clauses (c) and (d) is specified in the following circular, issued by the Central Board of Direct Taxes.

Circular No. 108F. 131(9) 173 TPL, dated 20th March, 1973

Provisions for enabling the Central Government to enter into tax treaties with foreign countries for exchange of information for preventing evasion or avoidance of taxes and recovery thereof.

Under Section 90 the Central Government is empowered to enter into an agreement with the Government of any foreign country for the avoidance of double taxation of income and to make provisions for implementing the agreement by the issue of notification in the Official Gazette. Some of the tax payers having transactions with outside countries resort to dubious methods for evading their liability under the tax laws. Tax evasion is thus closely linked with transaction involving over invoicing and under invoicing in import and export business operations through secret foreign bank accounts and smuggling of valuable articles into and out of India. Cases of taxpayers who thwart the attempts of the administration to collect tax dues by either retaining their assets abroad or transferring them secretly outside India are also not unknown. With a view to enabling the tax administration to tackle the problem of tax evasion having international ramifications, the Finance Act, 1972 has substituted a new section for the existing Section 90 in order to empower the Central Government to enter into agreements with foreign countries not only for purposes of avoidance of double taxation of income but also for enabling the tax authorities to exchange information for the prevention of

[92] *Shell Company of India Limited v. CIT*, (1964) 51 ITR 669 (Cal)

evasion or avoidance of taxes on income or for investigation of cases involving tax evasion or avoidance or for recovery of taxes in foreign countries on a reciprocal basis.

A consequential change has also been made in the provision of the Income-tax Act relating to recovery of arrears of taxes by inserting a new section 228A. Where the tax-treaty provides for the recovery of taxes due to the Government of one treaty country in the other and the Government of the foreign country or any authority specified in this behalf in the tax treaty sends the Central Board of Direct Taxes a certificate for the recovery of any tax due in the foreign country, the Board has been empowered to send the certificate to the Tax Recovery Officer within whose jurisdiction the property of the defaulters is situated and thereupon the Tax Recovery officer will proceed to recover the dues in the manner specified in the Income-tax Act. Likewise, if a taxpayer in India has property in the foreign country, the Income-tax officer will be enable to send a certificate to the Board, certifying the amount of arrears due from the tax-payer and thereupon the Board will take action for the recovery of the dues in the foreign country in accordance with the terms of the tax treaty.

The Companies (Profits) Sur-Tax Act, Wealth-Tax Act and Gift-Tax Act also contain similar provision enabling the Central Government to enter into agreements with foreign countries for the avoidance e of double taxation will respect to taxes levied under these Acts. The corresponding provisions in these Acts have also been brought in line with the provisions of the Income-tax Act.

The above modifications have come into force with effect from 1.4.1972.

THE TAX TREATIES OVERRIDE THE INCOME-TAX ACT

As per section 90(2) of the Income-tax Act, "Where the central Government has entered into an agreement with the Government of any country outside India under sub-section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assesse".

It is an established position in law that the provisions of the agreement for avoidance of double taxation prevail over the general provisions contained in the Income-tax Act. In fact, the tax treaties themselves provide that the laws in force in either country will continue to govern the assessment and taxation of income in the respective country except where provisions to the contrary have been made in the tax treaty.

MORE BENEFICIAL PROVISIONS TO APPLY

Section 90(2) specifically provides that where the Central Government has entered into an agreement with the Government of any country outside India for granting relief of tax, or, as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of the Income-tax shall apply to the extent they are more beneficial to that assessee. It is clear that where there is a conflict between the provision as contained in the tax treaty and the provision of the Income-tax Act, a taxpayer can take advantage of that provision which is more beneficial to him[93].

NO RELIEF IF TAX NOT PAID IN ONE COUNTRY

The provisions of section 90 which empower the Central Government to enter into agreement for avoidance of double taxation with other countries are intended to grant relief to a taxpayer where his income has been subjected to tax both in the foreign country and in India. This power can be exercised only for avoidance of double taxation of the same income under the Indian Income-tax Act and the corresponding laws in force in the country. Thus, the liability to pay tax both in India and the foreign country entitles a taxpayer to claim relief under the provisions contained in the agreements for avoidance of double taxation. It, therefore, follows that if a taxpayer pays tax or is liable to pay tax under the laws in force in one country along, he cannot claim any relief from a non-existence burden of double taxation under the agreement for avoidance of double taxation. Such agreements are intended for the benefit of those taxpayers only who are liable to pay tax twice on the same income.

[93] *Arabian Express Line Ltd., of UK & Others v. Union of India*, (1995) 212 ITR 31 (Guj)

CHAPTER IX: DRAFTING OF FOREIGN COLLABORATION AGREEMENT

The collaboration agreement is essentially a contract between the Indian party and the foreign collaborator. It is a pure commercial contract and hence all the incidents of a valid contract under the Indian Contract Act attach to the agreement.

DRAFTING OF THE MEMORANDUM OF UNDERSTANDING

Drafting of the MOU is that stage in foreign collaboration agreement that generally follows the exchange of correspondence and preliminary personal level discussions held either in India or abroad. The MOU which is a form of rough blue print of the terms of the collaboration should generally cover the following salient aspects:-

a) nature of collaboration, whether technical and/or financial
b) duration of the collaboration agreement
c) in case of technical collaboration
   - know-how fee payable
   - royalty payable
   - technical service, personnel exchange for training
   - warranty/guarantees
   - buy back arrangements
   - exclusive use of techni\ology/sub-licensing etc.
   - mutual rights and obligations
d) in case of financial collaboration
   - extent of equity participation
   - management of the company and collaborator's involvement in it.

e) broad time frame by which the agreements should be put through

f) buy back arrangements if any.

DRAFTING OF THE PROMOTERS' AGREEMENT

The promoters' agreement sometimes variously called as "shareholders' agreement", "shareholders' cooperation agreement", etc. becomes relevant in financial collaborations where the foreign party has stakes in the equity of the Indian company. This agreement encompasses the following aspects, namely-

a) the nature of the product/project for which the collaboration is envisaged;
b) obtaining of approval of government/other authorities;
c) capital structure
d) raising of loans
e) composition of the Board of Directors
f) Reimbursement expenses
g) Voting rights/transfer of shares
h) Know how agreement
i) Other usual clauses pertaining to arbitration, force majeure etc.

DRAFTING OF THE TECHNOLOGY TRANSFER AGREEMENT

Drafting the technology transfer agreement is the most important aspect in any collaboration proposal. Detailed discussions and perfect understanding should precede the drafting of the agreement. The contents of a technology transfer agreement are: -

a) definition of important terms used in the agreement-know how, plant, basic engineering, equipments, patent rights, etc.
b) supply/transfer of technical know-how, design, drawings and documents;
c) Guarantees by the seller (foreign party)
d) Grant of Licence-whether exclusive or in conjunction with any other party; if so, for how many years etc.
e) Secrecy of the seller's (foreign party) technical information – Buyers' obligations thereof
f) Warranty by seller in regard to patent rights
g) Price and payments consisting of-
    (i) Know-how
    (ii) Detailed engineering review
    (iii) Improvements
    (iv) Tax aspects
    (v) Instalments in which payments are to be made
    (vi) Opening of letters of credit, etc. to secure the payment
h) Parties' right to assign the agreement
i) Effective date of the agreement
j) Law governing the agreement
k) Arbitration of disputes
l) Design conferences in India/abroad
m) Language to be used in communication/training
n) Signature of the parties

A model technical Know-how agreement is given in Appendix.

AGREEMENT FOR TECHNICAL SERVICES IN INDIA

Since technology transfer agreements necessarily involve erection and commissioning of the plant in India, sometimes a separate agreement for technical services is entered into between the Indian company and the collaborator. It is also possible to incorporate these

aspects in the Technology Transfer Agreement itself. This is purely a question of convenience of parties. The points covered in this types of agreement are :

(i) Meaning of technical services, know-how, etc

(ii) Level of personnel who would provide the technical service

(iii) Scale of remuneration payable

(iv) Manner of payment of remuneration

(v) Conduct aspects of the technical personnel deputed to India

(vi) Whether the payment of remuneration will be net of taxes or not

(vii) Working hours, stay, boarding and lodging, etc. aspects of the foreign technical personnel visiting India.

AGREEMENT FOR TRAINING OF INDIAN TECHNICAL STAFF ABROAD

In any technical collaboration, there is a dire necessity for imparting of training to the Indian personnel working with the India Company. For this also, either separate agreement is entered into or what is called a "side letter" is signed by both the parties. The usual clauses in the "side letter" or agreement ink this regard are :

(i) Number and level of trainees to be sent abroad

(ii) Working hours and conduct

(iii) Duration of training (training programme)

(iv) Meeting of expenses of the trainees abroad.

DISPUTES, DEFAULTS AND THEIR SETTLEMENT IN TECHNOLOGY TRANSFER AGREEMENTS-LEGAL ASPECTS

DEFAULTS UNDER TECHNOLOGY TRANSFER AGREEMENTS

The technology transfer agreement is essentially a contract between the licensor (foreign party) and the licensee (Indian party). Therefore, the terms of this agreement determine the rights and obligations of the respective parties if any of the parties to the agreement. If any party commits any breach of its obligations or fails to comply with any of its terms, the party is said to have committed a default. Since each technology transfer agreement is specie in itself and the terms and conditions evolve out of the negotiation process between the parties, the types of defaults which arise under the technology transfer agreement cannot be standardized. The default may be committed party by the licensor and partly by the licensee.

DEFAULTS BY THE LICENSOR (FOREIGN COLLABORATOR)

Under the technology transfer agreement; the licensor is under obligation to supply all information which is of a technical nature to enable the Indian party to work the technology fruitfully in India. In other words, the know-how is to be disclosed to the Indian party by the collaborator. The agreement usually stipulates the time, manner and method of supply of the technical know-how; the different types of defaults which may be committed at the instance of the collaborator may broadly fall under the following categories –

(a) failure to deliver or supply any technical information or service;
(b) supply of incomplete information skill or services'
(c) delay, both avoidable and unavoidable in the supply of know-how;
(d) know-how supplied being not able to bring about the indicated results stipulated in the agreement;
(e) any default regarding allegations of infringement of trade mark or patent rights purported to be possessed by the collaborator.

DEFAULTS BY THE INDIAN PARTY (LICENSEE)

The Indian party may also commit defaults under the collaboration agreement. Certain situations can be:

(a) delay in payment of the technology fee;
(b) failure to pay the technology fee;
(c) dispute regarding collection and payment of royalties;
(d) failure to maintain absolute secrecy of the know-how transmitted;
(e) illegal sub-licensing of the technology.

NORMAL REMEDIES FOR DEFAULTS

The remedies for various types of defaults committed by either of the parties to the technology transfer agreements may be anyone of the following types:

(a) Option to terminate the agreement after giving requisite notice;
(b) Along with (a) above, return of payments which have already been made under the agreement:
(c) Payment of damages;
(d) Revision of payments.

For different types of defaults, different types of remedies may b e envisaged un;der the agreement.

PAYMENT OF DAMAGES BY THE DEFAULTING PARTY

Damages in law are intended to place the affected party in the same position, in terms of money in which he would have been placed had the contract been performed as contemplated in the agreement. So, for any default damages arise as a result of loss or injury caused to the other party. Usually specific provisions for payment of damages are incorporated in the agreement. Even in the absence of any such specific provision, under

the Indian Contract Act, section 73 provides for any aggrieved party to a contract to recover damages for the defaulter.

FORCE MAJEURE CLAUSE IN THE AGREEMENT

Although the parties to the agreement contemplate different types of defaults by either of the parties, there are certain acts which are prescribed in the agreement which will not amount to a default. These types of events are couched in what is called Force Majeure clause; Where a default by a party arises by reason of a force majeure clause, no penalty would arise with reference to the defaulting party under the agreement. For instance, from the date of the agreement, if the collaborator could export the machinery in question but subsequently the export of such machinery is banned in the collaborator's country by law, it would constitute a default under the force majeure clause for which the collaborator cannot be held responsible. Similar would be the situation where the Indian Government prohibits imports of certain machinery. Therefore, the collaboration agreement elaborately covers all such acts which will not give rise to allegation of defaults on the part of the parties to the agreement.

SETTLEMENT OF DISPUTE ARISING OUT OF DEFAULTS

There are many methods of settlement of disputes in commercial contracts. Mutual discussions, consultations, give and take and mutually agreed compensations are the most effective and less time-consuming as also cost effective. Sometimes intervention by well-meaning friends of either or both the parties to the agreement might prove effective in bringing about an amicable settlement of disputes. Sometimes Chambers of Commerce and Trade Associations might help in bringing about amicable settlement of disputes.

Invariable all technology transfer agreements contain a provision for referring disputes a4rising out of the agreement for arbitrations which is also an Indian Law. Therefore, certain legal disputes have arisen involving vital questions of law in regard to arbitration

conducted outside India following rules of procedure applicable under the international rules of arbitration inspite of the fact that the collaboration agreement is to be implemented in India. These subtle legal points deserve discussion at some length.

PART B

CHAPTER I: ATTRACTING FDI THROUGH INCENTIVES

INTRODUCTION

"To attract companies like yours ... we have felled mountains, razed jungles, filled swamps, moved rivers, relocated towns ... all to make it easier for you and your business to do business here"[94].

Attracting FDI has become a policy priority in many countries, both developed and developing. Restrictions on FDI have been substantially reduced and as a result, FDI regimes have become increasingly similar. For governments this has enhanced the significance of incentives as a tool for attracting investment, specially also since, by their very nature, they can be more easily manipulated by governments than other factors influencing investment decisions.

Incentives are defined as any measurable economic advantage afforded to specific enterprises or categories of enterprises by (or at the direction of) a government, in order to encourage them to behave in a certain manner[95]. They include measures specifically designed either to increase the rate of return of a particular FDI undertaking, or to reduce (or redistribute) its costs or risks. They do not include broader non-discriminatory policies, such as infrastructure, the general legal regime for FDI, the general regulatory and fiscal regime for business operations, the free repatriation of profits or national treatment. While these policies certainly bear on the locational decision of Multinational Corporations, they are not FDI incentives per se.

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[94] An advertisement placed in *Fortune* in 1995 by the Philippine government.

[95] A distinction needs to be made between incentive and a subsidy which is "a financial aid granted by a government or other organization to an individual or legal entity for something that is considered to be of some advantage to the public". A subsidy may take the form of payment by the government or of the government's foregone revenue it would otherwise receive. While most incentives have, in one way or another, a subsidy component, there are some (e.g. monopoly rights or market preferences) that do not entail a financial cost to the governments.

The increasingly competitive environment for foreign investment among developing countries is stimulating new efforts to market countries to foreign investors. Organizations, multinational firms or host countries that seek to develop competitive strategies for marketing activities can, to some extent, influence two variables:

1) the price or the relative cost to the investor of locating and operating within a particular investment site, through tax incentives and direct grants; and
2) the promotion activities that disseminate information about the country about the country to induce the prospective investors to invest in the country, and seek to provide services for them.

ARGUMENTS FOR AND AGAINST INVESTMENT INCENTIVES

There are many arguments made for offering foreign investors investment incentives in general and tax incentives in particular, but most of these arguments can be boiled down to two categories: first, it is argued that incentives will increase the total flow of new investment; that is, investments will be made that would not be made in the absence of incentives. Second, it is argued that if governments of locales that are alternative locations for foreign investors offer incentives, then the government eager to ensure that it gets the investment must match those incentives or face the prospect of losing investment to the competing territories[96]. This might be true even if the investor would, in

[96] Sometimes referred to as the *prisoner's dilemma*- a game theory where two players in the game can choose between two moves, either "cooperate" or "defect". The idea is that each player gains when both cooperate, but if only one of them cooperates, the other one, who defects, will gain more. If both defect, both lose (or gain very little) but not as much as the "cheated" cooperator whose cooperation is not returned. The game got its name from the following hypothetical situation- two criminals arrested under the suspicion of having committed a crime together. However, the police does not have sufficient proof in order to have them convicted. The two prisoners are isolated from each other, and the police visit each of them and offer a deal: the one who offers evidence against the other one will be freed. If none of them accepts the offer, they are in fact cooperating against the police, and both of them will get only a small punishment because of lack of proof. They both gain. However, if one of them betrays the other one, by confessing to the police, the defector will gain more, since he is freed; the one who remained silent, on the

the absence of any incentive, make the investment somewhere in the region. Thus, in somewhat more abstract terms, the two general arguments are as follows: first, incentives increase the aggregate of foreign investment available to developing countries; and second, incentives can affect the spatial distribution of investment, even if the first argument does not stand up.

The main arguments made against investment incentives can also be boiled down to two. The first is that incentives have little, if any, effect on the total foreign investment that is made worldwide, and thus in the aggregate, incentives create a net transfer from taxpayers (or, in the case of indirect subsidies such as protection from imports, from consumers of the relevant product) to investors. In the case of foreign investors in developing nations, this transfer is primarily from a poor country to a richer one. The second argument is that even if the first argument does not fully stand up (that is, because incentives do increase the total investment worldwide), the cost to the public of incentives exceeds the additional benefits that are created by the investment that would otherwise not occur.

TYPES OF INCENTIVES

The following types of FDI incentives can be distinguished:

FISCAL INCENTIVES

Their overall objective is to reduce the tax burden for a foreign investor. Tax- incentive scheme can be classified in different ways depending on the tax base. The various types of tax incentives in a host country can have a different effect on the overall corporate tax paid by a parent company, depending on the home country's tax laws and any tax treaties

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other hand, will receive the full punishment, since he did not help the police, and there is sufficient proof. If both betray, both will be punished, but less severely than if they had refused to talk. The dilemma resides in the fact that each prisoner has a choice between only two options, but cannot make a good decision without knowing what the other one will do.

between the home and the host countries. The purpose of double taxation agreements is to allow for taxes paid in the host country to be deducted from corporate income taxes at home. However, this does not necessarily prevent a home country from taxing the income that is exempt from tax in a host country. For this reason, certain types of double taxation agreements provide for tax sparring, whereby the home country gives credit to the taxes that would have been paid in the host country if no tax exemption had been given. This device ensures that tax concessions given in a host country benefit foreign investors instead of resulting in a transfer of tax revenue from the host to the home country.

MAIN TYPES OF FISCAL INCENTIVES FOR FDI[97]	
Profit-based	Reduction of the standard corporate income tax rate; tax holidays, allowing losses incurred during the holiday period to be written off against profits earned later (or ealier).
Capital Investment based	Accelerated depreciation; investment and reinvestment allowance.
Labour based	Reductions in social security contributions; deductions from taxable earnings based on the number of employees or on other labour related expenditure.
Sales based	Corporate income tax reductions based on total sales.
Value added based	Corporate income tax reductions or credits based on the net local content of outputs[98]; granting income tax credits based on net value earned[99].

[97] UNCTAD. Division on Transnational Corporations and Investment.
[98] "Net local content" is the value of sales less depreciation of capital equipment and value of imported raw materials and supplies.
[99] "The net value earned" is the value of sales less the cost of raw materials and components, supplies and utilities, and depreciation of capital equipment.

Based on other particular expenses	Corporate income-tax deductions based on, for instance, expenditures relating to marketing and promotional activities
Import based	Exemption from import duties on capital goods, equipment on raw materials, parts and inputs related to the production process.
Export based	a) Output related e.g., exemptions from export duties; preferential tax treatment of income from exports; income tax reduction for special foreign exchange earning activities or for manufactured exports. b) Input related e.g., duty drawbacks, tax credits for duties paid on imported materials or supplies; income tax credits on net local content of exports; deduction of overseas expenditures and capital allowance for export industries.

FINANCIAL INCENTIVES

Financial incentives involve the provision of funds directly to firms to finance new foreign investments or certain operations, or to defray capital or operation costs. The most common types include government grants, subsidized credit, government equity participation and insurance at preferential rates.

MAIN TYPES OF FINANCIAL INCENTIVES FOR FDI	
Government grants	A variety of measures (also sometimes referred to as "direct subsidies") to cover (part of) capital, production or marketing costs in relation to an investment project.

Government credit at subsidized participation	Subsidized loans; loan guarantees; guaranteed export credits.
Government equity participation	Publicly funded venture capital participating in investments involving high commercial risks.
Government Insurance at preferential rates	Usually available to cover certain types of risks such as exchange rate volatility, currency devaluation, or non-commercial risks such as expropriation and political turmoil.

OTHER INCENTIVES

Some types of incentives elude easy classification, their common denominator being that they are designed to increase the profitability of a foreign affiliate by non-financial means. Examples are certain subsidized services, preferential treatment on foreign exchange, etc.

MAIN TYPES OF OTHER INCENTIVES FOR FDI	
Subsidized dedicated infrastructure	Includes provision at less than commercial prices of land, building, industrial plants, or specific infrastructure such as telecommunications, transportation, electricity and water supply.
Subsidized services	Services offered may include assistance in identifying finance; implementing and managing projects; carrying out pre-investment studies; information on markets, availability of raw materials and supply of infrastructure; advice on production processes and marketing

	techniques; assistance with training and retraining; technical facilities for developing know-how or improving quality control.
Market preferences	Preferential government contracts; closing the market for further entry; protection from import competition; granting of monopoly rights.
Preferential treatment on foreign exchange	Special exchange rates; elimination of exchange risks on foreign loans; special concessions on the repatriation of earnings and capital.

Incentives may be granted conditionally or unconditionally. The former may be linked to performance requirements which in some cases can have a disincentive effect on the investment. They can be granted, financed and/or administered at all levels of government. Incentives may be granted automatically or there may be varying degrees of discretion on the part of the administering authority to decide on the awards. Also awards may be granted before the conditioning element has taken place or retroactively after the condition has been met.

Not only there is a wide array of choices for designing FDI incentives but in addition the characteristic of their administration and implementation can also make a difference. Indeed the same benefit for the foreign investor may cost a government less or more, depending on the type of incentive used and how it is administered. In practice, however, in the case of large or important FDI projects, incentives are often granted as a part of negotiation process with an investor not seldom demanding incentives, be it to match incentives offered elsewhere or to compensate, e.g., for perceived higher structural costs.

PROMOTIONAL PROGRAMS

Investment incentives are one "pricing" technique governments have used to try to attract investment, but these incentives were effective in influencing decisions only for certain types of projects.

In addition to incentives, governments of countries like United Kingdom, Canada, Costa Rica, Indonesia, Ireland, Jamaica, Malaysia, Singapore and Thailand have set up promotional programs to market their countries' investment opportunities and incentive packages to prospective foreign investors. Such techniques to promote foreign investment can be divided into three groups, according to the objectives of promotion agencies and the accomplishments of the techniques:

1) techniques aimed at building or changing the investment image of the country
2) Techniques used to generate investment directly
3) Techniques directed as servicing existing and prospective investors

Although governments tend to engage in all three types of investment promotion activities to varying degrees most of the time, they usually concentrate their mix of promotional activities at any one time towards image building or investment generation.

INCENTIVE BASED COMPETITION AMONG COUNTRIES FOR FDI

In recent years competition among governments to attract FDI has heated up. The main reason for this is the large number of developing and emerging market economies that have moved during the 1980s and 1990s from relatively closed state-led growth strategies to more open and market friendly policy regimes, and have moved in the process to seek actively to attract FDI. For example, China alone has moved from a policy of virtually excluding FDI, until 1979, to successfully attracting an annual FDI inflow of over $40 billion by the mid 1990s and in doing so has caused developing and emerging countries throughout Asia, and beyond, to worry about intensifying competition, with China and with each other, to attract FDI. The crisis that emerged in Asia in 1997 has tended, if anything, only to heighten those worries[100].

[100] Charles P. Oman, Policy Competition for Foreign Direct Investment: A Study of Competition among Governments to Attract FDI, available at http://www1.oecd.org/daf/conference/oman.pdf. (May 24, 2002).

There are two types of competition among countries to attract FDI. These are rules-based forms of competition and the incentives-based forms of competition. Rules-based forms of competition are a broader and more heterogeneous group of government actions and include: changes in the rules on workers' rights; protection of the environment; signing of regional-integration treaties with neighboring countries; greater protection of intellectual property rights; strengthening the rule of law & improved judicial systems; the establishment of "export-processing zone's or special economic zones" with distinct legislation from the rest of the country; the privatization of state owned enterprises; market deregulation; and the liberalization of trade and investment policies.

Incentives-based forms of competition refer to fiscal and financial incentives. Common *fiscal incentives* include: a reduction in the base income tax rate a particular category of investors must pay; tax holidays; exemptions from import duties or duty drawbacks; accelerated depreciation allowances; investment and re-investment allowances; specific deductions from gross earnings for income-tax purposes; and deductions from social security contributions. The most important financial incentives are grants; subsidized loans and loan guarantees. These incentives are frequently targeted for specific purposes, such as grants for labour training, wage subsidies, donations of land and/or site facilities, rebates on the cost of electricity and water, and loan guarantees for international lines of credit. Other incentives include government provision or subsidization of "dedicated" infrastructure such as railroads, roads, industrial sites, sewage treatment facilities and the like built specifically for the investment project.

Another prominent form of incentive offered is profit repatriation. Companies enjoy unconditional transferability of net profits or dividends; payment in respect to loan servicing where a foreign loan has been obtained; royalties, fees, and charges related to a technology transfer agreement; the remittance of proceeds if a business is liquidated; and emoluments and other benefits paid to foreign personnel in Tanzania employed by the firm.

IMPACT OF INVESTMENT INCENTIVES ON THE INVESTMENT DECISION

Incentives such as tax holidays were found to have a negligible impact on investments designed to serve a country's local market[101]. However lowering the cost of the main factors of production was found to have an impact on investments for export. Investment incentives such as tax holidays or direct cash grants to investors were found to influence investment decisions by firms that plan to serve export markets. These same incentives, have however, little influence on the decisions of firm that plan to serve domestic markets.

In a major study financed by the Development Committee and overseen by IFC, Guisinger and Associates (1985) reached the conclusion that the relevance of incentices varies for different kinds of FDI[102]. This study also added an important dimension to the question: investors generally do not consider incentives as a determining factor in their investment if the incentives are more or less matched by competitor countries. Earlier, less sophisticated surveys had simply asked whether incentives had influenced an investment decision; in the context of similar incentives being available from many countries, most investors responded "no". Guisinger asked a different question, i.e. would it have made a difference if the country offered no incentives while competing countries did offer them, and a significant number of investors answered "yes". Finally, the Guisinger study was perhaps the first to state clearly and explicitly what all experience seems to support: that fiscal incentives (or more generally cost-reducing incentives) tend to be effective in two apparently different but basically similar situations: where the investment decision is among either:

- Similarly attractive platforms for producing for export to other markets, or

[101] Stephen E. Guisinger and Associates, *Investment Incentives and Performance Requirements*, 78 (New York, Praeger, 1985).
[102] *Id.*

- Similarly attractive parts of one large market (such as states within the United States, or Brazil, or countries within the European Union – then the Common Market)

In other words, where the investor is considering alternative locations that offer acceptable and roughly comparable conditions for producing for export to a market that is a lot larger than the political jurisdictions in question, he faces actual or potential competition from other investors who may choose any of the same locations, so reducing his costs is very important.

The effectiveness of incentives also differs depending on the kind of investor, the kind of incentive, the degree of competition for the investment, the quality of the place, and the response of other countries to the increasing or decreasing of incentives by their competitors. Fiscal or other cost-reducing incentives tend to be effective:

- for foot-loose, export-oriented investments,
- in countries or regions that are similar to neighboring countries or regions,
- in places where the other aspects of the business climate are also favorable, and
- where the incentives occur sooner in the project's life and with more certainty.

CONCLUSION

The problem of whether and how to use incentives is among the most important but least heralded of issues facing national and regional policymakers throughout the world.

Perhaps even more important, the ease with which incentives can be granted imposes still another cost: policymakers tend to ignore the more difficult reforms that will have a larger impact on foreign investment. These include relaxing constraints on investors (for example, closed industries, domestic content requirements, domestic ownership

requirements), reducing bureaucratic barriers, remedying deficiencies in infrastructure, and so on.

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CHAPTER II: TAX INCENTIVES FOR FDI

INTRODUCTION

"Tax exemption is like a dessert; it is good to have, but it does not help very much if the meal is not there".

Different countries have being taking various approaches to attract FDI due to the assumed roles of FDI in these countries. These roles include, but are not limited to, possibility for increased government revenue mainly through taxation[103], employment creation, improved balance of payment by increasing exports and/or reducing imports, technology transfer, improved managerial and entrepreneurial skills, increased competitiveness in the market, and linkage with the rest of the economy.

Among the approaches taken by countries to attract more FDI include a general improvement in the investment environments in these countries like improvement of infrastructure, liberalisation of the economy and granting of various incentives, among them tax incentives.

The ability to offer an internationally competitive tax system for foreign investors is increasingly seen as a determining factor shaping the investment climate, with corporate income tax identified as that part of the tax system that impact most directly on the

[103] Tax systems are used by the governments to achieve a variety of policy and political objectives. A review of tax systems across countries and over time shows a remarkable degree of diversity in approaches that have been taken in pursuit of these goals. Despite the diversity one can identify at a fundamental level three main roles or functions of tax system.
The most important role of a tax system is its revenue raising function. In addition to relying on the issuance of debt and creation of money, governments impose taxes to finance the cost of expenditures they undertake.
Second, tax systems have an important income distribution function. Individuals that are better off than others in terms of their ability to pay taxes measured by overall or comprehensive income, should pay proportionately more tax. For this reason, most countries provide an exemption for some initial threshold income amount and/or apply a progressive personal income tax rate schedule which taxes successively higher bands of income at higher marginal personal tax rates. This recognizes that a general perception that the tax system imposes a fair tax burden across taxpayers is essential to the effective operation of a voluntary compliance system of taxation.
Third tax systems play an import resources allocation function.

multinational corporations. Therefore much of the pressure for accommodating changes to lower host country tax burdens in order to attract capital is focused upon this tax. The policy makers strive to ensure that their tax systems are internationally competitive and that impediments to FDI are removed. Corporate income tax is at the center of this debate with much attention given to ensure that the burden it imposes is not excessive.

HOW FDI AFFECTS CORPORATE TAX REVENUE

FDI affects corporate tax revenue mostly through transfer pricing. To take for instance, a multinational in a high-tax country producing a good with inputs from a branch in a low-tax country. For interfirm trade, the multinational has an incentive to overstate the price of inputs, because this increases the profits in the low-tax country and reduces the profits in the high-tax country, thus minimizing worldwide tax liabilities. Even though OECD[104] countries have adopted transfer-pricing[105] rules, which aim at making firms charge arm's-length prices for intrafirm trade (that is, prices at which a willing buyer and a willing, *unrelated* seller would freely agree to transact), transfer pricing is part of corporate reality.

WHY TAX INCENTIVES ARE USED TO ATTRACT FDI

The corporate income tax system may be used as a policy instrument to influence economic behaviour including foreign direct investment. A variety of arguments have been advanced for using tax incentives to attract FDI under the following headings:-

a) International competitiveness

   Tax incentives designed to encourage FDI including general host country tax relief measures and those targeted at investment in R& D and those tied to exports

[104] Organization for Economic Cooperation and Development.

[105] Transfer pricing the practice of either under-invoicing or over-invoicing transaction taking place between a parent company and its subsidiaries. The aim of under-invoicing is to lower the costs of the subsidiary so that its prices are reduced and it can eliminate its competitors from the market (disguised predatory pricing). The aim of over-invoicing is to increase costs artificially, in order to reduce profits and avoid taxation, or circumvent profit repatriation rules in the host country.

are often recommended as a means to enhance the "international competitiveness" of a country, by improving its ability to attract internationally mobile capital. This view assumes that MNCs take tax incentives into account when making locational decisions and that tax incentives operate at the margin to swing investment decision in favour of the host country.

Success in attracting foreign capital is believed to improve a country's economic performance by generating increased employment, increased incomes and ultimately higher tax revenues, creating a strong industrial and economic base, improved infrastructure and increased living standards. At the same time, inflows of foreign capital are often believed to improve a host country's productivity o its cost competitiveness for example through indigenous R&D leading to lower unit production costs, enabling a higher share of world production in one or more industry sectors, or access to production or process technologies used elsewhere by parent companies. The developments themselves would be expected in turn to attract additional investment.

Tax incentives may be viewed as necessary where similar relief is being offered by a neighboring jurisdiction also competing for foreign capital. This raises question of the appropriate form and scale of tax incentive relief as well as a range of other design issues.

b) "Market failure" considerations

Tax incentives targeted at FDI may be argued for in instances of "market failure" --that is in instances where the operation of private markets is believed to fail in yielding a socially optimal level of investment. In theory, an efficiently low level of FDI may arise where there are spillover effects that are not incorporated into private investment decisions. A classic example of positive spillovers is R&D. Firms undertaking R&D generally ignore the positive spillover benefits that accrue to others when they decide upon the amount of R&D to undertake, which may result in an inefficiently low level of investment from society's perspective.

Tax incentives targeted at research activities or at the development and implementation of new production processes and products, may be introduced to encourage firms to increase their investments in these areas.

Foreign investors generally would not be expected to take into account the beneficial effect on host countries generated by FDI. Such benefits could include providing skills and training to employees that could be applied elsewhere in the economy, or generating market demand by labour and other factors of production that might not otherwise exists. While tax incentives hold out the possibility of stimulating FDI and thereby granting spillover benefits including knowledge transfer, new employment opportunities and demand for local products, a key issue is whether tax incentives can do so in an efficient manner taking into account possible market or policy related impediments to FDI.

Where tax incentives are introduced for this reason, or more generally to correct for general market failure, there is in general no reason to target the incentive solely towards FDI.

c) Regional development and income distribution

Tax incentives may be targeted at investment in regions where employment is a serious problem, for example on account of remoteness from major urban centers, tending to deprive up factor costs, or labour immobility or wages rigidities that prevent the labour market from clearing. Operating from a remote area may mean significantly higher transportation costs in accessing production materials and in delivering end products to markets, placing that location at competitive disadvantage relative to the other possible sites. Certain areas may also suffer from a lack of natural resources tending to pout them at a further cost disadvantage. Moreover, firms may find it difficult to encourage skilled labour to relocate and work in remote areas that do not offer the services and convenience

available in other centers. Workers may demand higher wages to compensate for this, which again implies higher costs for prospective investors.

Tax incentives may be provided in such cases to compensate investors for these additional business costs. Where the incentives are successful in attracting new investment and/or forestalling the outmigration of foreign capital they may contribute to an improved income distribution in the country. There may also exist a policy desire to address regional income distribution concerns through subsidizing employment through investment initiatives, rather than through direct income supplement programs.

d) Macroeconomic consideration

Tax incentives have also been advocated as tools to address, at least in part, a range of macro-economic problems, including concerns over cyclical (or structural) unemployment, balance of payments deficits and the effects of high inflation on tax liabilities. Such incentives would not be specifically targeted at FDI, but to investment generally regardless of the residency of the investor.

Where tax incentives are used to provide counter-cyclical stimulation (by encouraging investment and thus aggregate demand in the economy) they are often introduced as temporary measures. Temporary incentives offer the prospect of generating increased investment in short term relative to permanent incentives to the extent that investors shift investment plans forward in order to benefit from the tax relief. Where such measures are used, they are typically announced and then immediately introduced so as to not stall current investment plans. The use of temporary measures raises a number of difficult timing issues.

Businesses can start enjoying tax holidays at different times of investments' life. It can be when the production starts; the first year of profit; first year of firms' positive cumulative profit on its operations. For large projects with huge start-up costs, tax holidays, which start, when production occurs may actually increase the tax paid over the life of the project. This therefore, becomes a disincentive to invest. If losses are experienced in the holiday period they may not be allowed to be carried forward out of the holiday period. Therefore, tax holidays may occur when no taxes would have been paid in any event and taxes may be increased following the holiday because no losses are available to offset the profits.

Tax holidays are sometimes viewed erroneously as a simple incentive with a relatively low compliance burden. This perception tends to make this form of incentive attractive, particularly to countries that are just establishing corporate tax system. However, the simplification benefits can be greatly overstated and may not exist at all. Provisions will be required to impose certain tax related obligations. For long term investment projects, investors will typically be required to keep records of capital expenditures and other items before and during the holiday period to be able to comply with the tax system following the holiday. Moreover the rules needed to target the incentive and ensure that income that should not taxable is not artificially transferred to qualifying firms, can be complex to administer and to comply with and may impose burdens on firms that do not qualify for the holiday itself.

A tax holiday may be targeted at new firms in a specific region and/or industry sector. Sectoral targeting of tax holidays (as with other incentives) may address a perceived knowledge gap in the host country and draw in skills and knowledge transfer to domestic workers in key areas. Targeting by sectors or activity raises problems of how to treat firms already engaged in a targeted sector/activity and in other sector/activity that do not qualify. On option is to deny the holiday in such cases. Another option is to grant the holiday provided that a higher percentage of the assets of the company are employed in targeted area and to restrict holiday benefits to income from the targeted sector/activity. Regional targeting may

support regional development and income distribution policy goals. However it should be noted here that in practice, tax incentives that seek to combine regional development goals with attracting FDI often yield poor results as the tax relief is insufficient to counteract negative regional factors (e.g. remote location with high transportation costs, limited infrastructure, limited labour pools). Investor groups may also be targeted as in the case of incentives targeted exclusively at foreign investors. In the context of FDI, it is often held out that targeting foreign investors can provide access to external capital, skills, contacts.

Tax holidays are most attractive firms in sectors where profits are generated in early years of operations[107]. However these tend to be activities that would likely have occurred in any event and so incentives provide a windfall gain to investors and a pure revenue loss with little or no additional investment and employment to the host country. Moreover, where a tax holiday is necessary to attract mobile activities, there exists the threat that business will exist following the holiday. Tax holidays are generally least attractive to firms in sectors requiring long term capital commitments, where loss-carry over provision may be more beneficial. From the host country perspective, tax holidays tend to be particularly problematic in terms of revenue loss where significant business already exists in targeted activities, given the incentive to create "new" business from existing ones, or to transfer inflated profits into qualifying firms, using a variety of tax planning techniques.

The main benefit of tax holidays is that they provide large benefits as soon as the company begins earning income, and are thus more valuable than an incentive, such as a lower corporate tax rate, that accrues more slowly over a longer period of time. However, they primarily benefit short-term investments, which often are undertaken in so-called footloose industries characterized by companies that can quickly disappear from one jurisdiction to reappear in another. Tax holidays also

[107] These include the trade sector, and short-term construction or service sector in real estate; restaurants; hotels and short-term market exploitation firms. Major capital intensive projects are not likely to benefit from this incentive, as they do not normally make profits in the early years of operation.

tend to reward the founding of a company, rather than investment in existing companies, and to discriminate against investments that rely on long- lived depreciable capital. Last but not least, they can lead to a large erosion of the tax base as taxpayers learn how to escape taxation of income from other sources.

Tax holidays place significant burdens on tax administration and on other taxpayers, who have to make up the lost revenue. Tax holidays are usually granted on a project basis, rather than on a firm or business-group basis. Therefore, some parts of a business- either particular product lines or those parts located in different regions-can be subject to tax holidays while other parts bear normal income taxes.

Among the problems that this incentive present is that it can be used to shelter income (from existing domestic operations) from taxation through transfer pricing and the transfer of operations from existing firms to new ones that qualify for the holidays.

STATUTORY CORPORATE TAX RATE REDUCTION

A common form of tax incentive to encourage FDI, sued by developing and developed countries alike, is a reduced (statutory) corporate income tax rate on qualifying income. The rate reduction may be broad based, applicable to all domestic and foreign source income, or it may be targeted at income from specific activities, or from specific sources (e.g. foreign source income) or at income earned by non-resident investors alone or some combination of these.

As with a tax holiday, difficult definitional, administrative[108] and compliance issues arise where the low rate is targeted at income from a subset of activities or

[108] Tax holidays also increase administrative problems because tax authorities usually do not monitor company books during the period in which a firm is exempt from taxes. As a result, asset purchases, depreciation charges, and other accounts can be manipulated during the holiday period to reduce reported income, and thus taxes, after the end of the holiday.

investors. If the reduced rate applies only to profits from a targeted activity, then careful legislative drafting, regulation and administration are generally required to clarify eligibility and limit tax avoidance and revenue leakage. The rate reduction may be introduced as either a temporary or permanent measure and generally is more attractive to foreign investors the longer the period that they can expect to benefit from it. From the point of view of effectiveness, the major problem with a rate reduction is that it generally also applies to income generated by investments made before the introduction of the inventive. Such revenue loss has no direct investment incentive effect.

SPECIAL INVESTMENT ALLOWANCES

Another channel through which FDI incentives may be offered is via special tax provisions that lower the effective price of acquiring capital. Two main sorts of incentives can be distinguished in this category:

a) Investment allowances which are special enhanced deductions against taxable income; and
b) Investment tax credits which are special deductions against corporate income tax otherwise payable.

Both investment allowances and investment tax credits are earned as a fixed percentage of qualifying investment expenditures. However, because the first is deducted against the tax base, its value to the investing firm depends, among other things, on the value of corporate income tax rate applicable to the tax base-the higher (lower) is the tax rate, the higher (lower) is the amount of tax relief on a given amount of investment allowance claimed. In contrast, variations in the corporate tax rate do not affect the value of investment tax credits.

Under an investment allowance, firms are provided with faster or more generous write-offs for qualifying capital costs. Two types of investment allowances can be distinguished. With *accelerated depreciation* firms are allowed to write off capital

costs over a shorter period than dictated by the capital's useful economic life, which generally corresponds to the accounting basis for depreciating capital costs. While this treatment does not alter the total amount of capital costs to be depreciated it increases the present value of the claims by shifting them forward, closer to the time of investment. The present value of claims is obviously the greatest where the full cost of the capital asset can be deducted in the year the expenditure is made. With an *enhanced deduction* firms are allowed to claim total deduction for the cost of qualifying capital that exceed the (market) price at which it is acquired. Depending on the rate at which these (enhanced) costs can be depreciated, this carries the risk that it may generate a stream of tax deductions that exceed in present value the corresponding acquisition costs.

This type of tax incentive presents some problems. It is difficulty to define the eligible expenditures and to choose the rate of allowance or credit. It is also a problem to set a restriction on their use. This is of little benefits for the quick profit types of firms, which can take best advantage on tax holidays. Tax allowances are of greatest benefit for firms within income from existing operations. Firms with low income or start-up firms cannot begin to take advantage of the incentive until income is earned. Investment allowance is usually made in the year of acquisition or the first year of use of an asset. It does not reduce the basis for write-off in later years. It is common in connection with different kinds of capital expenditure, particularly in respect to industrial undertakings. It reduces the taxable income.

Investment tax allowances have other limitations and drawbacks also. If the investment tax allowance is not refundable, existing companies reap the full benefits (that is, supporting expansion), while start-up companies must first earn enough income to be able to take the allowance. Also, projects with long gestation periods suffer in comparison with those that begin earning income quickly. When inflation is high, the allowance aggravates the tax system's uneven impact on the investment behavior of companies. Companies in high-inflation countries will benefit more if they borrow to finance capital, because tax deductions for capital

expenditures are more valuable. This is the reverse of tax holidays and of lower corporate tax rates, which reduce the advantages of interest cost deductions for tax purposes during high inflation.

INVESTMENT TAX CREDITS

Another main tax incentive instrument is the investment tax credit earned as some percentage of qualifying expenditures. Tax credits provide an offset against taxes otherwise payable, rather than a deduction against the tax base (thereby removing the dependency of the value of a tax credit claim on the income tax rate).

Investment tax credits may be flat or incremental. A *flat investment tax credit* is earned as a fixed percentage of investment expenditures incurred in a year on qualifying (targeted) capital. In contrast, an *incremental investment tax credit* is earned as a fixed percentage of qualifying investment expenditures in a year in excess of some base, which is typically a moving average base (for example, the average investment expenditure by the taxpayer over the previous three years).

The main argument for using these investment subsidies, as opposed to a reduced corporate income tax rate, is that subsidies to the cost of purchasing capital benefits only new investment- therefore, a large reduction in the effective tax rate on investment can be achieved at a lower revenue cost.

Furthermore, investment tax credits should have the most stimulating impact when targeted at short-lived assets, rather than long lived assets of the same productivity. This follows from the fact that the present value of the stream of tax payments on revenues from a short-lived assets is smaller than in the case of a longer-lived asset. Therefore, an investment tax credit at a flat, fixed rate offsets a larger percentage of the tax revenues imposed on the stream of earnings from a short lived asset. Viewed differently, short-lived assets are replaced more frequently than long-lived assets, so the credit is earned more frequently.

TAX SPARING AND FDI

"Tax sparing" is the practice of adjusting home country taxation of foreign investment income to receive the full benefits of host country tax reductions[109]. For example, Japanese firms investing in countries with whom Japan has "tax sparing" agreements are entitled to claim foreign tax credits for income taxes that they would have paid to foreign governments in the absence of tax holidays and other special abatements. Tax sparing is a practice designed to promote the effectiveness of local tax incentives for foreign investment.

Tax sparing is the practice by which capital exporting countries amend their taxation of foreign source income to allow firms to retain the advantages of tax reductions provided by host countries. Specifically, "tax sparing" often takes the form of allowing firms to claim foreign tax credits against home country tax liabilities for taxes that would have been to foreign governments, in the absence of special abatements, on income from investment in certain developing countries.

"Tax sparing" agreements encourage FDI if foreign investors receive special tax abatements from host governments that would otherwise be offset by home country taxes. For some reasons, host governments are considerably more likely to give special tax abatement to foreign investors if their home governments grant "tax sparing". In turn, tax abatements reduce the value of attracting additional FDI, and thereby make host governments somewhat les willing to provide non-tax inducements for FDI[110].

Tax sparing encourages FDI in two ways: by reducing home country taxation of foreign source income and by encouraging host governments to offer special tax abatements to foreign investors[111].

[109] James R. Hines, Jr., "Tax sparing and Direct Investment in developing countries", http://www.nber.org/papers/w6728 (May 25, 2002).
[110] *Id*
[111] *Ibid*

IMPACT OF TAX INCENTIVES ON FDI

By the mid-1980s, understanding the exact role of incentives in attracting FDI became a new research agenda. One direction has been to explore the reaction of multinational companies to changes in tax policy when they differ in their activities, motivations, market structure, and/or financing. Others have searched to examine which tax instruments may have the greater effect on the behavior of international investors. While most early studies examine the impact of taxes on the average foreign investor, there are many reasons to believe that this impact differs greatly depending on the characteristics of the multinational company. International investors often have at their disposal numerous alternative methods of structuring and financing their investments, arranging their transactions between related parties located in different countries, and returning profits to investors. These alternatives have important tax implications, and there is considerable anecdotal evidence that tax considerations strongly influence the choices that firms make[112].

One of the earlier findings in the literature is that the impact of tax rates on investment decisions is generally higher on export- oriented companies than on those seeking the domestic market or location-specific advantages[113]. Moreover, Taxes may play a more important role in the cost structure of small companies because they do not have the financial and human capacity to develop sophisticated tax avoidance strategies.

When factors such as political and economic stability, infrastructure, and transport costs are more or less equal between potential locations, taxes may exert a significant impact. This is evidenced by the growing tax competition in regional groupings (such as the

[112] Tax incentives might be ineffective as a determinant of location of investment in cases where the home country policies offset the tax savings created by the incentive. As a practical matter, such offsets result when the home country taxes income of its investors on a worldwide basis and rejects "tax sparing" provisions in treaties to avoid double taxation.
[113] Stephen E. Guisinger and Associates, *Investment Incentives and Performance Requirements*, 85 (New York, Praeger, 1985).

European Union) or at the subregional level within one country (such as in the United States). This impact, however, has to be qualified on two important counts.

First, the impact of tax policy may significantly depend on the tax instruments used by the authorities. For example, tax holidays and a general reduction in the statutory tax rate may have an equivalent impact on the effective tax rate but significantly different effects on FDI flows and a government's revenues. Second, the effectiveness of tax policy and incentives is also likely to vary depending on the multinational firm's activity and on its motivations for investing abroad. For example, tax incentives seem to be a crucial factor for mobile firms or firms that operate in multiple markets because they can better exploit the different tax regimes across countries.

Lastly, corporate tax policies pursued by one country can affect other countries in different ways. If a country's domestic tax burden is high relative to other countries, the tax base may shift to countries with a less burdensome tax regime, implying outward flows of FDI. Countries can compete to attract inward investment flows as well. Taxes may also play a major role in firms' decisions about where to declare profits.

ISSUES INVOLVED

Tax Incentives are mostly in the form of reduction of corporation income tax and other fiscal advantages. The question is, whether such a behaviour does not meet characteristics of harmful tax competition as defined in OECD (1998)[114] and whether the result is not only reduction of tax revenues without significant increase of investments.

OECD uses the term harmful tax competition to describe tax heavens and preferential tax regimes designed primarily for tax avoidance of non-residents, without real economic activities. It defines the harmful tax competition by following characteristics:

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[114] OECD, 1998, Harmful Tax Competition: An Emerging Global Issue

- the effective tax rate is zero or much lower then ordinary
- there is no effective exchange of information between the tax heaven and tax authorities of other countries
- the regime is not transparent and does not require any economic activity from the non-resident

From the analysis of the above given criteria it can be concluded that mere reduction of tax burden is not considered to be a harmful tax competition. A significant feature is lack of co-operation and no obligation to carry out a real business operation in the tax heaven.

Another fact that follows is that though tax incentive cannot be the only determining factor in the absence of other factors such as availability of natural resources, economic and political stability, transparent legal environment, efficient public administration, infrastructure and cost-efficient and skilled labour force, they nevertheless can be effective in investment decisions.

Tax incentives are often limited to certain sectors and/or regions, or if not strictly limited they are stronger for certain sectors and regions. Moreover, the issue of tax competition between countries and across regions is also widely debated in view of the growing importance of this phenomenon worldwide. Finally, several highly publicized recent deals reveal that a few multinational companies have received large, perhaps disproportionate, tax rebates, which suggests that the costs-not only the benefits-of tax incentives need to be examined more closely.

CONCLUSION

The corporate tax system plays an important withholding function, collecting tax revenues on income derived in the host country. The desire to tax this income, while not discouraging foreign investors, raises difficult questions concerning the appropriate design of various tax rules including tax incentive provisions that together determine the host country tax burden.

Given the fact that tax incentives are costs to the government due to the lost revenue, one could suggest that all tax incentives be abolished. In essence the main aim of taxation as a fiscal policy instrument is to collect revenue for the government. Taxation's main goal is not to attract FDI, although a policy instrument may have multiple purposes. But due to some factors like pressure from MNEs and tax competition with other countries competing for FDI, granting of tax incentives becomes inevitable.

Since at the time of initial locational choice, investors will be influenced *prima facie* by data that is easily available and comparable, it is necessary that a host country corporate tax rate structure needs to be looked at. Sector specific demands for tax holidays have already been made by some foreign investors. Such instances can only multiply in future. Instead of making any *ad hoc* decisions, its desirable to develop a broad based policy relating to corporate taxation for foreign investment.

CHAPTER III: COMPETITION AMONG ECONOMIES TO ATTRACT FDI

INTRODUCTION

As barriers to international investment have fallen over the last two decades, the significance of competition for FDI has increased. Competition among governments to attract corporate investment appears to have heated up in recent years.

One reason this competition appears to have heated up is the large number of developing and emerging market economies - comprising three-quarters of humanity - that have moved during the 1980s and 1990s from relatively closed state-led growth strategies to more open and market-friendly policy regimes, and have moved in the process to actively seek to attract foreign direct investment.

The impact of these policy changes and enhanced attention to the importance of promoting corporate investment, in terms of fomenting inter-governmental competition to attract FDI, has in turn been amplified by "globalization[115]" - also a phenomenon of the 1980s and 1990s - which has increased the pressures of competition felt by governments, as well as by firms and workers. Particularly important, in this regard, is the extent to which globalization has increased the *mobility* of capital, making it easier for a prospective investor to play potential host governments off against one another in their bids to attract, or perhaps retain, a major investment project[116].

The apparent intensification of competition among governments worldwide to attract corporate investment is thus often blamed, rightly or wrongly, on the growing openness of developing and emerging economies and, in particular, their growing efforts to attract

[115] Global integration of the world economy.
[116] C. Oman. *The Policy Challenges of Globalisation and Regionalisation*, Policy Brief No. 11, OECD Development Centre, Paris. 1996.

FDI by OECD-based investors. However, the effects of such competition on the economies of the developing and emerging economies are poorly understood.

To the extent that foreign direct investment projects generate positive externalities for the host countries, related to activities such as innovation or labor training, there is a case for countries to offer subsidies in order to lure potential investors to locate within their boundaries. However, the increase in the intensity of competition observed in recent years has raised concerns regarding its effects on the welfare of host countries[117]. In particular, as a result of competition, foreign firms may be able to appropriate all the benefits associated to FDI. This raises a number of important questions: What are the effects of competition for FDI on the welfare of the world as a whole? Are host countries better off by banning incentives for FDI? Should these countries restrict competition in any way?

Apart from globalization, there are several other reasons why the intensity of competition for FDI may have increased in recent years. One of them is the spectacular increase in the volume of FDI itself. This increase means that the stakes in the quest to attract FDI are now much higher. Another reason for the intensification of the competition is the increased number of players in this "game". Countries that used to discourage FDI, such as China, have become major players.

The relevant space of competition for FDI is defined not only by the willingness of potential host countries to engage in competition, but also by the nature of the goods produced, and the existence of natural and policy-induced barriers to trade. The more tradable the goods, and the lower the barriers to trade, the greater the scope for competition. The reduction in trade barriers experienced in most of the world has increased the space of competition. Similarly, the appearance of new activities such as e-business, which can provide similar services to the entire world from any location, may potentially increase the intensity of competition as well.

[11] Fernández-Arias. Courting FDI: Is Competition Bad?, http://www.udesa.edu.ar/lames2001/papers/courting.pdf. (June 3, 2002).

Competing by offering subsidies is not the only way for countries to court potential investors. There are other also other forms of competition. Countries could compete by improving their institutions, the quality of their labor force or the quality of their infrastructure. This competition would obviously have a positive effect. But, the countries could also compete by relaxing labor or environmental standards, which could have obvious adverse effects on the welfare of the population. Such competition raises policy makers' concern that intensifying global competition among governments to attract FDI may have undesirable effects. The main concern is that global "bidding wars" to attract FDI may be producing an uncontrolled upward spiral in costly "investment incentives" that weaken public finances while introducing market distortions in the allocation of real investment, and/or that such "wars" are putting excessive downward pressure on global standards of protection of the environment and/or of workers' rights.

The actual degree of global competition to attract FDI is not known, moreover, and while there is considerable evidence that such competition is widespread, involving sub-national as well as national governments both in OECD countries and in developing and emerging economies, it is difficult to predict whether that competition will intensify in the coming years.

POTENTIALS OF COMPETITION FOR FDI

As in any other debate there are two sides to the effects of competition among countries for attracting FDI. Those arguing that competition has beneficial effects on the host countries base their arguments primarily on the "fundamentals" (political and macroeconomic stability, market access and long-term growth potential, the availability of appropriately skilled workers and of necessary infrastructure) and attach more

importance to it compared to than they do to fiscal or financial incentives offered by the prospective host government[118].

The reasoning is that, because governments know, or should know, the high priority investors attach to the "fundamentals" relative to fiscal and financial incentives, an intensification of competition among governments to attract investment can be expected to induce governments to focus on improving the "fundamentals". Governments responding to intensifying competition will thus seek to improve domestic supplies of human capital and infrastructure, in particular, as well as to ensure political and macroeconomic stability. The effect of intensifying inter-governmental competition may then lead governments to take actions that will strengthen their economies, to the benefit of their own firms and workers - even if, ultimately, those actions do not actually attract much additional FDI (if for example, other countries are also doing likewise).

The important point is that more intense competition among governments to attract FDI can be expected, according to this argument, to lead governments to increase their optimal level of investment either directly or indirectly (or both) to a degree they would not have done in the absence of such competition. Such competition may also give governments more incentive to increase the *efficacy* of whatever investment goes into human capital formation and infrastructure.

Moreover, it is noted, FDI as a whole can have important "public good" characteristics in the sense that it can produce important benefits in the host economy which are not captured by the investor - the so-called "spillover effects". These benefits range from local learning effects (derived, for example, from domestic firms' imitation of foreign investors' practices, from labour and managerial mobility between foreign-owned and domestic firms, and/or from supplier relationships) to enhanced competition in the local

[118] D. Weigel, N. Gregory and D. Wagle, *Foreign Direct Investment: The Lessons of History*, Foreign Investment Advisory Service (FIAS) and the International Finance Corporation (IFC) of the World Bank Group, Washington.D.C., 1997; and G. Reuber, *et al.*, *Private Foreign Investment in Development*, Clarendon Press for the OECD Development Centre, Oxford, 1973.

market - competition that pressures local firms to modernize, improve product quality, seek-out new technologies, become more efficient, reduce prices, etc.

Thus, in addition to inducing governments individually and collectively to pursue actions that enhance their economies' growth and productivity levels even in the absence of additional FDI, according to this argument, those actions are likely to induce an increase in the global supply of investment and FDI - independently of the extent to which investment is diverted from one country to another by those actions. And because FDI can produce significant spillover benefits for the host economy, this increase in global FDI brings up the level of global FDI from a sub-optimal level to one that is closer to socially optimal.

Thus, according to this argument, intensifying competition among governments to attract FDI should prove beneficial, on balance, both to investors and to governments, and to society as a whole[119].

ARGUED HARMFUL EFFECTS OF COMPETITION

While the *potential* for FDI competition among governments can have positive effects, it is equally plausible that, in practice, these potentials get offset due to the dynamics of competition. The problem, according to this argument, is that as the competition heats up, governments come under increasing pressure to engage in costly "bidding wars" that leads them continually to increase the level of public subsidies offered to investors -fiscal and financial "incentives" - until that level far surpasses any that could possibly be justifiable from society's perspective (even taking account of the possible spillover-benefits to be derived from additional global FDI)[120].

[119] Charles P. Oman, *Policy Competition for Foreign Direct Investment: A Study of Competition among Governments to Attract FDI*, OECD Development Center
[120] *Id.*

While governments have a collective interest in refraining from such bidding wars, individual governments engage in the bidding process because of the danger that if they refrain from doing so, FDI will be diverted from the economy under their jurisdiction to that of one that offers investors more incentives (The "prisoners" dilemma).

Even though investors overwhelmingly attach more importance to the "fundamentals" than to "incentives" when selecting the site for a major long-term investment project, they also tend, in practice, to draw up a short list of preferred sites, any one of which would be acceptable in terms of the criteria the investor judges most important. Then, because these sites are commonly located in the jurisdiction of different governments (sub-national and/or national governments) it is common practice for investors to negotiate conditions and possible incentives with each government[121]. Investors may do so openly, to foment competition among the governments, or else "ask for their best offers", before making their final site selection.

As competition among governments heats up, the negative effects can be expected to extend beyond the pressures to engage in bidding wars on fiscal and financial incentives. They can notably be expected to create strong downward pressures on effective public standards of protection (*de facto* and/or *de jure*) of the environment and of workers' rights. The concern over the environment is that governments will increase their willingness, to one degree or another, to become "pollution havens" in order to attract certain types of investment, notably in heavy industry. The concern over workers' rights is that whether or not governments actually change their labour legislation, they will become more lax about enforcing workers' rights to organise and bargain collectively, enforcing minimum job safety standards, etc.

These downward pressures on labour and environmental standards, it is argued, can even lead to a process of "regulatory arbitrage" as investors play governments off against one another in terms of local production costs. Such pressure - or governments' fear, or anticipation, of such pressure - can trigger a process of competitive downgrading of

[121] *Ibid.*

standards. Such a process predictably would be neither constrained nor guided, moreover, by any government's concept of socially optimal levels of standards, anywhere.

RULE BASED AND INCENTIVE BASED COMPETITION

Rules-based forms of competition are a broader and more heterogeneous group of government actions, ranging from changes in the rules on workers' rights or protection of the environment - or in the level of enforcement of existing rules - to the signing of regional-integration treaties with neighbouring countries, for example, as a means to attract FDI. Other important rules-based means which governments use to attract FDI include greater protection of intellectual property rights, strengthening the rule of law and improved judicial systems, the establishment of "export-processing zones" or "special economic zones" with distinct legislation from the rest of the country, the privatization of state-owned enterprises, market deregulation, and, of course, the liberalization of trade and investment policies.

Incentives-based competition for FDI is a global phenomenon: governments at all levels (national and sub-national) engage in it worldwide.

Most incentives-based competition is effectively intra-regional, since much of the real investment for which national and sub-national governments compete is investment the investor intends in principle to locate in a particular region.

Incentives-based forms refer to fiscal and financial incentives. Common *fiscal* incentives include a reduction in the base income tax rate a particular category or categories of investors must pay (e.g., foreign investors, investors in certain types of activity); tax holidays (on income tax, on national or local sales taxes, on other taxes collected by national or sub-national governments); exemptions from import duties or duty drawbacks, accelerated depreciation allowances; investment and re-investment

allowances; specific deductions from gross earnings for income-tax purposes; and deductions from social security contributions.

The most important *financial* incentives are grants; also widely used are subsidized loans and loan guarantees. These incentives are frequently targeted, at least nominally, for specific purposes, such as grants for labour training, wage subsidies, donations of land and/or site facilities, rebates on the cost of electricity and water, and loan guarantees for international lines of credit[122].

Both fiscal and financial incentives may be granted automatically (subject to qualifying conditions) or with up to a high degree of discretion by the administrative authority. (Discretion is often seen as a necessary condition for successful negotiation with investors, to ensure efficient targeting of incentives, and to allow for quick responses to competition. It also reduces transparency, of course, and increases the scope for abuse and corruption.) That authority may be at the level of local or municipal government, regional or state government (in a federal system), national government, or even at the supra-national level in the case of the European Union (whose Commission regulates the use of the "regional aids" which national and sub-national EU governments use to attract investors).

Among *fiscal* incentives, the most widely used is a reduction in the base rate of corporate income tax. In OECD countries, the next most widely used, in descending order, are accelerated depreciation, specific deductions for corporate income-tax purposes, and reductions in other taxes (including state and local). In developing countries the next most widely used, after reduced base income-tax rates, are tax holidays, and import-duty exemptions and drawbacks. *Financial* incentives are widely used in OECD countries by sub-national governments and targeted to promote investment in specific regions and/or types of activity (and job creation or retention).

[122] Governments can also seek to enhance their attractiveness to FDI through policies (including public investments) aimed at promoting the development of domestic infrastructure and other local "factors of production" (e.g. human skills) which may not be "dedicated" to a particular FDI project.

Those opposing competition among countries for FDI see both incentives-based and rules-based forms of competition for FDI as having negative effects whose incidence is likely to be both economic and political. This viewpoint holds that the economic cost of incentive bidding wars can be very high, not only in terms of the value of resources drained from the public treasury, but also in terms of the damage that can be done by market distortions and resource misallocation. The cost to the broader policy-making process within governments is also seen as likely to be high, not least because of the widespread *need* for lack of transparency in the use of incentives, and the consequent difficulty to control abuse and corruption that can be associated therewith. These effects are seen, moreover, as likely to be cumulative, self-reinforcing, and mutually reinforcing over time, with growing damage caused both to the body politic and to the economy.

The supporters of the competition, on the other hand, see both incentives-based and rules-based forms of competition as having positive effects. While they see incentives-based competition bringing investment in both human-capital formation and infrastructure closer to socially optimal levels, for the mutual benefit of investors and economies, they also consider it likely to increase the global supply of investment, again with significant net benefits for society as a whole. These include the considerable pressures on governments to create a more secure legal environment; to enhance the stability, transparency and credibility of economic policies in general, and perhaps (therefore) to help strengthen political stability, as well as to improve the quality of macroeconomic policies; and to protect intellectual property rights more effectively, which arguably promotes the inflow of advanced technologies and know-how. The intensification of competition among governments to attract FDI, and real investment as a whole, is thus seen by its supporters as stimulating governments into behaving - or behaving more - in ways that favour the growth of investment, efficiency and productivity levels, and thus real income, in individual countries and globally. Investors and the economies of governments that compete for their investment are seen as benefiting substantially.

IMPACT OF POLICY COMPETITION

Although competition among governments is indeed widespread, and can be very intense in particular industries or for particular investment projects, overall the competition for real long-term corporate investment has both positive and negative effects, and it is important not to overstate its net effects in either direction. While the inherent difficulty to obtain reliable data particularly on the subsidies that investors actually receive makes any conclusion tentative (neither the governments that provide them nor the investors that receive them readily supply such information), the most damaging overall effects appear to stem less from the direct financial cost to governments of investment subsidies paid out, or from any lowering of environmental or labour standards, than from the lack of policy transparency and government accountability that the process of competition for FDI tends to engender. This lack of policy transparency and accountability creates significant possibilities for graft and corruption, and for rent-seeking behaviour more broadly, which can in turn be highly detrimental to the processes of developing competitive markets and sound policy-making - processes which are fundamental to development itself.

Intensifying global competition among governments to attract FDI could also, however, produce beneficial effects. These effects may include inducing governments to strengthen their economies' "fundamentals" (e.g., by pursuing policies to enhance the supply of modern infrastructure and appropriately trained workers, by achieving greater macroeconomic and political stability, by improving long-term economic growth perspectives), which should in turn promote economic development almost independently of their impact on FDI flows *per se*. Another effect may be to increase the global supply of FDI, to the benefit of investors and host economies alike.

Competition among governments to attract corporate investment can, and in a growing number of cases does, create *upward* pressure on environmental standards[123]. An

[123] Charles P. Oman, *Policy Competition for Foreign Direct Investment: A Study of Competition among Governments to Attract FDI*, OECD Development Center

important reason is the growing prevalence of relatively "clean" knowledge-intensive industries and services among those activities in which governments most actively seek to attract investment, combined with the growing desire of corporations investing in these activities to locate in communities where their managers and employees and their productivity levels, will benefit from high standards of environmental protection.

Another question that arises in this context is whether competition among governments to attract FDI is leading them to weaken their protection of workers' rights and their enforcement of labour standards. Are they lowering those standards, on a *de jure* or a *de facto* basis, thereby putting pressure on other governments to follow suit? Many OECD countries have tried to confront the issue by actively taking the position that a set of internationally recognisable "core" labour standards should be included in WTO discussions. (Core labour standards are defined as the right of workers to associate, i.e. to form independent unions of their choice, and to bargain collectively, including the right to strike; the prohibition of forced labour and of exploitative child labour; and non-discrimination in employment[124].) These governments argue (i) that core labour standards reflect basic human rights which should be observed in all countries, irrespective of a country's level of development; (ii) that observance of these rights can stimulate economic development, and is thus in the interest of all workers (and countries) world-wide; and (iii) that global observance of these rights would help to neutralise protectionist pressures, notably in high-wage countries, and thus strengthen political support for the open multilateral trading system. These governments further emphasize that multilateral discussions of core labour standards should not focus on specific rules on working conditions (e.g. minimum-wage levels), and would not be prejudicial to any country's pursuit of trade based on a comparative advantage in low-wage industries. Several major developing countries strongly oppose the proposal, however, on the grounds that it risks serving as a guise for trade protection directed especially against the labour-intensive products in which developing countries are most likely to be competitive.

[124] OECD, *Trade, Employment and Labour Standards*, OECD, Paris, 1996.

The question of the effects of the worldwide policy competition to attract corporate investment is quite critical. In addressing this question one can usefully distinguish two broad categories of effects: (i) those on investment per se, both as regards investors' location decisions and as regards the aggregate supply of investment; (ii) those on government behaviour and policy making[125].

EFFECT ON INVESTMENT DECISION

Only in recent years have academic studies begun to recognise the ability of incentives and other discretionary government actions aimed at attracting FDI to be very effective. The evidence in the study undertaken by Charles Oman (OECD, 2000), is clearly and broadly consistent with an interpretation of investment-location decisions as consisting of a two-stage (or multi-stage) process in which investors first establish a "short list" of potential sites that satisfy their requirements for the type of location they are seeking, including satisfactory "fundamentals". Once investors have established such a "short list" many will then, and only then, consider the availability or even seek to generate offers of incentives which the governments in whose jurisdictions those sites are located are willing to provide, or negotiate, before the final site selection is made. At this stage in the location decision-making process, incentives and other discretionary government offers can be decisive.

It can be counterproductive, on the other hand, for governments to offer significant incentives to attract investors if the economy or potential investment sites under their jurisdiction fail to meet the "fundamentals" criteria or other basic requirements of investors. Such offers not only tend to fail to attract the kinds of investment sought, they tend to "soften" the credibility of the governments that make them and thus further weaken their ability to attract solid investors. Thus, while skillfully targeting specific investors can have positive effects, it is equally true that undiscerning policy competition

[125] *Supra* note 122 at 89.

can actually have a negative effect on FDI inflows - and it is probably this second lesson that too many governments fail to grasp.

EFFECT ON POLICY MAKING

Competition for FDI exerts some *upward* pressure on labour and environmental standards. This pressure arises as governments, particularly local governments, in developing and emerging economies as well as in OECD countries compete, increasingly, to attract investments in relatively "clean" and knowledge- or skills-intensive manufacturing and service industries. The pressure arises because investors in these industries increasingly seek out investment locations that offer relatively high environmental standards (sites where their managers and employees prefer to live, and that minimize pollution costs to their operations) and that ensure adequate long-term supplies of workers capable of responding to the much more demanding human-resource needs of flexible enterprises.

Competition for FDI with incentives is unlikely to be eliminated but excessive incentives can be contained and channelled into more effective areas, such as investment in public infrastructure[126]. Unilateral action by a country can check the competitive behaviour of other countries to an extent. The UNCTAD study on "Incentives and Foreign Direct Investment " calls for countries to undertake a national FDI incentives review, and to ensure a proper balance between the use of incentives and investment *promotion* activities (the latter compete with incentives for the same scarce budget resources, are often more cost-effective at the margin, and tend less to fan the flames of cut-throat competition among governments).

[126] United Nations Conference on Trade and Development (UNCTAD), Division on Transnational Corporations and Investment, *Incentives and Foreign Direct Investment*, Current Studies, Series A, No. 30, New York and Geneva, 1996.

CONCLUSION

Undiscerning use of investment incentives and other discretionary policies by governments to attract FDI can have a negative effect on FDI inflows, in part because the incentive programmes and policies tend to be seen by investors as unsustainable.

Many of the governments that are most successful in attracting FDI are also among those that best meet the requirements for good governance (requirements that include sound public finances because they lend credibility to incentives programmes in the eyes of investors, and legitimacy in the eyes of voters, by making them likely to be seen as sustainable).

Investors often choose sites where the host government's strategy to attract investors is part of a broader process of mobilisation around a project of social and political reform in which the government redefines its role, turning away from rigid structures and exclusive relationships with vested interest groups in favour of greater transparency, democracy and market competition. This process both enhances and is reinforced by growing exposure of local and foreign firms in the domesic market to international competition.

Competition for FDI among sub-national governments also contributes to, a broader process of reform of policy-making, which includes regulatory reform, privatization and liberalization of trade and investment policies. In addition to strengthening market forces, this process tends to induce sub-national governments to modernize and organize themselves better, and more flexibly, to enhance the competitiveness of the economies under their jurisdiction.

Policy competition raises the delicate question of how to ensure the accountability of government officials, particularly those involved in the negotiation of discretionary incentive packages, and points up the need for governments to be able to monitor their own use of incentives.

For developing and emerging economies, whose scarce financial resources often push them into a heavy use of fiscal incentives to attract FDI, it is important to stress the value of moving away from incentives-based means towards greater use of domestic and international *rules-based* means of attracting FDI, while maintaining or strengthening their defense of workers' rights and the environment. Strengthening the domestic judiciary system, and domestic competition policy, should be a central part of such a move. Transparency should be one of its objectives.

CHAPTER IV: FDI AND CORPORATE GOVERNANCE

INTRODUCTION

Corporate governance concerns the systems by which companies are directed and controlled[127]. Traditionally, the phrase "corporate governance" invokes a narrow consideration of the relationships between the firm's capital providers, that is the shareholders and top managers as mediated by its board of directors[128].

The essence here is that the shareholders, provide the capital, and expect a return from it, by the mechanism of the corporation, which had essentially come to mean the management and the Board of Directors. However, corporate governance is more than simply the relationship between the firm and shareholders. Corporate governance also implicates *how the various stakeholders that define the business enterprise serve, and are served by, the corporation.* In other words, Corporate Governance has come to mean implicit and explicit relationships between the corporation and its employees, creditors, suppliers, customers, host communities - and relationships among these stakeholders themselves - fall within the ambit of a relevant definition of corporate governance. As

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[127] Cadbury Report. Some other definitions of Corporate Governance are given below to illustrate this point, http://www.encycogov.com/WhatIsGorpGov.asp (May 30, 2002).

- "Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance";
- "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment"
- "Corporate governance is about promoting corporate fairness, transparency and accountability".
- Corporate governance is a field in economics that investigates how corporations can be made more efficient by the use of institutional structures such as contracts, organizational designs and legislation. This is often limited to the question of shareholder value i.e. how the corporate owners can motivate and/or secure that the corporate managers will deliver a competitive rate of return.

[128] Hart, O., "Corporate Governance: Some Theory and Implications", 105 *Economic Journal*.675 (1995).

such, the phrase calls into scrutiny not only the definition of the corporate form, but also its *purposes* and its *accountability* to each of the relevant stakeholders.[129]

Corporate governance is therefore the top management process that manages and mediates value creation for, and value transference among, various corporate claimants in a context that ensures accountability to these claimants. This definition of corporate governance emphasizes both, stakeholders rights and accountability of the management.

WHY DO WE NEED CORPORATE GOVERNANCE

Corporate governance issues have attracted considerable attention, debate, and research world wide in recent decades. Corporate governance has wide ramifications and extends beyond good corporate performance and financial propriety though these are no doubt essential.[130]

Good corporate governance is the key to efficiency in a competitive environment. In this corporate governance provides a cutting edge. Good corporate governance is not merely desirable but it is essential for survival. It is necessary not just because it is good for the shareholders and other stakeholders, it is essential because it is in the interest of the company itself in the present competitive environment. It is good for the shareholders because it is good for the company on which their future depends. Decision making processes should be transparent, consistent with the need to protect the competitive interests of the company as otherwise shareholders and other stakeholders in the enterprise would lose out.

Host countries have sometimes perceived operations of foreign companies as a possible threat to their economic and political sovereignty. Unlike domestic companies, MNCs are not accountable to local constituencies and lack that particular incentive to support or

[129] *Ibid.*
[130] *Report on Corporate Excellence on a Sustained Basis to Sharpen India's Global Competitive Edge and to Further Develop Corporate Culture in the Country,* http://www.nic.in/dca/corp-exc.htm (May 26, 2002).

implement host countries' policies, since their headquarters, shareholders and consumers are in a different country. In several cases MNCs have gained control over significant shares of national economies and have been able to shape national policies and play key political roles outside any form of democratic process or control.

MNCs' operations also raise concerns on the ground of environmental protection and respect of basic human and labor rights. When operating in other countries, MNCs sometimes use environmental and social standards lower than those used in their home countries. Also, many corporations have taken advantage of the relatively lax implementation practices of host countries, and some studies indicate that countries deliberately lower environmental and labor standards in an effort to attract MNC investment. Research has also found evidence that MNCs adopt lower occupational health and safety standards in host countries than in home countries.

Investment projects have also led to labor and human rights abuses. Poor working conditions ranging from exploitation of child labor to lack of basic health and safety conditions have been widely documented in industries such as apparel, footwear and textiles, and have received extensive media coverage.

Concerns for the economic, political, environmental and social consequences of foreign investments have existed for quite some time. However, recent trends of economic liberalization have greatly increased them. That's the reason why corporate governance has become a very important international issue with the increase in volume of FDI. It is one of the main issues facing those who deal with the international political economy and business studies.

CORPORATE RESPONSIBILITY

The concepts of governance and social responsibility are inseparable. Corporate social responsibility is a concept based on expecting companies, particularly the largest and/or multinational corporations, to accept a range of social obligations to balance their

economic rights. These responsibilities revolve around accountability to society not simply to shareholders; e.g. for use of resources, human rights records. It relates to corporate governance and involves ensuring sound and ethical financial practices within and between companies.

Corporate social responsibility is about the voluntary measures that a company takes to develop good management systems, which in turn enhance a company's ability to sustain their franchise, build a record of sustained growth and do so by engaging positively with the societies in which they operate. Corporate responsibility objectives, or goals of "better practices," may or may not be derived from "codes" but are reflected through the implementation of management systems.

The decision by a company to adopt a corporate code of conduct or one of the many corporate responsibility pacts, systems, initiatives or other instruments that are being promoted today, depend on the objectives of the individual company and the relative value added each code or initiative can offer. The primary audience for many codes often remains the company itself, namely its business units, managers, employees and shareholders.

However, it is the behaviour of the company that counts and not the existence of a formal set of business principles to which management "signs up." So whether or not a company decides to adopt and publish a business code, vision, principles or similar communication vehicle should not be seen as an indicator of its commitment to good business practices.

IDENTIFYING BASIC PRINCIPLES FOR RESPONSIBLE FOREIGN INVESTMENT OPERATIONS

In the past fifty years the international community has developed a series of principles that have been approved and acknowledged in different national and international fora and are now part of the civil consciousness of most citizens around the world. These are

principles defining basic human rights, minimum levels of labor rights and general principles of environmental protection. Together, they cover the variety of public interests that should be protected and promoted when regulating FDI. They can thus be used as a commonly accepted basis for the development of standards for TNCs.

a) States' Regulatory Authority over Foreign Investment

The Resolution on Permanent Sovereignty over Natural Resources approved by the UN General Assembly on December 14, 1962 defines permanent sovereignty over natural water and resources a basic condition of the right to self-determination. Its importance as basic responsible FDI principal is the assertion of the right of countries to retain control over their economies and the identification of this right as an integral part of the notion of sovereignty. In particular the resolution states that:

- Provision of economic and technical assistance loans and increased foreign investment must not be subject to condition which confliect with the interests of the recipient state
- The right of peoples and nations to permanent sovereignty over their natural wealth and resources must be exercised in the interest of their national development and of the well-being of the people of the state concerned
- The exploration, development and disposition of natural wealth and resources as well as import of foreign capital required for these purposes should be in conformity with the rules and conditions which the people and nations freely consider to be necessary or desirable.

b) Respect for Fundamental Human and Labor Rights

MNCs' operations should not violate, directly or indirectly through local laws or institutions, fundamental human rights as identified by main international agreements such as the Universal Declaration of Human Rights, the International Covenant on Economic, Social and Cultural Rights, the Convention on the Elimination of All Forms of Discrimination Against Women, the Convention on the Elimination of All Forms of Racial Discrimination, the Convention on the

Right of the Child, and the ILO Convention Concerning Indigenous and Tribal Peoples in Independent Countries.

MNCs' investment operations should also comply with ILO's standards established through ILO's conventions and recommendations on issues such as abolition of forced labor, freedom of association, equality of treatment and opportunity, conditions of work, maternity protection, minimum age, protection of migrants.

c) Compliance with Fundamental Principles of Environmental Protection

MNCs' operation should also be consistent with widely recognized fundamental principles of environmental protection such as :

- Precautionary principle, requiring MNCs to adopt adequate measures against possible environmental damage, even in lack of full scientific evidence of the connection between MNCs' activities and environmental damage
- Polluter and user pays principle, requiring polluter and users of natural resources to bear the full environmental and social costs of their activites
- Creation of categorical prohibitions, excluding FDI from those sectors where investment operations cannot be conducted in a sustainable way (e.g. logging in primary tropical forests, building of large dams, large resettlements).

d) Public participation and Information disclosure

Local communities should be consulted on the establishment and operations of investment projects. They should have proper information about the company's strategy, the economic, environmental and social impacts of the project and access to this information should be granted to citizens and interested groups. Communities should also be involved in the decision making process that leads to policies regulating foreign investment and MNCs behavior.

OECD GUIDELINES FOR MULTINATIONAL ENTERPRISES

The guidelines are recommendations addressed by governments to multinational enterprises operating in or from adhering countries. They provide voluntary principles and standards for responsible business conduct in a variety of areas including employment, human rights, environment and information disclosure. Although many business codes are now publicly available, the Guidelines are the only multilaterally endorsed and comprehensive code that governments are committed to promoting. The guideline recommendations express the shared value of governments of countries that are the source of most of the world's direct investment flows and home to most multinational enterprises.

The approach of the guidelines is not one of regulation: rather it favours cooperation and accumulation of expertise in order to enhance further the benefits of international investments. A few illustrations:

- Technology and human capital- In their chapters II, IV and VIII, the guidelines recommend a series of steps that MNEs should take to facilitate technology diffusion and human capital accumulation in host countries-two areas that have long been recognized as central to growth and productivity increases in less developed countries.

- Local communities- In their chapter II and others, MNEs are asked to cooperate with local communities, keeping in mind the distinctive needs of different communities as well as their cultural diversity.

- Refrain from seeking exemptions- The guidelines also ask MNEs to refrain from seeking or accepting exemptions from host countries' regulatory requirements in

areas such as environment, labour or financial incentives. This echoes efforts by developing countries to avoid being trapped into some kind of race of incentive based competition to attract FDI, which in long run benefits no country.

- Labour management practices- the guidelines cover all core labour standards and underline the importance of capacity building in host countries through local employment and training. Far from imposing inappropriate labour standards on developing countries, the guidelines enhance the positive role that multinational enterprises can play in helping to eradicate the root causes of poverty, through their labour management practices, their creation of high quality jobs, and their contribution to economic growth.

- Disclosure-Chapter III on disclosure promotes business transparency on the basis of standards set forth in the OECD principles of Corporate Governance. Further global dissemination of these standards will promote development by strengthening the effectiveness and robustness of financial systems elsewhere.

- Human rights-the guidelines also contain provisions asking MNEs to respect the human rights of all people affected by their operations. While the countries adhering to the guidelines recognize that governments play the primary role in protecting human rights, companies can help in a number of important ways. Respect of human rights is increasingly viewed as the most fundamental feature of successful market systems. Thus the business community's assistance in promoting human rights will not only help reducing the sufferings caused by human rights abuses, but will promote economic development.

At the outset, the Guidelines were intended to provide government recommendations for good business conduct and, as part of the wider OECD Declaration on International Investment and Multinational Enterprises, to encourage a balance of responsibility between international business and governments.

As the only comprehensive set of voluntary principles for international business collectively endorsed by governments, the OECD MNE Guidelines serve as an important benchmarking tool for companies as they develop their internal management systems. They have played that role for more than 25 years. The clear aim of the MNE Guidelines is to improve the climate for foreign direct investment, sustainable growth, and to promote the positive contribution that multinational enterprises can bring to society.

ENHANCING GOVERNANCE

Being in command of cutting-edge technology, financial and human resources, and organizational know-how, the MNCs have a pivotal role to play as responsible agents in the globalisation process. They have to assume responsibility above and beyond the immediate realm of interest of their enterprise, and commit themselves to contributing to development of the larger community. In the area of employment and social policies, there is ample international guidance available for MNCs that wish to act in compliance with international development goals and international labour standards. Next to the 1998 ILO Declaration on Fundamental Principles and Rights of Work and other ILO conventions, there are two international instruments specifically designed to guide the conduct of MNCs at home and in their foreign operations. These are the 1976 ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy, and the 1997 OECD Guideline on Employment and Industrial Relations. Furthermore, MNCs should also make commitments to redress growing inequalities. In particular, they should aim locating their investments to achieve greater regional balance across and within transition countries, and to accomplish gender equity in employment and occupation and the integration of ethnic minorities and disadvantaged groups into the labour market.

Good governance today refers not merely to government but to contributions from stakeholders of civil society, notably industrial associations, organizations of workers and employers, NGOs, etc. Superior results have been achieved where voluntary, bottom-up

organizations have actively participated in local development, where public-private partnerships have been formed, and where the government has shifted its function from the conventional taking direct control to one of becoming a co-ordinator and facilitator of negotiations to reconcile diverse national and local interests.

CONCLUSION

Good public governance is essential to attract FDI and trade, which in turn increase consumer choice, create jobs, and most importantly generate revenue for public spending on education and training that is essential for economies to adjust to and sustain the benefits of growth.

Companies cannot substitute for governments in building the policy mosaic, which is the coordinated legal framework and basic infrastructure, needed to establish fully functioning market economies that attract business and are necessary for a company to flourish. One major weakness of voluntary standards adopted by the companies is their enforceability. Companies may sign onto voluntary standards yet not comply with them. As it is a company's choice to adopt them, it is a company's choice to apply them. One way to increase compliance is to use public disclosure, market pressure and consumer awareness as leverage. Companies are more likely to comply with voluntary standards when they are rewarded in terms of public image or consumer behavior. Voluntary standards can be enforced by making non-compliance public and thus affecting company's reputation and consumers' choices.

Shareholder activism can be a tool to influence corporate behavior. Shareholder activism can be used to urge companies to adopt voluntary codes and to enforce voluntary standards to which a company has committed. By pressuring companies and filing shareholder resolutions, activists can pressure companies to adopt independent social and environmental monitoring and verify compliance with standards and codes of conduct.

CHAPTER V: THE CORRELATION BETWEEN FOREIGN DIRECT INVESTMENT AND PROTECTION OF INTELLECTUAL PROPERTY RIGHTS

INTRODUCTION

Intellectual property rights (IPR) protection is a market-based mechanism for disseminating knowledge. Tolerance of lax, theft-enabling IPR regimes for purposes of short-term political expediency can only damage the propensity to invest in new knowledge. IPRs are territorial in character, that is, they are created by national laws and differ across countries.

The relationship between IPR protection and FDI is quite complex. On the one hand, a weak IPR regime increases the probability of imitation, which makes a host country a less attractive location for foreign investors. On the other hand, strong protection may shift the preference of multinational corporations from FDI towards licensing. However, the importance of IPR protection varies between industries. The concern about the IPR regime also depends on the purpose of an investment project, being the highest in the case of R&D facilities and the lowest for projects focusing exclusively on sales and distribution.

BENEFITS OF IP PROTECTION

Overall stimulus to research and development

IP protection is likely to help a country attract technology, spread it through the domestic economy, and ultimately, develop local industries. IP protection could be expected to work as a spur both domestically and internationally.

Technological transfers

IP protection makes it easier to transfer technology. When technology owners detect a potential for "piracy" in a country with week IP systems, they do no have incentives to transfer their exclusively owned knowledge to this country. The strengthening of global IP protection creates a better environment for technology transfer.

Disclosure of new knowledge

The spread and use of innovation could be more advantageous to a developing country than its production per se. Imitation is not free of costs, so it might prove beneficial to grant protection of an intellectual property products in exchange for secrets.

Capital formation

IP protection could also lead to an increased capital formation in high tech areas. If IP rights are not adequately protected, foreign firms will tend to avoid selling licenses in these countries and investing there.

COSTS OF IP PROTECTION

Administrative and enforcement costs

The administrative costs of implementing an effective IP system are not insignificant. These cost are highly correlated with the size of the domestic market and the R&D intensity of the domestic economy. The costs of administering patents are usually a great deal bigger than the cost of administering other instruments of protection.

Net royalty payments

Under the assumption that the country is a net importer of embodied and disembodied knowledge, which most developing countries are, strengthening the protection of IP, would tend to increase royalty payments to the knowledge-exporting countries in the Western part of the world.

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The possibility of reverse engineering

In technology-importing countries reverse engineering, the process by which firms take products apart to learn how to produce them, enables firms to learn how to develop new products themselves and therefore helps in a country's development. As the technological know-how improves in a country, these firms will themselves begin to innovate. And when this stage is reached, the protection of IP rights generally begins to increase. This has been seen in many developing countries and, until recently, also in some developed countries.

The opportunity costs of increased R&D

The opportunity costs of resources devoted to R&D should also be estimated if national and foreign corporations respond with some additional investment in a country changing its IP system to a higher level.

Higher prices and fewer available products

Stronger protection of IP rights may come at the expense of higher prices and reduced availability of products. Especially the least-developed countries will have difficulties paying the higher price that knowledge-intensive goods will cost when they are given patent protection in these countries.

Anti-competitive effects

There is a general fear that strengthening of IP protection in the Least developed countries would not only bring significant price increases, but it would also diminish the process of technological diffusion.

ARGUMENTS SUGGESTING STRONGER IPR PROTECTION ENHANCES FOREIGN DIRECT INVESTMENT

The argument in favour of IPR protection is that it raises the incentives for firms to conduct research and develop new products. Unless a company can reap the benefits of the investment that it makes in R&D then it will have little reason to innovate. Countries that offer effective protection are more likely to be recipients of FDI from companies, which are concerned about the loss of their intellectual property.

Weak IPR protection increases the probability of imitation, which erodes a firm's ownership advantages and decreases localization advantages of a host country. At the same time, a weak IPR system increases the benefits of internalization, since it is associated with a greater risk of the licensee's breaching the contract and acting in direct competition with the seller. An inadequate IPR regime, therefore, deters FDI and encourages exporting. A strong IPR system may also have a negative impact on FDI by making licensing a viable alternative to direct investment[131].

Opponents argue that it is a means of sustaining the lead of the developed economies. Most holders of IPRs tend to come from OECD countries and their ability to withhold the technology, or to set their own price for it, will hamper the efforts of developing economies to grow. They also argue that the WTO is about reducing barriers to trade, while IPR protection achieves the reverse.

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[131] Indeed Yang and Maskus (2000) find that licensing is more likely to take place in countries with strong IPR protection. Yang, Guifang and Keith Maskus. "Intellectual Property Rights and Licensing: An Econometric Investigation", 137 *Weltwirtschaftliches Archiv* 58-79 (2001).

RATIONALES OF IP INCENTIVES

IP rights aim at protecting inventors' rights to profit from innovative and creative activity, and as such they play a critical role in economic growth and development as international trade and foreign direct investment in knowledge-intensive products increase. IP rights are in a sense second-best solutions to the problems created by the "public good" nature of knowledge. They are supposed to foster investment in research and development (R&D) and knowledge creation. However, a static distortion arises as IP rights constrain the current consumption of knowledge, by strengthening the market power of the property right owners. IP laws seek to resolve the conflict between the need to provide incentives for invention or innovation, and to ensure the widespread diffusion of knowledge. The social contract, embodied in IP protection, creates a short-term deadweight loss in return for dynamic R&D benefits. This rationale is typically used with respect to patent and copyright laws, and trade secrets are rationalized as a necessary supplement to the patent system. However, when it comes to trademarks and industrial designs, for instance, the need for protection in this area is usually explained in terms of incentives for investments in reputations (quality).

INTELLECTUAL PROPERTY RIGHTS AND FOREIGN DIRECT INVESTMENT

One of the greatest problems plaguing multinational corporations (MNCs) in many of the developing economies around the world is intellectual property theft. Lack of adequate protection of IPRs acts as a disincentive for FDI that is to come in. It also takes away the incentive for invention and creativity. Logically, no entrepreneur will invest in a country unless he is sure that his interests are safe and legally protected against taking away what was developed over the years by spending substantial amount of money.

In this regard, the UNCTC[132] report notes that the relationship between FDI and IPRs is widely disputed. While for some a strong IPRs system is an essential component of a climate conductive to FDI, technology transfer and R & D by multinationals, for others including many governments and experts in developing countries, a high degree of protection does not necessarily mean a higher or a better composition of FDI flows. Any analysis of impact of IPRs on FDI has to confront difficult methodological problems, foremost being how to isolate effects of IPR protection and distinguishing it from influence of other factors, as also the time-lag between up-front costs of stronger IPRs and resulting benefits of FDI.

As a result, many of the studies have either provided inconclusive evidence or reinforced preconceived notions. There was a consensus that the main factors explaining FDI flows is economic environment prevailing in a particular country - cost conditions, market size, level of human capital and infrastructural development and the broad macro-economic conditions. But regulations in areas such as remittances, price controls and foreign investment do not seem as influential on investment decisions as economic factors. The UNCTC report extended this conclusion to include IPRs, which has not been considered a major influence on most investment decisions in the literature on investment decisions, and noted that conclusions on the degree to which the level of IPR protection affects the volume and composition of FDI has been elusive.

Nevertheless, the report observed the following considerations to be pertinent:

- To the extent that most countries would observe similar standards of protection and such standards would become "normal" in all or most countries, the role of IPRs as a factor to induce or deter FDI in a country will lost significance, though differences might still remain over enforcement and this in turn could affect FDI.
- The patent system will be the area most affected, with the non-discrimination clause in the TRIPs agreement becoming a provision with highest potential impact on FDI strategies. According to one interpretation, this clause will prevent

[132] "Intellectual Property rights and Foreign Direct Investment" (UN Sales No E.93.II.A10), by Carlos M. Correa, UN Center for Transnational Corporations.

national legislation from establishing compulsory licensing or other remedies in cases of failure or insufficient local working of the invention.

One way to understand whether there is any correlation between FDI inflow and intellectual property rights is to scrutinize the R&D investments of multinationals overseas[133]. Clearly, strong IPR is desired by MNCs, which set up foreign production and research units. But it is not a prerequisite. Most R&D conducted by overseas affiliates of multinationals or transnational corporation is of an adaptive nature: products and processes are being fine-tuned to local markets and manufacturing conditions. Hence, big risk R&D or invention is not on the agenda in the first place. MNCs may even be encouraged by weak IPR regimes that tend to protect local adaptations of foreign innovations better than they protect foreign innovations. Thus, MNCs can conduct adaptive research and similarly corner markets at lower cost. In such cases, the determination of location for overseas R&D is far more predicated on local research infrastructure than the availability of strong IPR, especially in the chemical and food industries.

A further source of ambiguity stems from the fact that differing levels of IPRs protection may affect a firm's decision on its preferred mode of serving a foreign market. A firm may choose to serve a foreign market by foreign direct investment (FDI) or by licensing its intellectual asset to a foreign firm instead of exporting the product in an environment characterized by strong IPRs[134]. Thus, strengthened IPRs protection may have a further negative effect on trade flows in this respect[135].

Moreover, patents and trademarks provide greater certainty to firms, lower the costs of transferring technology, and facilitate monitoring of licensee operations. In this view, stronger IPRs in developing economies promise long-term benefits as they attract FDI and licensing and encourage follow on innovation and technology spillovers. This

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[133] Nagesh Kumar, "Intellectual Property Protection, Market Orientation and Location of Overseas R&D Activities by Multinational Enterprises", 24 (4) *World Development* 673-687 (1996).
[134] Ferrantino,M.J., "The Effect of Intellectual Property Rights on International Trade and Investment", 129 *Weltwirtschaftliches Archiv* 300-331 (1993).
[135] FDI as a mode of serving a foreign country is of special relevance because the existence of intangible assets such as intellectual property is a major rationale for the existence of (horizontally integrated) MNCs

outcome is only likely to emerge if the implementation of stronger IPRs is accompanied by complementary policies that promote dynamic competition.

IMPACT OF IPR PROTECTION ON VOLUME OF FDI

IPRs affect international trade flows in several ways. A firm, for example, may be deterred to export its patented good into a foreign market, if potential "pirates" can diminish the profitability of the firm's activity in that market because of a weak IPRs regime. Accordingly, a strengthening of a country's patent regime would tend to increase imports, as foreign firms would face increasing net demand for their products reflecting the displacement of pirates. On the other hand, a firm may choose to reduce its sales in a foreign market as a response to stronger IPRs protection because of its greater market power in an imitation safe environment. These opposing market-expansion and market-power effects imply that the overall effect of IPRs protection on bilateral trade flows is theoretically ambiguous[136].

IMPACT OF IPR PROTECTION ON COMPOSITION OF FDI

Intellectual property rights do not play an equally important role in all sectors or even in all technology-intensive industries. For instance, Mansfield[137] mentions that IPR protection may be less crucial in sectors such as automobile production, in which firms frequently cannot make use of a competitor's technology without many complex and expensive inputs. On the other hand, the IPR regime is likely to be important for sectors such as drugs, cosmetics and health care products; chemicals; machinery and equipment; and electrical equipment.

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136 Maskus, K.E. and M. Penubarti, "How Trade-Related are Intellectual Property Rights?" 39 *Journal of International Economics* 227-248 (1995).
137 Edwin Mansfield, *Intellectual Property Protection, Foreign Direct Investment, and Technology Transfer*, IFC Discussion Paper Number 19 at page 19.

Investment in lower-technology goods and services, such as textiles and apparel, electronic assembly, distribution, and hotels, depends far less on the strength of IPRs than on input costs and market opportunities. Firms investing in a product or technology that is costly to imitate may also place little emphasis on local IPRs in location decisions, though falling imitation costs in many sectors raise the importance of IPRs. Firms with easily copyable products and technologies, such as pharmaceuticals, chemicals, food additives, and software, are more concerned with the ability of the local IPRs system to deter imitation. Firms considering where to invest in a local R&D facility would pay particular attention to protection for patents and trade secrets[138].

Specifically, investments in facilities to make components or complete products are likely to increase the country's technological competence to a greater extent than investments in sales and distribution outlets or in rudimentary production and assembly plants. Because firms tend to be much more likely to regard intellectual property protection as important for the former than for the latter types of investment, a country's system of intellectual property protection may influence the composition of direct foreign investment[139].

INDIAN SCENARIO

IPR is an important policy area for some firms and countries. The impact of IPR regime on investment flows is not beyond doubt. The latest study on this by International Finance Corporation[140] came to the conclusion that technology flows rather than investment flows, only in high technology sectors are influenced by IPR regime. The study also concluded that India is perceived to have one of the weakest IPR regime by foreign investors. Information collected during the course of the present study revealed that IPR is a major concern for some firms, principally in the area of pharmaceuticals and

[138] Keith E. Maskus, *Intellectual Property Rights and Foreign Direct Investment*, Center for International Economic Studies, Policy Discussion Paper No. 0022 at page 10.
[139] *Supra* note 7 at 19.
[140] *Id.*

agro-chemicals. These firms have in fact two different types of concerns[141]. First, as a major multinationals, they have a large product portfolio of which many are off-patents. IPR regime is not a concern for these products while the regulatory control mechanism, represented by registration formalities, submission of detailed documentary evidence, etc. are. Second, IPR is a concern where new products are involved. Here the attitude is that these will not be brought into India, till the IPR issues get settled satisfactorily.

CONCLUSION

Governments all over the world compete fiercely to attract foreign direct investment hoping that multinational corporations will bring new technologies, management skills and marketing know-how. To the degree that different levels of IPRs across countries are a locational determinant of FDI and technology transfer, the trend toward harmonization of IPRs could offset such advantages. Thus, it would make more attractive those countries that strengthen their IPRs but would reduce the relative attractiveness of countries already providing strong IPRs. This harmonization of global minimum standards presents great opportunities for firms that develop technologies and products because they will no longer have to pay as much attention to localized protection and enforcement problems. Rather, they can focus their R&D programs on those areas with the highest global payoffs. Ultimately, however, it means that IPRs no longer will play much role in determining locational choice.

One way of looking at FDI in this context can be in terms of Dunning's OLI framework. This framework says that three major factors that drive FDI are ownership, location and internalization advantages. A firm that wants to sell its products abroad is initially disadvantaged vis-à-vis local producers because it is less familiar with the environment in a foreign country, distribution networks, customs or tastes. Therefore, this firm needs to be better than local producers in some ways; it needs to possess the so-called ownership

[141] B. Bhattacharyya, "Foreign Direct Investment in India" 28 (4) *Foreign Trade Review* 317 (1994).

advantages. And these advantages may take the form of superior technologies or patents, blueprints, established brand names and so on and so forth.

Now, if the foreign country has a strong ability to imitate, and this imitation is likely to take place, it will clearly erode the ownership advantages of the firm. Conclusively, it can be expected that as host countries strengthen their IRP protection, there would be a positive impact of this change on exports, FDI and licensing, since these are three ways of serving a foreign market. And this would be the so-called market expansion effect.

However, the literature in this area has also pointed out another possibility. Stronger IPR protection will give a firm greater monopoly power. Therefore, firms may use it to restrict the supply, and therefore, in such a situation, we would observe that the volume of exports, FDI as well as licensing, would decrease, and this would be the so-called market power effect. Empirical evidence, however, suggests that the market expansion effect is stronger than the market power effect.

The second advantage in Dunning's framework is the so-called location advantage. A firm might prefer to locate its production abroad due to transportation costs, differences in factor prices, availability of natural resources. As protection of intellectual property in a host country increases, these location advantages increase and the country becomes a more attractive location for FDI and licensing.

The final advantages are the so-called internalization advantages. They explain why a firm would prefer to keep the technology inside its operations rather than to license it to third parties, and the explanation here is that it may be difficult to negotiate the price of the transaction. It may be difficult to present to the potential buyer the value of the technology without actually revealing too much, and it is also difficult to enforce licensing contracts. So it would be expected that as protection of IPRs becomes stronger, enforcing licensing contracts becomes easier and the volume of licensing goes up.

However, like any other factor IPR is not the key determinant of FDI inflow. They do not operate in isolation, but rather interact with market structures, competition rules, and deregulation of trade and investment to determine the effective strength of those rights and the resulting incentives for FDI. Given the fact that TRIPs Agreement shall force all the countries to have a minimum level of IPR protection and that the IPR regime in all the WTO member countries are going to be harmonized or even homogenized by December 31, 2005 (i.e., deadline for all the member countries of WTO to comply with TRIPs requirement), this will become even the least significant determinant of FDI inflow.

The provisions on FDI were contained in two agreements: The General Agreement on Services (GATS) and The Agreement on Trade Related Investment Measures (TRIMs) in relation to trade in goods.

It is sometimes argued that WTO is not the appropriate forum for framing a compact on FDI because its mandate does not extend to investment. It is concerned with trade. In any case, trade and investment in the services sector are on the WTO agenda and, except in the case of so-called long-distance services, efficient delivery of most services requires the presence of the producer in the locale of the consumer. Here production and trade are coterminous. More often than not the presence of the service producer in the locale of the consumer is established through foreign investment. Again, the Agreement on Trade-related Investment Measures (TRIMs), a product of the Uruguay Round negotiations, is about the polices of host countries towards foreign firms. Trade-related investment measures impact on the production decisions of foreign firms, including the sourcing of inputs. Admittedly, the justification for the inclusion of TRIMs in the WTO is that all such measures, at one remove or the other, impact on trade. But then there are very few policy measures that do not impact on trade in one way or the other. Though foreign direct investment in one form or the other is already being addressed in the WTO system, but the regulations relating to it are haphazard and scattered throughout, in agreements relating to services, TRIMs, subsidies and government procurement.

TRADE RELATED ASPECTS OF INVESTMENT MEASURES (TRIMs) AND FDI

The Agreement on Trade Related Investment Measures (TRIMs) is one of Agreements signed at the end of the Uruguay Round (UR) negotiations. The Agreement addresses investment measures that are trade related and that also violate Article III (National treatment) or Article XI (general elimination of quantitative restrictions) of the General Agreement on Tariffs and Trade. An illustrative list of the measures that are violative of the provisions of the Agreement is annexed to the text of the Agreement. These pertain

broadly to local content requirements, trade balancing requirements and export restrictions, attached to investment decision making.

The agreement on Trade Related aspects of Investment measures recognizes that certain investment measures restrict and distort trade. It provides that no contracting party shall apply any TRIM[142] inconsistent with Articles III (national treatment) and XI (prohibition of quantitative restrictions) of the GATT. The agreement requires mandatory notification of all non-conforming TRIMs and their elimination within two years for developed countries, within five years for developing countries and within seven years for least-developed countries. It establishes a Committee on TRIMs, which will, among other things, monitor the implementation of these commitments. The agreement also provides for consideration, at a later date, of whether it should be complemented with provisions on investment and competition policy more broadly.

It has been recognised that TRIMs can be used by hosts in bargaining with multinational enterprises (MNEs): foreign direct investment (FDI) will only take place if the MNE perceives a gain, likewise the host wants to ensure that it derives benefits from the investment[143]. The total gain can be viewed as the rents from the FDI activity. The MNEs utilise their market power to appropriate most of the rents to themselves; hosts respond with TRIMs and other investment requirements to capture rent for the host country. In this view, TRIMs are a countervailing power.

It follows that the abolition of TRIMs reduces host government bargaining power and reduces the potential gains from FDI for the host economy. As FDI becomes more important, as is likely to be the case, the potential loss of "rents" or reduction of benefits to the host does represent a cost to developing countries. This potential cost is greater for

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[142] TRIMs stands for Trade Related Investment Measures and is one of the many trade Agreements which make up the WTO, and which all members are subject to. It applies to any investment measure relating to the trade of goods. This covers any Foreign Direct Investment (FDI), joint venture or complete venture that a company, domestic or transnational, may make. This FDI or venture may be along the lines of a MNC investing in another country in order to extract materials or manufacture all, or part, of its goods.

[143] Greenaway, D., "Trade Related Investment Measures and Development Strategies", 45 *Kyklos* 139-159 (1992).

countries such as India and China that attract large inflows of FDI, but is real for all developing countries[144].

TRADE RELATED INVESTMENT MEASURES

Trade related investment measures (TRIMs) refer to restrictions attached by host states to the activities of multinational enterprises (MNEs) that have invested in the host. They are termed investment measures because they relate to MNEs that have engaged in foreign direct investment (FDI), i.e. that are undertaking production activities in the host (the discussion could be extended to investment in services). They are trade related because the activities of the MNE impact on trade flows, in one or more of three essential ways. The MNE may be potentially able to export, and the TRIM may relate to export requirements (e.g. stipulating a share or value of output to be exported). Alternatively, the MNE may be producing import-competing goods, and the TRIM may restrict such competition (e.g. limiting the share or value of output that can compete with imports). Finally, the MNE may import inputs that are available locally, and the TRIM may require some minimum amount of inputs be purchased from local producers (such as local content requirements). A TRIM, therefore, affects trade flows, the level of imports and/or exports. It follows that the removal of a TRIM can affect trade flows, and such removal is the intention of the TRIMs Agreement in the Uruguay Round Agreement.

The principal problem facing developing countries is that their legal systems, in particular their capacity to implement competition policy and regulate MNEs without TRIMs, are limited. In such situation, the approach to FDI adopted by China and India, amongst other developing countries, may offer the best solution. If developing countries want to increase the benefits to the host economy of investment by multinationals, it may be best to require that investment is in conjunction with local partners. Proposing joint ventures and equity stakes as alternatives to FDI will secure greater benefits for the local

[144] Oliver Morrissey, *Investment and Competition Policy in Developing Countries: Implications of and for the WTO*, Centre for Research in Economic Development and International Trade, University of Nottingham, CREDIT Research Paper No. 00/2 at page 3

economy. Alone, this does not ensure the benefits extend beyond the local partners. The general principle is that government should promote domestic competition.

THE COMMONLY USED TRIMS AND THEIR ADVANTAGES

Governments establish TRIMs for foreign investors because governments want to ensure the positive impacts of FDI on the FDI - receiving countries' employment and export performance. The domestic sectors can also be protected under TRIMs from the increasing competition after the injection of foreign investment.

TRIMs are more frequently used by developing countries than developed countries. It is because most infant industries in developing countries are not well prepared to compete in the world market, it is necessary for developing countries to use TRIMs to protect their local industries during the transitional period. The followings are examples of TRIMs that are commonly used.

- Local content requirements (LCRs)

  One of the commonly used measures is the local content requirements (LCRs). They are popular government policies in developing countries to regulate FDI. Foreign investors are required to utilize a certain proportion of local parts and components in their production. By regulating the multinational enterprises to use local resources and factor inputs, employment in the local industries of the host countries will be bound to increase. Besides, governments also require the multinational enterprises to transfer the technology to the local industries so as to maintain the quality of the finished products. Imposing LCRs consolidates the positive impacts of FDI on employment opportunities and technological levels in the host countries.

  Meanwhile, foreign subsidiaries also gain under the local content requirements. Under these requirements, foreign subsidiaries are required to buy a proportion of

resources from local suppliers. In order to become the providers of resources to the foreign subsidiaries, the local suppliers will compete against each other by lowering the sales prices. As a result, foreign subsidiaries can exercise their monopsonistic powers to drive down the buying prices as well as the production costs.

- Trade balancing requirements

Another type of performance requirements is the trade balancing requirements. These requirements limit the amounts of imported products purchased or used by foreign enterprises which are located in host countries and require the foreign enterprises to export a certain amount of their finished products. Trade balancing requirements can ensure that imports coming in would not be more than exports going out to avoid potentially serious balance of payments deficits in host countries. The precaution of balance of payments crisis is an incentive for governments to use this type of TRIMs.

- Foreign exchange balancing requirements

The foreign exchange balancing requirements is another type of TRIMs that protects the interests of the host countries. These requirements aim at linking the import level of a foreign firm to the value of its exports in order to maintain a net foreign exchange earning. This TRIM is similar to exchange control under which the amount of foreign currencies available to multinational enterprises is limited by the performance of their exports. By imposing these requirements, foreign subsidiaries cannot import goods as much as they want. Governments can also directly limit the domestic sales of home currency to foreign currencies, thus preventing the adverse effects on foreign exchange reserves and reducing the possibility of speculative attacks. That is the reason for countries commonly using these measures to maintain a stable balance of payments.

- Export performance requirements (EPRs)

These requirements are the restrictions on the sales of products in domestic market, that is, a certain proportion of production should be stipulated for export. Countries with aims of export-led growth have the tendency to impose EPRs on foreign investors because these regulations help the penetration of domestic products to overseas markets, fitting well with the development objectives of the host countries.

- Technology transfer requirements

These requirements restrict specified technologies to be transferred and/or specific levels and types of research and development (R & D) to be conducted locally. Foreign investors are required to share new technologies and researches with local researchers, government agencies, businesses or local communities. The aim is obvious that the governments want to improve the technological level of the host countries.

- Joint venture requirements

The host countries try to limit foreign ownerships of the firms located in home countries and influence the activities of foreign investors by requiring them to take on local partners in joint venture rather than to own the whole firm. The objective of these requirements is to help local partners achieve more technology transfer through the cooperation with foreign investors. On the other hand, these requirements also benefit the foreign investors. With the help of their local partners, foreign investors can acquire the location-specific knowledge regarding the host-country market without any costs. The local partners can also help them establish backward linkages to the domestic industrial base. Therefore, foreign investors can access the local market and input suppliers more easily.

- Other TRIMs

Other than the above commonly used TRIMs, there are several more requirements or restrictions, such as manufacturing requirements, manufacturing limitations and remittance restrictions, which may be imposed by the host countries. Under the manufacturing requirements, foreign investors have to manufacture certain products locally. In contrast, manufacturing limitations prevent companies from manufacturing certain products or establishing certain product lines in the host countries. These limitations aim at protecting domestic industries by reducing the competition between foreign subsidiaries and domestic enterprises. While remittance restrictions limit the rights of foreign investors to repatriate returns from their investments; the host countries always hope that the return can be re-invested in different projects and generate more income in domestic economies.

THE FLIPSIDE OF TRIMS

Firstly, TRIMs discourage free trade and free competition, thus adversely affecting the host economies. If a country wants to be a World Trade Organization (WTO) Member and benefits from free trade, the country is obligated to obey the articles mentioned in WTO agreement. One of the important principles in WTO agreement is "national treatment". It prescribes the obligation that an imported product should be treated as a national product. That means there should be no discrimination between domestic and imported products. However, TRIMs like local content requirements and trade balancing requirements violate this principle. They restrict the use of imported resources and limit the quantity of imported goods entering the host countries. As a result, countries using TRIMs cannot enjoy the benefits from free trade.

Secondly, TRIMs have a negative impact on the economic efficiency of a foreign operation in a country. It is because under LCRs, foreign investors are forced to use the local resources, which do not have comparative advantages, as their inputs. These restrictions indeed raise foreign companies' production costs and ultimately discourage

foreign investors from investing in the host countries. Meanwhile, consumers will suffer if multinational enterprises transfer the extra costs to them. Under the LCRs, foreign investors in host countries cannot import resources in bulk amount. Therefore, the foreign investors have to pay higher prices of resources. In sum, there are high inefficiency in the host countries where LCRs have been imposed.

Other than undermining economic efficiency, TRIMs also slow down the pace of technological upgrading of local operations in host countries.

GATS AND FDI

The General Agreement on Trade in Services (GATS) contains a set of commitments and obligations on policies affecting services trade. Establishing a commercial presence in a country, usually through FDI, is one of the four modes of service delivery covered by the GATS. Barriers to FDI in services are therefore covered for the first time in a binding multilateral agreement.

Four possible modes of service delivery are defined in the GATS. *Cross border supply* is where the supplier and consumer are located in different countries, as with overseas telephone services. *Consumption abroad* involves the consumer moving to the foreign supplier, as in tourism or education. *Temporary movement of people* involves the supplier moving temporarily to the consumer, as in consulting services. *Commercial presence* is where the supplier establishes a commercial presence, often through FDI, to deliver the service in a foreign country.

Since "Commercial presence" is defined as any type of business or professional establishment including setting up branch or liaison office, FDI gets included in this category. GATS framework provides for two basic principles: application of Most Favoured Nation (MFN) treatment to member countries and national treatment. While the former is general in its application, the latter is specific in terms of its linkage to market access in sectors included in the Schedules of concessions of each country. The

application of MFN treatment means that equally favourable or unfavourable treatment will be extended to all signatories of the Agreement. This is subject to the exceptions attached to the Agreement that will be regularly reviewed and are to be phased out over a 10 year period.

The GATS could potentially have a significant impact on FDI barriers. The general and specific commitments relate to all four modes of service supply, including commercial presence, which is often through FDI. For example, under the market access principle, the widely used FDI policy of restricting the share of foreign ownership in a sector, or in individual firms within a sector, could not be maintained. Under the national treatment principle, screening of FDI proposals and application of net economic benefits tests or national interest criteria could not be maintained, where they are not equally applied to domestic investment proposals.

However, in practice the impact of the GATS will be limited. Barriers to commercial presence and FDI in many sectors are not covered by the Agreement, because countries have chosen not to include those sectors in their schedule. And for those sectors where some commitments are made, restrictions on market access or national treatment for commercial presence are frequently listed as "unbound" or exempt. Many other sectors are simply not listed or scheduled by many countries, and therefore fall outside the scope of the Agreement.

For the commercial presence mode of supply, common restrictions on market access include limits on foreign ownership and authorisations based on whether certain economic, social and cultural criteria are met, particularly for sensitive sectors such as broadcasting. National treatment violations take a range of forms, including limits on the number of foreign members of company boards and restrictions on the nationality of partners of legal or other professional practices.

Unlike the large gamut of sectors negotiated in respect to trade in goods however, under GATS, each country negotiated a list of GATS exempted sectors. In these sectors, FDI in the form of "commercial presence" can, in principle, be subject to substantial restrictions.

MULTILATERAL AGREEMENT ON INVESTMENT (MAI) AND FDI

The purpose of an MAI is to create a "level playing field" for foreign investors around the world so that they are legally assured that they will stand on the same footing as domestic investors when they wish to make an investment in a host country. This principle of non-discriminatory or national treatment is to apply to all stages of an investment, namely, entry, establishment and operation of an investment.

The attempt to draft a Multilateral Agreement on Investment (MAI) by OECD members was one of the most controversial chapters in the era of globalization, and the failure of the effort taught many lessons about the sensitivities of investment issues.

The OECD trade ministers recognized that controversies about foreign investment policy occur most frequently in developing countries. Therefore, an initial effort to draft a Multilateral Agreement on Investment (MAI) was initiated by governments of the OECD nations in the hope they might be like-minded and would readily agree on terms for investor protection. However, after several years of discussion, the negotiations ended without a draft agreement.

The negotiations on Multilateral Agreement on Investment began in May 1995 and were expected to be completed two years later but the negotiating parties failed to reach an agreement in time.

The MAI as advocated by the industrialized countries and as evidenced by the mandate and draft of the OECD negotiations had four major components (a) the liberalization of foreign investment regimes by host countries; (b) fair and equitable treatment of

investment; (c) legal security for investment; and (d) effective dispute settlement procedures. Furthermore, the draft OECD MAI defined investment as "every kind of asset owned or controlled, directly as indirectly, by an investor", while "investor" means any natural or legal person of a Contracting Party, with the legal person being any kind of entity constituted or organised under the applicable law of a Contracting Party. Such a definition of investment was intended to go far beyond the traditional notion of foreign direct investment. It covered not only equity investment (regardless of whether it is above or below any specified threshold level), but also portfolio investment, debt capital, monetary and financial transactions, and more importantly, every form of tangible and intangible asset, including, in particular, intellectual property rights, concessions and licences.

The MAI's main provisions were as follows:

- It ensured that all multinational companies receive national treatment, or most-favoured-nation treatment (whichever is better) in every member country;
- It prohibited any performance requirements on MNC's even if the same requirements apply to domestic companies. It prohibited host nations from any "unreasonable or discriminatory measures" which could impair the "operation, management, maintenance, use, enjoyment or disposal of investments";
- It provided for a state-to-state and investor-to-state dispute settlement mechanism;
- It was a stand-still and roll-back treaty. Once a country ratified the treaty, it could not withdraw from the MAI for a minimum of five years. Having announced its intention to withdraw from the MAI, a country would continue to be bound by its provisions for 15 years.

However, there were several weaknesses in the proposed wording of the MAI:-

- *The MAI severely curtailed the power of sovereign states.*

  The treaty prevented governments from any act which could reduce the ability of foreign investors to "enjoy" their investments. By raising environmental or labour

standards, governments could be accused of expropriating profits from multinationals.

- *The MAI conferred numerous rights on MNCs, but did not increase their responsibilities.*

  The OECD argued that the MAI should not burden MNCs with any further responsibilities as they are already subject to codes of conduct from the UN and the OECD.

- *The MAI did not address the issue of investment incentives*

  Perhaps the greatest welfare loss associated with FDI is the large sums of money spent by governments to attract MNCs. Because it is a prisoner's dilemma-type situation, this is one issue where multilateral policy co-ordination is required. However, the MAI completely ignored this issue.

The MAI was only one initiative amongst many bilateral, regional and plurilateral instruments related to foreign direct investment (FDI). The MAI negotiations set out to provide high standards for the liberalization of investment regimes and investment protection between the OECD member countries and, eventually, other interested non-member States. While the detailed and extensive exchange of views that took place in the negotiations pointed to a convergence of views on a number of substantive areas, various outstanding issues remained at the time the negotiations were suspended.

DIFFERENCES BETWEEN THE PROPOSED MAI AND INDIA FOREIGN INVESTMENT REGIME

The key and the most critical difference between Indian foreign investment regime and the MAI demanded by the industrialised countries lies in the "pre-establishment phase national treatment" issue, i.e. non-discriminatory treatment as between foreign and domestic investors at the stage of entry and establishment of an investment.

Indian FDI regime embodies the national treatment principle only in the post-establishment or operation phase of an investment. Once an investment is made and a business entity is established, Indian laws apply equally regardless of whether the entity is wholly or partially national or foreign owned. There is therefore no major problem so far as the principle of national treatment in the post-establishment phase is concerned.

But the proposed principle of national treatment in the pre-establishment phase is wholly contrary to present Indian policies and regulatory framework for foreign investment. The existing framework in India is based on (a) screening and approval of foreign investment (b) exclusion of foreign investment from certain sectors or activities and (c) domestic ownership requirements, including limitations on foreign portfolio investment in existing enterprises. It is true that there is the "automatic approval" process for foreign direct investment but it is only an exception to the normal screening and approval procedures and it still involves a foreign investor going through a process that is not applicable to a purely domestic investor. Thus, the pre-establishment phase national treatment standard cuts at the roots of existing Indian policy and regulatory framework for foreign investment.

MULTILATERAL INVESTMENT GUARANTEE AGENCY (MIGA)

The Multilateral Investment Guarantee Agency (MIGA) was created in 1988 as a member of the World Bank Group to promote foreign direct investment into emerging economies to improve people's lives and reduce poverty. MIGA fulfills this mandate and contributes to development by offering political risk insurance (guarantees) to investors and lenders, and by helping developing countries attract and retain private investment[145].

MIGA's purpose is to encourage foreign investment in developing countries by providing:

[145] India is a member of MIGA.

a) Guarantees to foreign investors against currency transfers, expropriation, war, revlountion or civil disturbance, and breach of contract risks; and
b) Advisory services to developing member countries on means of improving their attractiveness to foreign investment.

MIGA promotes the flow of investment capital and technology through the following two inter-related activities:

- Firstly to serve as an insurer of such investment against stipulated political risks in the host country, and

- Secondly to offer technical assistance and policy guidance to developing countries to aid them in the improvement of their investment scenario and the attraction of new investment.

Chapter Two and Three of MIGA, authorize it to insure eligible investments against loss resulting from the three recognized classes of political risks, namely :

(a) incovertibility of investment proceeds or inability to transfer them out of the host country;
(b) expropriation and similar measures; and
(c) war and civil disturbances.

MIGA's technical assistance services also play an integral role in catalyzing foreign direct investment by helping developing countries around the world define and implement strategies to promote investment. MIGA develops and deploys tools and technologies to support the spread of information on investment opportunities.

MIGA is among the first investment insurers to expand the traditional limits of expropriation coverage and offer an investor protection against losses due to breach by the host Government of an investment contract with it. It is an important catalyst, promoting foreign direct investment - a key driver of growth - into developing countries

through its guarantees program and technical assistance services. FDI supported by MIGA often serves as a model for encouraging local investments, and spurs the growth of local businesses that supply related goods and services.

FOREIGN DIRECT INVESTMENT IN SINGAPORE

Attracting foreign investment into the country - initially to spearhead industrialization and subsequently to climb the technological and value-added ladders - has been a key economic strategy of the government since independence in 1965. Through it, Singapore has evolved into a base for MNC's to engage in high-end manufacturing and product development, and coordinate regional procurement, production, marketing, and distribution operations.

Several factors contributed to the success of Singapore's early efforts to industrialize based upon the export of labor-intensive manufactures. One example is the political commitment to openness to trade in both goods and capital. When it was not a popular position, Singapore adopted a consistently liberal policy towards foreign direct investment. Over time, the country's consistency in welcoming foreign investors built for the government strong credibility as a host country. The other main factors which attracted foreign investors to Singapore were the government's welcoming attitude expressed in positive assistance mainly through the Economic Development Board and other government departments and instrumentalities, and the efficiency of the public services and utilities. The establishment of key institutions is another factor behind Singapore's success.

PERFORMANCE REQUIREMENTS/INCENTIVES

Singapore does not impose performance requirements on foreign investors as a condition for establishing operations. However, if investment incentives are requested, a company's track record, the amount of its investment, and their contributions to Singapore's goal of becoming a knowledge-based economy are important considerations in the selection process.

The government does not require investors to purchase from local sources or specify a percentage of output for export. The government also does not limit investors' access to foreign exchange or require local equity ownership in the investment.

The Companies Act requires that every company must have at least two directors, one of whom must be resident in Singapore. Foreign investors face no requirement to reduce equity over time and are free to obtain their necessary financing from any source. Employment of host country nationals is not required. The government discourages dependency on unskilled foreign labor, encouraging companies to automate and re-engineer their work processes instead. To manage the foreign worker problem, the government sets a limit on the percentage of foreign workers that various industries may employ, and imposes a monthly levy for each foreign worker

There are no rules on the level and period for investors to effect transfer of technology. However, a conducive business climate and supportive government policies have encouraged foreign investors to deepen and diversify their manufacturing and service operations, as well move up the value-added and technological ladders, providing Singapore with valuable engineering and management know-how in the process.

The Economic Development Board (EDB), the Trade Development Board (TDB) and the MAS offer a broad range of attractive tax and other incentives to investments relevant to Singapore's goal of becoming a knowledge-based economy and a global financial center.

RIGHT TO PRIVATE OWNERSHIP AND ESTABLISHMENT

Foreign and local entities may freely establish and operate their own enterprises in Singapore. Except for representative offices, whereby foreign firms maintain a local representative but do not conduct commercial transactions in Singapore, there are no restrictions on carrying out remunerative activities.

All businesses in Singapore must be registered with the Registry of Companies and Businesses. Foreign investors can operate their businesses in one of the following forms:

- Sole proprietorship: an individual operating as a sole trader regulated under the business registration act;
- Partnership: two to 20 persons, regulated under the business registration act;
- Incorporated company: comprising not more than 50 shareholders and operating as a company limited by shares or guarantee, or as an unlimited company regulated by the provisions of the Companies Act ;
- Foreign company: registered as a branch of the parent company under the Companies Act but not incorporated as a Singapore company; or
- Representative office: offices of foreign corporations, which undertake promotional and liaison activities on their parent company's behalf. They must not engage in business, conclude contracts, provide consultancy for a fee, undertake transshipment of goods, or open or negotiate any letters of credit directly or on behalf of their parent companies.

TRANSPARENCY OF THE REGULATORY SYSTEM

Singapore's regulatory environment is business-friendly and is characterized by transparency and clarity. The bureaucracy is efficient and effective.

Prior to implementing any law or regulation, the government usually consults relevant bodies and agencies, companies and the public. Tax, labor, banking and finance, industrial health and safety, arbitration, wage and training rules and regulations are formulated and reviewed with the interests of foreign investors and local enterprises in mind. However, local laws give regulatory bodies wide discretion to modify regulations and impose new conditions. This allows government agencies to negotiate the way they provide incentives or other services to foreign companies on a case-by-case basis.

FDI-RELATED INSTITUTIONAL STRUCTURE IN SINGAPORE

The highest institution involved in FDI obviously is the Government of Singapore, which acted as both the facilitator and entrepreneur. The EDB has traditionally been responsible for investment legislation and tax incentives to promote FDI. Following the findings and recommendations of the Economic Committee, which identified the service sector as the other engine of growth, the EDB was tasked to promote this sector as well. Other statutory boards also play important facilitating roles in FDI promotion.

Since the launch of the regionalization policy in 1993, the Trade Development Board (TDB) has enlarged its functions in promoting companies abroad. The National Science and Technology Board (NSTB) is another statutory board, which has a clear mandate in terms of driving the restructuring effort on to a high technology road. There are other infrastructures, which promote FDI in Singapore, such as in the Science Park to enhance high technology industries.

PHASES OF SINGAPORE ECONOMIC DEVELOPMENT AND MAJOR INVESTMENT RELATED POLICIES

Phase I, 1959-1967 Inward looking development Policy

- Import substitution
- EDB set up in 1961
- Independent sovereign state in 1965
- Basic tax incentives for investments
- Economic expansion Incentives Act
- Labour intensive activities preferred

Phase II, 1968-1978 Outward oriented Development Policy

- Employment Act, 1968
- Industrial Relation Act, 1968
- Transition to more capital intensive activities

- Export promotion

Phase III, 1979-1985 Restructuring Policy

- Intensification of export promotion
- Corrective wage policy
- Skill development Policy
- Priority list of industries for foreign investments: capital and technology intensive

Phase IV, 1986- Post recession Development Policy

- Service sector promotion
- Introduction of investment allowance
- Wage reform
- Regionalization

GOVERNMENT OF SINGAPORE

The Government of Singapore believes in the basic freedom of private enterprises and encourages foreign investments in the country. Consistent with this philosophy, no restrictions are imposed on foreign investments. However, certain industries which the Government deemed essential, such as utilities, telecommunications, public housing and education, weapons and ammunition production, the legal system, were closed to private enterprises, or were made subject to prior approval of appropriate government authorities for undertaking private investment in those areas (see table). The Government also has extensive ownership in key industries such as banking, shipbuilding, tourism and trading Government participation in industry may take one of the two organizational forms: as a statutory board or as a limited liability company.

In order to stimulate investment in Singapore the Government created joint venture companies with private local and foreign investors. The Government believed that through its investment, it would remove bottlenecks to the expansion of private industry and thus would provide a positive encouragement to further private investment. The Government aimed to help overcome initial entrepreneurial difficulties, strengthen the confidence of private investors and spearhead new ventures through equity participation under the Capital Assistance Scheme established by the Economic Development Board.

Public investment was only intended to complement private investment and not to compete with it.

The establishment of the various statutory boards was for the purpose of meeting specific needs and to accelerate economic growth. The basic rationale for these mostly monopolistic institutions was to provide the necessary infrastructure for the Government's ambitious industrialization programme and to supply low-priced (public and merit) goods and services.

PRIOR APPROVAL FROM. RELEVANT GOVERNMENT AUTHORITIES MUST BE OBTAINED BEFORE ANY OF THE FOLLOWING BUSINESS ACTIVITIES CAN BE UNDERTAKEN

Business activities	Relevant authorities
Banking, finance, insurance, stock broking, commodity trading, money changing and remittance.	Monetary Authority of Singapore/Commissioner of Insurance.
Certain manufacturing and industries within the scope of the Control of Manufacture Act.	Industry Development Division of the Economic Development Board.
Electrical work and contracting	Public Utilities Board
Housing development	Controller of Housing
Shipping establishments with foreign interest	Trade Development Board
Broadcasting	Ministry of Information and the Arts
Newspapers and printing	Ministry of Information and the Arts
Travel agents	Singapore Tourist Promotion Board
Massage/health centers	Licensing Officer Massage Establishments Section, Ministry of Community Development
Hotels, restaurants and entertainment	1. Hotel Licensing Board- Hotels section of the Ministry of Community Development. 2. Building Control Division- Ministry of National Development 3. Licensing and Entertainment Division (Customs and Excise Department).

	4. Liquor license if required can be obtained from the Customs and Excise Department.

ECONOMIC DEVELOPMENT BOARD

On the basis of recommendations of the World Bank, the British colonial government had created the Industrial Promotion Board (IPB) in 1957 to encourage investment by private enterprises in Singapore. However, promotion policies were not thoroughly thought through. Hence, the IPB limited its activities to giving away subsidies to already existing companies. In 1961, the government dissolved the IPB, incorporated the Economic Development Board (EDB) as a statutory board and transferred the assets of the former to the latter. The government granted the EDB a substantial budget of $ 100 million and provided it with far-reaching powers laid down in the Economic Development Ordinance of 1961. It has among others, the power:

- To underwrite the issue of stocks, shares, bonds or debentures of industrial enterprises with the written approval of the Minister of Finance.
- To guarantee loans raised by industrial enterprises with the written approval of the Minister of Finance.
- To grant loans to industrial enterprises;
- To manage, control, supervise, or invest in industrial enterprises;
- To acquire, sell or lease land for industrial sites or for general economic development;
- To provide technical advice and assistance.

From the beginning, the EDB approached potential investors in a very pragmatic way. Besides dealing with enquiries and evaluating applications for tax and other incentives, the EDB, through its *one-stop service*, assisted investors to obtain land and factory space, long term financing, skilled manpower and other services. Within a few days an investor could sign an agreement with the EDB and could start producing within three months.

Currently there was hardly any restriction on the types of businesses that could be set up in Singapore. For some businesses, such as banks, finance companies, insurance and stock-broking firms, however, special licenses have to be obtained from the government. There are also no restrictions on the remittances of profits, repatriation of capital or any equity ownership. With this favourable business environment in connection with a stable and pro-business oriented government, Singapore strives to be an excellent choice for setting up production facilities in South-East Asia.

EDB administers the series of tax incentives granted to investors under the Economic Expansion Incentives.

Each investor is treated as a client and the EDB tries its best in meeting the needs of the client and always with a view to establishing a long-term relationship based on mutual trust. The prosperity of the corporation and the economic well being of the whole economy is co terminus. With the trend towards business globalization, the EDB has adopted strategic marketing initiatives efforts are made to match investors growth plans with Singapore's economic development goals to ensure a mutually beneficial business fit.

TRADE DEVELOPMENT BOARD

The Trade Development Board (TDB) is a statutory today established to specifically assist Singaporean businessmen in meeting the dynamic challenged of today's international trade. The mission of the TDB is to contribute to Singapore's prosperity through trade expansion especially by developing the international trading hub and assisting Singapore companies to expand business overseas. The goals of TDB are:

- To develop Singapore as an international trading hub and distribution center through several schemes which are aimed to attracting international firms to use Singapore as their regional headquarters;
- Promoting Singapore's export of goods and services and develop new markets;

- Assist Singapore companies to expand their businesses overseas in line with the regionalisation efforts, especially in creating the synergy between international companies in Singapore and local firms;
- Safeguard and further enhance Singapore's external trade interest through bilateral, regional and global for a such as the ASEAN, Asia Pacific Economic Cooperation (APEC), World Trade Organization (WTO) and others;
- Administer and facilitate Singapore's international trading system.

The TDB provides assistance to both local and foreign companies through an intensive network of world-wide offices. It arranges business appointments with suppliers and organizes trade missions and the participation of Singapore companies in international trade fairs.

In 1989, TDB launched TradeNet, an electronic data interchange network which enables traders to submit a single trade declaration through a computer to all relevant processing authorities. It is envisaged that the system will completely replace paper documentation. In addition, the TDB Globalink was also introduced to provide on-line customized trade information to cater for the needs of the business community.

NATIONAL SCIENCE AND TECHNOLOGY BOARD

The National Science and Technology Board (NSTB) was formed in 1991 to develop Singapore into a center of excellence in selected fields of science and technology so as to enhance Singapore's international competitiveness in the industrial and service sectors. Its major activities are:

- Formulation of the National Technology Plan which has two crucial targets, namely, to raise the national expenditure on research and development (R&D) from 0.9 per cent in 1991 to 2 per cent of GDP by 1995 and to increase the number of research scientists and engineers from 29 for every 10,000 workers to 40 over the same period.

- Conduct of a national survey to monitors R&D expenditure and activities in the public and private sectors including institutions of higher education and public research institutes;
- Taking over the Research and Development Assistance Scheme (RDAS) from the Science Council to stimulate company-based R&D by providing grants;
- Providing funding for six public research institutes comprising Grumman International-National Technological University for Computer-Integrated Manufacturing (GINTIC), Institute of Molecular and Cell Biology (IMCB), Institute of Microelectronics (IME), Institute of Manufacturing Technology (IMT), Institute of Systems Science (ISS) and Information Technology Institute (ITI);
- Promoting manpower development to increase research scientists and engineers which included the launching of the Joint Industry Masters Programme to sponsor employees in TNCs for Masters courses in local and foreign universities.

SCIENCE PARK

The idea of the Singapore Science Park was first mooted in the 1970s by the EDB but the concept took off in collaboration with the Ministry of Trade and Industry in 1979. The specific objectives of the Singapore Science Park include:

- Promotion and development of high technology industries and highly trained scientists, engineers and technocrats;
- Stimulating research and innovation in manufacturing and information technology;
- Fostering interaction among researchers in the Science Park and various universities, polytechnics and research institutes;
- Facilitating EDB's investment promotion efforts by centralizing R&D personnel and facilities in one "nucleus" area at the Science Park which is in close proximity with other universities and research

institutions in the "western corridor of technology" (western part of Singapore);

- Pooling and sharing R&D facilities and services in the Science Park to bring about "agglomeration economies" through linkages among established firms.
- Providing a critical mass to launch future R&D programmes.

NATIONAL COMPUTER BOARD

The National Computer Board (NCB) was established in 1981 dedicated to the development of information technology (IT) and make Singapore an exploiter and provider of IT products and services. As the IT architect, the NCB envisions, defines and helps create the information infrastructure to spawn new applications and services. The prototype version of the National Information Infrastructure (NII) developed by NCB and its partners was launched in 1993. It will deliver information services to people at work or in homes. The massive infrastructure consists of a high-speed conduit, a software architecture for service providers to build useful services and a content architecture for efficient exchange of multimedia information through the conduit.

CONCLUSION

The Government and its agencies aim to work together with the private sector to make Singapore one of the easiest places in the world to do business in. An efficient bureaucracy, market performing incentives and interventions as well as a sound macroeconomic policy help to fulfill this role.

CONCLUSION

From the study, it follows therefore that the best way to limit the risks associated with FDI, avoid its undesirable effects, and increase the likelihood of it making a positive contribution to a country's socio-economic development efforts is to pursue a policy of-

a) selectivity with respect to the magnitude and timing of capital inflows including FDI. This implies that governments should be able to determine the composition of capital inflows and to formulate appropriate policies of government intervention to manage capital inflows, including those of FDI.

b) selectivity with respect to specific projects, with preference for those with large technological spill-overs or other important socio-economic benefits. This may involve confining FDI to economic sectors and sub-sectors regarded as priorities in the country's overall socio-economic development.

c) Further liberalizing the procedural technicalities involved.

With regard to the provision of investment incentives, the evidence is that investment incentives make only a marginal difference to the likelihood of attracting FDI. However, at present no country can afford to refrain from offering such incentives from fear that potential investment will flow to similarly placed countries with respect to locational advantages but which also offer investment incentives. Clearly, all developing countries lose from competition among themselves to offer ever-greater foreign investment incentives. The policy conclusion to be drawn, therefore, is that, in addition to being selective in their acceptance of FDI, developing countries would benefit collectively from co-operation on the matter of investment incentives rather than competition in this sphere[146].

[146] They will in any case need to consider a joint approach to the matter of investment incentives that forms part of the agenda relating to the WTO Agreement on Subsidies and Countervailing Measures (ASCM). Already ASCM stipulates that certain fiscal, financial or indirect incentives are considered as subsidies in that they provide a financial contribution or constitute an incoming payment foregone by a government or public body. As such they are prohibited and subject to multilateral disciplines.

In India, foreign direct investment policy has been given a concrete shape, keeping in mind the following issues vital for the country's economic freedom.

1. Scarcity of foreign exchange resources, which necessitates a judicious use of available foreign exchange in sectors considered to be vital for development of the country

2. The need of appropriate and most recent technology and, therefore, the utilization of foreign exchange reserves for transfer of technology needed for enhancing international competitiveness;

3. The required perception that is essential to create a broad industrial base so that the increasing needs of ever rising population could be met effectively and efficiently; and

4. The firm conviction to be self-reliant strengthened by the colonial experience, which brought home the need of giving much emphasis on the development of indigenous know-how, skilled manpower, entrepreneurship and managerial skills.

In India, inflows of foreign direct investment have been a part of exchange regulation directives and as a result, foreign investors did find it more complicated and irritant. They also complained that rules relating to inflows of foreign direct investment have not been of comprehensive nature and they have been scattered in different statutes, regulations, circulars and guidelines. What has been needed by them have been the availability of all sorts of information relating to the areas identified for inviting foreign direct investment, norms to be followed by the foreign investors, organization to whom they should contact for FDUI, the time required for accepting and rejecting the proposal, and the provisions in regard to penalties if laws have been violated in one Act so that conducive environment could be created for them.

Foreign Direct Investment Policy of a country is only one of the several factors that the corporate units consider while deciding on an investment location. The FDI policy determines the ease of accessing the domestic market and the terms and conditions of entry. How the country is perceived as a desirable location in the long run depends on a firm's strategic considerations, which are unique to itself. An investor, therefore, cannot concern himself with only the Industrial Policy but he must evaluate the entire spectrum of rules, regulations and operating conditions once he is in. consequently issues like law and order conditions, labour policy etc., become as important as the FDI policy itself.

This brings the State level policies and procedures firmly in the picture. In the Indian polity, the States provide the location, the infrastructure, the works. They also extend,

increasingly these days, a host of incentives to attract investment, irrespective of their origin. State Governments and their agencies are responsible for the numerous clearances, approvals and operating procedures. It is this whole package of laws, systems and procedures and not the FDI policy which is considered by the far-sighted investor. And this is where India seems to be losing out to other competing countries.

From the standpoint of a foreign investor, a policy is also evaluated in terms of transparency, stability and adequacy. It appears that in all these counts, foreign investors have some reservations. Transparency means that the ground rules are clearly laid out. This is not the case whenever an investment proposal does not fall under the category of "automatic approval". This is also the situation in the case of raising equity from the current level to a higher level for an existing firm. Stability is an important element in any policy appraisal. Unless the corporate body is sure that the present policy will continue for ome time, it is not in a position to take a decision. Unfortunately, the records withy respect to stability is rather poor. The classic case relate to tax laws, some of which are changed in every budget, sometimes with retrospective effects.

Adequacy is to be defined with respect to the policy objective, i.e. whether the constituent elements of the total policy mix are adequate to achieve the overall objective of the policy. FDI policy package seems to be failing on this account as well. For example, it is more or less accepted by all that India's IPR regime is fairly weak especially in some sectors.

Incremental character and *ad hocism* in policy making should be avoided as far as possible. Policy relating to foreign investment in the power sector is a classic case where policies and procedures have been in a state of flux for a long time.

FDI should not be seen as an objective by itself but instead as a means to promoting the achievement of national development goals. For example, FDI can be instrumental for the attainment of higher rates of economic growth, higher real wages, higher rates of employment, the reduction of unemployment, underemployment and poverty, redressing

social exclusion and regional inequalities, the promotion of gender equality, higher job quality, and environmental sustainability of development. It is therefore recommended that India should, *inter alia,* -

- Enhance domestic environment for attracting as well as absorbing investments, foreign as well as domestic – good governance, emphasis on infrastructure, macroeconomic stability and commitment of the state to social development.
- Establish an institutional base for attracting and regulating investments
- Develop a strong domestic Competition Policy and a radical improvement in domestic governance.
- Further simplify the tax system

Foreign direct investment is admittedly a potent ingredient in the development process. It is an acknowledged conduit for the transfer of technology and human skills. It is a purveyor of new ideas. It is a source of capital. Policy makers in most developing countries are aware of FDI's contribution to the development process. Indeed, most developing countries, for a variety of reasons (including the decline in bank credit an d aid flows), have eagerly sought foreign investment from major enterprises around the world. Whist they may not have embraced FDI with open arms, most of them now accept it as "a necessary evil". In short, foreign direct investment is a superb catalyst of development, but it is not the prime mover. It functions most effectively as a catalyst only in the presence of the right kind of ingredients in sufficient volumes- therefore any form of regulation should take into account all such ingredients. It is then and only then that the benefits arising from FDI can be reaped to the maximum possible extent.

ANNEXURES

ANNEXURE A

LIST OF ACTIVITIES OR ITEMS FOR WHICH AUTOMATIC ROUTE OF RESERVE BANK FOR INVESTMENT FROM PERSONS RESIDENT OUTSIDE INDIA IS NOT AVAILABLE

1. Banking
2. NBFC's activities in financial services sector
3. Civil aviation
4. Petroleum including exploration/refinery/marketing
5. Housing and real estate development sector for investment from persons other than NRIs/OCBs.
6. Venture capital fund and venture capital company
7. Investing companies in infrastructure and service sector
8. Atomic energy and related projects
9. Defence and strategic industries
10. Agriculture (including plantation)
11. Print Media
12. Broadcasting
13. Postal services

ANNEXURE B

SECTORAL CAP ON INVESTMENTS BY PERSONS RESIDENT OUTSIDE INDIA

Sector	Investment	Description of activites/items/conditions
Telecommunications	49% 100%	a) In basic, cellular mobile, paging and value added services, and global mobile personal communications by satellite subject to the licence from Department of Telecommunication of Government of India. b) In manufacturing activities.
Housing and Real Estate	100%	Only NRIs/OCBs are allowed to invest in the areas listed below: a) Development of service plots and construction of residential premises b) Investment in real estate covering construction of residential and commercial premises including business centers and offices. c) Development of townships d) City and regional level urban infrastructure facilities, including both roads and bridges. e) Investment in manufacture of building materials f) Investment in participatory ventures in (a) to (e) above g) Investment in housing finance institutions.

Coal and Lignite	49% 50%	a) in public sector undertakings and b) in other than public sector undertakings ➢ where private Indian companies are setting up or operating power projects as well as coal or lignite mines for captive consumption; ➢ for setting up coal processing plants provided the company shall not do coal mining and shall not sell washed coal or sized coal form its coal processing plants in the open market and shall supply the washed or sized coal to those parties who are supplying raw coal to coal processing plants for washing or sizing. ➢ For exploaration or mining of coal or lignite for captive consumption.
Drugs and Pharmaseuticals	74%	For bulk drugs, their intermediaries and Formulations (except those produced by the use of recombinant DNA technology).

Hotel and Tourism	51%	a) Hotels include restaurants, beach resorts, and other tourist complexes providing accommodation and/or catering and food facilities to tourists. b) Tourism related industry includes travel agencies, tour operating agencies and tourist transport operating agencies, units providing facilities for cultural, adventure and wild life experience to tourists, surface, air and water transport facilities to tourists, leisure, entertainment amusement, sports and health units for tourist and convention/seminar units and organizations.
Mining	74% 100%	Exploration and mining of diamonds and precious stones Exploration and mining of gold and silver and minerals other than diamonds and precious stones, metallurgy and processing.
Advertising	74%	Advertising sector

Films	100%	Film industry (i.e., film financing, production, distribution, exhibition, marketing and associated activities relating to film industry) subject to the following: a) companies with an established tract record in films, TV, music, finance an insurance. b) The company should have a minimum paid-up capital of US $ 10 million if it is the single largest equity shareholder and at least US $ 5 million in other cases. c) Minimum level of foreign equity investment would be US $2.5 million for the single largest equity shareholder and US $1 million in other cases. d) Debt equity ratio of not more than 1:1 i.e., domestic borrowings shall not exceed equity. e) Provision of dividend balancing would apply.
Any other sector/activity (other than those included in annexure A)	100%	-

ANNEXURE C

GUIDELINES FOR THE CONSIDERATION OF FOREIGN DIRECT INVESTMENT (FDI) PROPOSAL BY THE FOREIGN INVESTMENT PROMOTION BOARD (FIPB)

The following Guidelines are laid-down to enable the Foreign Investment Promotion Board (FIPB) to consider the proposals for Foreign Direct Investment (FDI) and formulate its recommendations.

1. All applications should be put up before the FIPB by the SIA (Secretariat of Industrial Assistance) within 15 days and it should be ensured that comments of the administrative ministries are placed before the Board either prior to/or in the meeting of the Board.

2. Proposals should be considered by the Board keeping in view the time-frame of 30 days for communicating Government decision (i.e. approval of IM/CCFI or rejection as the case may be).

3. In cases in which either the proposal is not cleared or further information is required, in order to obviate delays presentation by applicant in the meeting of the FIPB should be resorted to.

4. While considering cases and making recommendations, FIPB should keep in mind the sectoral requirements and the sectoral policies vis-a-vis the proposal(s).

5. FIPB would consider each proposal in totality (i.e. if it includes apart from foreign investment, technical collaboration/industrial licence) for composite approval or otherwise. However, the FIPB's recommendation would relate only to the approval for foreign financial and technical collaboration and the foreign investor will need to take other prescribed clearances separately.

6. The Board should examine the following while considering proposals submitted to it for consideration:

   (i) Whether the items of activity involve industrial licence or not and if so the considerations for grant of industrial licence must be gone into;

   (ii) Whether the proposal involves technical collaboration and if so, the source and nature of technology sought to be transferred.

(iii) Whether the proposal involves any mandatory requirement for exports and if so whether the applicant is prepared to undertake such obligation (this is for items reserved for small scale sector and for 100% EOUs/EPZ units);

(iv) Whether the proposal involves any export projection and if so the items of export and the projected destinations;

(v) Whether the proposal has concurrent commitment under other schemes such as EPCG Scheme etc.

(vi) In the case of Export Oriented Units (EOUs) whether the prescribed minimum value addition norms and the minimum turn over of exports are met or not;

(vii) Whether the proposal involves relaxation of locational restrictions stipulated in the industrial licensing policy; and

(viii) Whether the proposal has any strategic or defence related considerations.

(ix) Whether the proposal has any previous joint venture or technology transfer/trademark agreement in the same or allied field in India, the detailed circumstance in which it is considered necessary to set-up a new joint venture/enter into new technology transfer (including trade mark), and proof that the new proposal would not in any way jeopardize the interest of the existing joint venture or technology/trade mark partner or other stake holders.

7. While considering proposals the following may be prioritised.

(a) Items/Activities covered under Automatic Route (i.e. those which do qualify for automatic approval).
(b) Items falling in infrastructure sector.
(c) Items which have an export potential
(d) Items which have large scale employment potential and especially for rural people.
(e) Items which have a direct or backward linkage with agro business/farm sector.
(f) Item which have greater social relevance such as hospitals, human resource development, life saving drugs and equipment.
(g) Proposals which result in induction of technology or infusion of capital.

8. The following should be especially considered during the scrutiny and consideration of proposals:

(a) The extent of foreign equity proposed to be held (keeping in view sectoral caps if any - e.g. 24% for SSI units, 40% for air taxi/airlines operators, 49% in basic/cellular/paging, etc. in Telecom sector).

(b) Extent of equity with composition of foreign/NRI (which may include OCB)/resident Indians.

(c) Extent of equity from the point of view whether the proposed project would amount to a holding company/wholly owned subsidiary/a company with dominant foreign investment (i.e. 75% or more) joint venture.

(d) Whether the proposed foreign equity is for setting up a new project (joint venture or otherwise) or whether it is for enlargement of foreign/NRI equity or whether it is for fresh induction of foreign equity/NRI equity in an existing Indian company.

(e) In the case of fresh induction of foreign/NRI equity and/or cases of enlargement of foreign/ NRI equity in existing Indian companies whether there is a resolution of the Board of Directors supporting the said induction/enlargement of foreign/NRI equity and whether there is a shareholders agreement or not.

(f) In the case of induction of fresh equity in the existing Indian companies and/or enlargement of foreign equity in existing Indian companies, the reason why the proposal has been made and the modality for induction/enhancement [i.e. whether by increase of paid up capital/authorised capital, transfer of shares (hostile or otherwise) whether by rights issue, or by what modality].

Cases pertaining to FIPB approvals, which involve increase in the non-resident equity within the approved percentage of non-resident equity in a joint venture company and enhancement of paid-up capital in a wholly owned subsidiary do not require FIPB approval provided the intent for increase in the amount of foreign equity is duly notified to SIA and formal documentation by way of intimation is made to SIA within 30 days of receipt of funds and allotment of shares (to non-resident shareholders).

(g) Issue/transfer/pricing of shares will be as per SEBI/RBI guidelines.

(h) Whether the activity is an industrial or a service activity or a combination of both.

(i) Whether the item of activity involves any restriction by way of reservation for the small scale sector.

(j) Whether there are any sectoral restrictions on the activity (e.g. there is ban on foreign investment in real estate while it is not so for NRI/OCB investment).

(k) Whether the item involves only trading activity and if so whether it involves export or both export and import, or also includes domestic trading and if domestic trading whether it also includes retail trading.

(l) Whether the proposal involves import of items which are either hazardous, banned or detrimental to environment (e.g. import of plastic scrap or recycled plastics).

9. In respect of actvities to which equity caps apply, FIPB may consider recommending higher levels of foreign equity as compared to the prescribed caps, keeping in view the special requirements and merits of each case.

10. In respect of other industries/activities the Board may consider recommending 51 per cent foreign equity on examination of each individual proposal. For higher levels of equity up to 74 per cent the Board may consider such proposals keeping in view considerations such as the extent of capital needed for the project, the nature and quality of technology, the requirements of marketing and management skills and the commitment for exports.

11. FIPB may consider and recommend proposals for 100 percent foreign owned holding/subsidiary companies based on the following criteria :

(a) where only "holding" operation is involved and all subsequent/downstream investments to be carried out would require prior approval of the Government.
(b) where proprietary technology is sought to be protected or sophisticated technology is proposed to be brought in;
(c) where at least 50% of production is to be exported;
(d) Proposals for consultancy; and
(e) Proposals for industrial model towns/industrial parks or estates.

12. In special cases, where the foreign investor is unable initially to identify an Indian joint venture partner, the Board may consider and recommend proposals permitting 100 per cent foreign equity on a temporary basis on the condition that the foreign investor would divest to the Indian parties (either individual, joint venture partners or general public or both) at least 26 per cent of its equity within a period of 3-5 years.

13. Similarly in the case of a joint venture, where the Indian partner is unable to raise resources for expansion/technological upgradation of the existing industrial activity the Board may consider and recommend increase in the proportion/percentage (up to 100 per cent) of the foreign equity in the enterprise.

14. In respect of trading companies, 100 per cent foreign equity may be permitted in the case of the activities involving the following :

(i) exports;
(ii) bulk imports with ex-port/ex-bonded warehouse sales;
(iii) cash and carry wholesale trading;
(iv) other import of goods or services provided at least 75% is for procurement and sale of goods and services among the companies of the same group and not for third party use or onward transfer / distribution / sales.

15. In respect of the companies in the infrastructure/services sector where there is a prescribed cap for foreign investment, only the direct investment should be considered for the prescribed cap and foreign investment in an investing company should not be set off against this cap provided the foreign direct investment in such investing company does not exceed 49 per cent and the management of the investing company is with the Indian owners.

16. No condition specific to the letter of approval issued to a foreign investor would be changed or additional condition imposed subsequent to the issue of a letter of approval. This would not prohibit changes in general policies and regulations applicable to the industrial sector.

17. Where in case of a proposal (not being 100% subsidiary) foreign direct investment has been approved up to a designated percentage of foreign equity in the joint venture company the percentage would not be reduced while permitting induction of additional capital subsequently. Also in the case of approved activities, if the foreign investor(s) concerned wished to bring in additional capital on later dates keeping the investment to such approved activities, FIPB would recommend such cases for approval on an automatic basis.

18. As regards proposal for private sector banks, the application would be considered only after "in principle" permission is obtained from the Reserve Bank of India (RBI).

19. The restrictions prescribed for proposals in various sectors as obtained, at present, are given in the annexure-IV and these should be kept in view while considering the proposals.

The Guidelines are meant to assist the FIPB to consider proposals in an objective and transparent manner. These would not in any way restrict the flexibility or bind the FIPB from considering the proposals in their totality or making recommendation based on other criteria or special circumstances or features it considers relevant. Besides these are in the nature of administrative Guidelines and would not in any way be legally binding in respect of any recommendation to be made by the FIPB of decisions to be taken by the Government in cases involving Foreign Direct Investment (FDI).

These guidelines are issued without prejudice to the Government's right to issue fresh guidelines or change the legal provisions and policies whenever considered necessary.

ANNEXURE D

TECHNICAL KNOW -HOW AGREEMENT

(Source: Amarchand & Mangaldas & Suresh A Shroff & Co., Bangalore)

THIS AGREEMENT is made on [ ] day of [ ] 2002 BETWEEN:

(1) ______________ **LTD.**, a company incorporated under the laws of Japan and having its registered / principal office at ______________ ("**Licensor**", which expression shall, unless repugnant to the context or meaning thereof, be deemed to include its successors in business and permitted assigns); and

(2) a company incorporated under the laws of India and having its registered office at [*insert address*] ("**Licensee**" which expression shall, unless repugnant to the context or meaning thereof, be deemed to include its successors in business and permitted assigns).

Licensor and Licensee are referred to herein individually as "Licensor" and "Licensee" respectively or as "Party" or collectively as "Parties".

WHEREAS:

(A) Licensor has developed and is in possession of know-how, technology and technical information relating to the Product;

(B) Licensee has been incorporated pursuant to a Joint Venture Agreement dated [*insert date*] ("JV Agreement") for the primary purposes of carrying on the business of manufacture, development, distribution and sale of the Product;

(C) Under that certain JV Agreement, Licensor has agreed to grant and make available to Licensee such know-how, technology and technical information including any improvements in relation to the Product;

(D) The Parties desire to record the terms on which Licensor will make available to Licensee such know-how, technology and technical information.

NOW THEREFORE, it is hereby agreed between the Parties as follows :

1. DEFINITIONS

1.1 In this Agreement, unless the context otherwise requires:

"Commencement Date"	means [date of this Agreement];
"Improvement(s)"	means all improvements, enhancements, modifications or adaptations to any part of the Technical Information and the Technical Know-How including, but not limited to, any process or methods;
["Licensed Territory"	means the Republic of India;
"Product"	means ______________________;
"Technical Information"	means all of the technical information, including data, know-how, experience, documentation, specifications, process, methods, systems and practices relating to the manufacture, processing, finishing, sale, use and application of the Product available to Licensor as of the Commencement Date, which Licensor has a right to license or disclose within the Licensed Territory and which Licensor is not prohibited from disclosing by virtue of any laws or effective contractual obligations as of the Commencement Date;
"Technical Know-How"	means all of the skills, expertise and experience in relation to the manufacture, processing, finishing and testing of the Product and implementation / use of the Technical Information;
"Training and Technical Assistance Agreement"	means the agreement entered into of even date between the Parties in respect of Licensor providing training and technical assistance to Licensee.

2. INTERPRETATION

2.1 References to sections, clauses and schedules are to the sections, clauses and schedules of this Agreement.

2.2 Words importing the singular include the plural; words importing any gender include every gender.

2.3 Words, terms and abbreviations which are not otherwise defined herein and have well-known technical, trade or industry meanings are used in this Agreement in accordance with such established meanings.

2.4 All determinations, consents, reviews or approvals to be granted and conducted by the Parties under this Agreement and any other acts calling for the exercise of discretion

shall be performed in good faith. Where the time periods are not specified, a reasonable period of time shall be allowed.

2.5 Words elsewhere defined / explained in this Agreement shall have the meaning so ascribed.

2.6 Unless the context otherwise requires reference to section, sub-section or schedule is to a section, sub-section or schedule (as the case may be) of or to this Agreement.

2.7 The section headings do not form part of this Agreement and are for convenience only and shall not be taken into account in its construction or interpretation.

2.8 The headings in this Agreement are inserted for convenience only and shall be ignored in construing this Agreement.

2.9 The rule known as the *ejusdem generis* rule shall not apply and accordingly general words introduced by the word "other" shall not be given a restrictive meaning by reason of the fact that they are preceded by words indicating a particular class of acts, matters or things.

2.10 General words shall not be given a restrictive meaning by reason of the fact that they are followed by particular examples intended to be embraced by the general words.

3. GRANT

3.1 Licensor grants to Licensee at no cost, on the terms set out in this Agreement, an exclusive license

3.1.1 to use the Technical Information within the Licensed Territory in respect of the Product; and

3.1.2 to use the Technical Know-How within the Licensed Territory in respect of the Product.

4. DURATION

This Agreement shall commence on the Commencement Date and shall continue unless terminated in any of the circumstances set out at clause 9 of this Agreement.

5. CONSIDERATION FOR THE GRANT

5.1 The consideration for this Agreement is that certain Joint Venture Agreement referred to in the recitals to this Agreement.

5.2 No monetary consideration shall be payable by Licensee to Licensor in relation to the grant of the Technical Information or of the Technical Know-How.

5.3 Licensee shall, however, reimburse to Licensor the cost, if any incurred by Licensor, for translating the Technical Information into the English language.

5.4 Licensee shall reimburse to Licensor (on actuals) expenses incurred by Licensor for importing the Technical Know-How to Licensee as provided in the Training and technical Assistance Agreement.

6. FURNISHING OF TECHNICAL INFORMATION AND TECHNICAL KNOW-HOW

6.1 Licensor shall commence furnishing to Licensee Technical Information -

6.1.1 immediately after the Commencement Date and shall complete the transfer as soon as possible and in any event within [x] months from the Commencement Date;

6.1.2 the Technical Information will be delivered to Licensee at Licensor facilities in Japan or such other location as may be determined by Licensor;

6.1.3 the Technical Information shall be in the English language and the metric system;

6.1.4 if and to the extent the Technical Information (or any part of the Technical Information) is the electronic media, Licensor will ensure that that is debugged; a back up copy is also available; and a disaster recovery mechanism is accessible to Licensor.

6.2 The Technical Know-How will be imported by Licensor to Licensee at Licensor's facilities in Japan.

7. IMPROVEMENTS

7.1 Any Improvements commercially implemented by Licensor during the term of this Agreement shall be promptly disclosed and made available by Licensor to Licensee.

7.2 Improvements disclosed by Licensor to Licensee shall be deemed to be part of and governed by this Agreement.

8. ADAPTATIONS

8.1 Licensee may adapt any part of the Technical Information provided –

8.1.1 Licensee is satisfied that any such adaptation will not adversely affect the quality of the Product;

8.1.2 if and to the extent reasonably required by Licensor, conducting tests / trial runs before commercially implementing any such adaptation;

8.1.3 makes available to Licensor, at Licensor's request, such adaptation for use by Licensor at Licensor's facilities in Japan.

8.2 Any adaptation made available by Licensee to Licensor shall be used exclusively by Licensor for its own purposes and Licensor shall not licence or otherwise import or permit any third party (including any Licensor affiliate) any such adaptation without prior consent of Licensee on terms mutually agreed.

9. SUB-LICENCE

Licensee may sub-licence limited portions of Technical Information to Licensee's suppliers [including contráct manufacturer(s) / processor(s)] Provided Licensee shall first require such manufacturer(s) / processor(s) to enter into a confidentiality covenant in form and content reasonably approved by Licensor.

10. WARRANTIES

10.1 Licensor hereby represents and warrants that -

10.1.1 it owns or is otherwise well and sufficiently entitled to the Technical Know-How and have full rights and authority to grant this licence to Licensee;

10.1.2 to the best of it's knowledge and belief the Technical Information is accurate and sufficient to enable Licensee to manufacture Product of quality commensurate with the quality of the Product manufactured by Licensor (provided always that that Licensor will promptly correct any significant errors in the Technical Information subsequently discovered by Licensor);

10.1.3 Licensor is not aware that the Technical Know-How or the use of the Technical Know-How infringes the rights of any third party;

10.1.4 Licensor will indemnify Licensee against any third party claim against Licensee that the Technical Know-How infringes such third party's rights;

10.1.5 Licensor has obtained corporate approvals, if any required, to enter into this Agreement and perform its obligations under this Agreement.

11. TERMINATION

11.1 Subject to sub-clause two below, this Agreement shall be coterminous with the JV Agreement,

11.2 Each Party shall have right to terminate this Agreement upon [x] days written notice to the other Party upon the happening of all or any of the following events and in such event, all the licenses, rights and permissions granted hereunder shall cease and terminate:

11.2.1 upon either Party making any arrangement or composition with its creditors or going into liquidation voluntary or otherwise (other than a liquidation for purpose of reconstruction or amalgamation, the terms of which have been approved by the other Party and the transferee/emergent company undertakes to comply with the terms and conditions of the Agreement).

12. EFFECT OF TERMINATION

12.1 On termination, Licensee shall return to Licensor all of the documents (whether in electronic form or otherwise). Licensee may continue to manufacture the Product with the experience and expertise derived by it.

12.2 On termination Licensor shall return to Licensee all adaptation received from Licensee except to the extent that any such adaptation is not in a recorded medium.

12.3 All provisions of this Agreement which in order to give effect to their meaning need to survive its termination shall remain in full force and effect thereafter.

13. CONFIDENTIALITY

13.1 Each Party agrees to maintain secret and confidential all Technical Know-How obtained from the other pursuant to this Agreement to use the same exclusively for the purposes of this Agreement and to disclose the same only to those employees pursuant to this Agreement to whom and to the extent that such disclosure is reasonably necessary for the purposes of this Agreement or otherwise as expressly permitted by this Agreement.

13.2 The foregoing obligations of sub-clause (1) above shall not apply to Technical Know-How which:

13.2.1 prior to receipt thereof from one Party was in the possession of the recipient Party and at its free disposal;

13.2.2 is subsequently disclosed to the recipient Party without any obligations of confidence by a third party who has not derived it directly or indirectly from the other Party;

13.2.3 is or becomes generally available to the public through no act or default of the recipient Party or its agents or employees;

13.2.4 which is required to disclosed by law.

14. NON-WAIVER

The failure or delay of either Party to require performance by the other of any provision of this Agreement shall not affect its right to require performance of such provision unless and until such performance has been waived in writing.

15. NOTICE

All notices which are required to be given hereunder shall be in writing and shall be sent to the address of the recipient set out below or such other address as the recipient may designate and may be delivered personally or by facsimile transmission or by sending the same through registered post or international courier. Each notice shall be deemed to have been served if by personal delivery when delivered, if by prepaid post seven (7) days after posting and if by facsimile transmission upon receipt of the answer back receipt.

Licensor: *insert address, fax number and attention details*

Licensee: *insert address, fax number and attention details*

16. ASSIGNMENT

The licence granted hereunder is personal and shall not be assignable or transferable.

17. SEVERABILITY

Notwithstanding that any provision of this Agreement may prove to be illegal or unenforceable, the remaining provisions of this Agreement shall continue in full force and effect.

18. MODIFICATION

No modification or amendment of this Agreement and no waiver of any of the terms or conditions hereof shall be binding unless made in writing duly executed by each of the Parties.

19. ARBITRATION

19.1 Except as otherwise provided under clause 19.5 below, all disputes, differences, controversies and questions directly or indirectly arising at any time under, out of, in connection with or in relation to this Agreement including, without limitation,

all disputes, differences, controversies and questions relating to the validity, interpretation, construction, performance and enforcement of any provision of this Agreement, shall be finally, exclusively and conclusively settled by reference to arbitration by a sole arbitrator under the Arbitration and Conciliation Act, 1996.

19.2 The arbitration proceedings shall be conducted in Mumbai, in the English language.

19.3 The Parties agree:

19.3.1 to be bound by any arbitral award or order resulting from any arbitration conducted hereunder;

19.3.2 not to commence, procure, participate in, or otherwise be involved in any action or proceeding that might result in any judgement, injunction, order or decision of any court concerning a dispute, controversy or question falling within clause 19 save and except for obtaining any judgement or order recognising or enforcing an arbitral award or order made in such arbitration or to maintain, as far as may be, status quo and otherwise preserve rights under this Agreement pending the reference to arbitration or during the arbitration proceedings.

19.4 The prevailing Party in any arbitration conducted under this Clause shall be entitled to recover from the other Party (as part of the arbitral award or order) its or their reasonable attorneys' fees and other costs of arbitration on actuals.

20. APPLICABLE LAW

This Agreement shall be governed by and construed in accordance with the laws of India.

21. COUNTERPARTS

This Agreement may be executed in any number of counterparts, each of which will be deemed an original, but all of which will constitute one and the same instrument.

IN WITNESS WHEREOF, the Parties hereto have caused this Agreement to be executed as of the day and year first above written by their duly authorised representatives.

LIMITED

By:....................................

Title:..................................

Date:............................2002

_____________________ LIMITED

By:.....................................

Title:..................................

Date:.............................2002

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