For years, many researchers and economists analysing the impact of foreign direct investment (FDI) inflows into developing countries have been concerned that the influence and control of foreign direct investors and the consequences of FDI for the host countries go far beyond that is captured by national FDI statistics.

According to economic theory, the three principal contributions of FDI to a host country are: (1) the financial capital invested by foreign firms; (2) the export market access provided by them; and (3) the faster technology development that is expected to occur through technology transfer as part of the FDI package. Each of these is believed to help the host country to achieve faster industrial catching-up than is feasible otherwise and thus contribute to the host country’s economic growth and development. The first two aspects are usually examined by analysing: (1) the shares of FDI in total external capital inflows into a host economy and gross domestic capital formation; (2) the extent and pattern of foreign ownership in various sectors in terms of the industrial composition of FDI inflows and sources of FDI; and (3) the export-orientation of foreign-invested firms.

In more in-depth studies, FDI’s export contribution has also been sought to be examined by relating the ownership structure and export-orientation of firms at the industry-level. But, it has been well understood that the role played by foreign enterprises could be more important than suggested by the average share of ownership in particular industries, since domestic partners in foreign-invested companies generally rely heavily on the technological and managerial expertise, marketing networks, etc. of their foreign partners. This is why, for examining the above mentioned third aspect of whether FDI contributes to technological upgradation and skill formation in the host country researchers have used the methodology of case studies to examine issues related to technology transfer within the direct invested company and the extent of domestic forward and backward integration achieved by foreign invested firms.

**FDI Definition**

The underlying rationale of all such analytical exercises to capture the overall impact of FDI inflows has been the basic understanding that because foreign investors often maintain tight control over operations of affiliated companies given the ownership advantages linked to their proprietary assets and lasting interest, the impact and implications of FDI for the development of host economies are very different from those of foreign portfolio capital inflows that are pure financial investments seeking capital gains. It is worth recalling that it is based on this distinction between FDI and foreign portfolio investment that developing countries have been encouraged (and often, compelled) to promote FDI through various investment incentives and liberalisation of their FDI policies since the early 1980s. Given that the key differentiating characteristic of FDI is the foreign direct investor’s necessity to maintain control, despite the existence of differing view points on the threshold of equity share to be considered as a controlling share, what has been internationally recognised as FDI has been the OECD Benchmark Definition of Foreign Direct Investment:

*Foreign direct investment reflects the objective of establishing a lasting interest by a resident enterprise in one economy (direct investor) in an enterprise (direct investment enterprise) that is resident in an economy other than that of the direct investor… The direct or indirect ownership of 10% or more of the voting power of an enterprise resident in one economy by an investor resident in another economy is evidence of such a relationship.*

It is clear that the central aspect of the operational FDI definition is lasting interest to be captured through a foreign investor’s ownership of minimum 10 per cent voting power in the
invested company. As the OECD definition explains, “the lasting interest implies the existence of a long-term relationship between the direct investor and the direct invested enterprise and a significant degree of influence on the management of the enterprise”. Evidently, this is how the foreign direct investor can maintain his ownership advantages over his proprietary assets.

Given that it is not possible to do detailed industry and firm-level studies at all times, the most immediate measure of the contribution of FDI in a host country is given by the absolute amount of recorded FDI inflows. In this context it came to be recognised that direct investment is not solely limited to equity investment (to be captured by a minimum 10% equity share) but also relates to reinvested earnings and inter-company debt. In the context of many countries, the concern has been that the ratios of FDI inflows to total capital inflows as well as those to gross domestic investment tend to understate the financial importance of FDI for a host economy, because recorded FDI flows do not capture even the complete financial contribution of foreign affiliates in many countries. This was true for several developed and developing countries like India, Thailand, etc., which did not include either reinvested earnings or inter-company debt or both in the reported FDI data until a few years ago.

But, given that we now live in a different world of proliferating Free Trade Agreements (FTAs) and Bilateral Investment Treaties (BITs) involving investment liberalisation that make privileges and treatment accorded to foreign direct investors legally binding, it may be important to recognise that beyond the concerns of being able to capture the ‘real’ financial and economic contribution of FDI inflows, developing country governments promoting FDI need to be aware that FDI definitions are also about protecting the ‘rights’ of the so-defined investors in the host country.

**FDI Policy in India**

It is in this context that it is pertinent looking at what the current FDI policy in India points to. Recently, the Department of Industrial Policy and Promotion (DIPP) under India’s Ministry of Commerce and Industry released the Draft Press Note on FDI Regulatory Framework consolidating all prior regulations on FDI into one document for comments. It reflects the current ‘regulatory framework’ on FDI in India. While the Draft Note confirms that:

“The motivation of the direct investor is a strategic long term relationship with the direct investment enterprise to ensure the significant degree of influence by the direct investor in the management of the direct investment enterprise”; it goes on clarify that “in India the ‘lasting interest’ is not evinced by any minimum holding of percentage of equity capital/shares/voting rights in the investment enterprise”.

Clearly, India is not following the international best practice. The attempt seems to be to try and capture the broad influence of FDI inflows in our economies by including all kinds of foreign capital into the definition of FDI.

This can serve two purposes. Clearly, such a catch-all definition that treats all foreign investments in Indian companies’ equity capital as FDI irrespective of the extent of their share will inflate the FDI inflow figures. This is surely helpful in cheering up ‘free market’ advocates who have been lamenting the smaller amounts of FDI received by India in comparison to those received by China and have constantly been pushing for greater policy liberalization for attracting larger amounts of FDI into India. Analysts and academicians have already pointed to the increasing role of private equity in the observed sharp increase in FDI figures and the increased routing of inflows through the tax havens in the years since 2005. Through a pioneering analysis of the officially largest 1832 individual cases of FDI inflows into India during the period 2004-2008, Rao and Dhar (2010) have just come out with empirical evidence on how FDI figures in India are indeed an overestimate if one were to consider the ‘normal’ Dunning type of FDI. Separating out private equity (PE) investors and portfolio investors as well as those controlled by Indians from the FDI category and considering only “Typical FDI” that would add to the
existing facilities, they found that only a little less than half of the inflows could be categorised under the FDI category. They have considered as FDI only those inflows from “foreign investors operating in the same sectors in their home countries and can be expected to be long-term players and can be expected to bring in not only capital but also associated benefits and on their own strength”.

**Direct Investment Categories**

Clearly, adding more investor/asset classes to the direct investment category will make this overestimation of actual FDI even worse. As already mentioned, the problems of dealing with assessing the development implications and macroeconomic consequences of FDI inflows under the prevailing norms already abound. Blurring the lines between direct and portfolio investments will also make a proper assessment of the true benefits from and consequences of FDI inflows more and more complicated and difficult. But, in addition to these problems, the consequences of having such broad national FDI definition without a clear distinction between direct and portfolio investments can be dangerous for India’s remaining policy space related to investment policies and capital controls. This is because, treating all foreign investments in Indian companies’ equity capital as FDI irrespective of the extent of their share will also make all these categories of foreign investors (or/and assets) eligible for the privileges and treatment accorded to FDI, such as freedom for capital repatriation and investment/investor protection including ‘investor-state dispute settlement’ mechanism. Further, lack of clarity in national FDI definitions can take away any leverage we have in investment negotiations with developed countries in Free Trade Agreements (FTAs), Economic Partnership Agreements (EPAs), etc. and will contribute to a wider process of multilateralisation of investment rules, as we shall discuss later on.

As shown by Rao and Dhar (2010), in inflows recorded as FDI in India, there are investments by banks and other financial intermediaries. However, going by the basic characteristics of FDI, these investments seeking purely capital gains cannot be considered FDI, unless they are in their own sectors (that is, in the financial sector itself). In the second category are investments by Private Equity (PE) funds, which are also generally not known to contribute anything more than risk capital. While venture capital is a form of private equity typically provided for early-stage, high-potential, growth companies, by definition VCs also take a role in managing these entrepreneurial companies, thus adding skills as well as capital. In this sense, they are differentiated from buy out private equity which typically invests in more ‘mature’ companies. However, both investments are in the interest of realising a return through an initial public offer (IPO) or sale of the company, unlike the lasting interest entailed in typical FDI. In a third category are investments by foreign investors who have base in India and who have expanded out of India, which have been identified as Round Tripping. It is contended that irrespective of whether the money brought in by them is raised abroad or might have been taken out by them at some point in the past, this category is also kept out of the consideration of FDI given that control over the investee company remains with Indians who have strong base in India. In particular, these investments also do not bring in any assets other than financial capital.

**Permission Routes**

Why has this anomaly come about? This has to do with the range of instruments through which FDI is allowed in India. Under the FDI scheme in India, an Indian entity/enterprise can issue equity shares/fully convertible preference shares/fully convertible debentures to raise FDI and after such issuance the company has to submit details about the above mentioned instruments in the prescribed (FCGPR) form to the Reserve Bank of India (RBI). However, a company can also issue only fully convertible preference shares/fully convertible debentures, without any equity participation from the foreign investor. So, if a foreign investor invests in fully convertible preference shares/debentures without any equity participation (or with equity participation...
below 10%), even then it is included as part of FDI. Only non-convertible, optionally convertible or partially convertible preference shares for issue of which funds have been received on or after May 1, 2007 are considered as debt (and accordingly, all norms applicable to external commercial borrowings or ECBs apply). Fully convertible preference shares are not only considered as equity, but they are also included when calculating the foreign direct investment (FDI) cap in sectors where foreign equity limits apply. While the finance ministry had made this differentiation in April 2007 in order to reduce the large amount of foreign capital (especially private equity) flowing into the real estate sector through the route of preference shares without adhering to any regulation on interest rates offered on these shares, sectoral equity caps, etc., considering foreign investment in fully convertible preference shares without any equity participation as FDI is problematic for two reasons at least. Most such investments are by international banks, other financial intermediaries and PE funds that not only do not have any lasting interest in the investee company, but these investors also do not own any proprietary assets in the area of operation of the investee company. Thus, in no way do these foreign investments conform to the understanding of what FDI entails. They are simply portfolio investments seeking capital gains. In fact, IMF’s BOP Manual 6 considers even fully convertible preference shares/debentures as debt instruments. Similarly, in India, Depository Receipts (DRs) and Foreign Currency Convertible Bonds (FCCBs) are also considered as FDI. Again, an FII can invest in a particular share issue of an Indian company either under the FDI Scheme or the Portfolio Investment Scheme. The Indian company which has issued shares to FIIs under the FDI Regulation for which the payment has been received directly into company’s account has to report these figures separately to the RBI in the FC-GPR Form (Annex) (Post-issue pattern of shareholding). However, it is not clear why institutional investors should be allowed under the FDI route at all. It should be noted that from June 1998 onwards, registered FIIs can individually hold up to a maximum of 10% of a company’s total issued capital and aggregate FII limit for a sector was raised to the sectoral cap for foreign investment as of September 2001. But, an FII can also invest in the equity shares of a company on behalf of his sub-accounts, wherein the investment on behalf of each such sub-account, in case of foreign corporates or individuals, can be up to a maximum 5% of the total issued capital of that company. We already know that the Participatory Notes (PNs) that are Offshore Derivate Instruments [ODI] in nature, are used by investors or hedge funds, which are not registered with the Securities and Exchange Board of India (SEBI), to invest in Indian securities market through these sub-accounts. Thus, for calculating both direct foreign investment (i.e. non-resident investment) in an Indian company and indirect foreign investment in an Indian company (wherein an Indian company having foreign investment in turn invests in another company), all kinds of foreign investment, namely, investment by FIIs (holding as of March 31), NRIs, ADRs, GDRs, FCCBs and convertible preference shares/debentures are considered in addition to FDI.

Indian experience shows these “new types of investors” already account for a significant proportion of the total inflows coming in as FDI, especially through the tax havens. Rao and Dhar (2010) found that just less than three-fourths of the inflows during 2004-2008 under the Round Tripping and PE/VC categories of investors entered through the Automatic route that does not require any prior approval from the government. They also found that typically these PE/VC and Round Tripping categories of inflows passed through the tax havens. These investors do not even profess to contribute anything more than a short-term financial contribution to the invested company.

**Dangers Involved**

What is the problem with the classification of an asset class that is primarily portfolio investment as FDI in the national FDI definition? First, the country is extending the ‘preferential’ conditions of entry and operations that are offered to FDI to a class of investors whose actual identity is
often unknown and some of whom are not regulated in their own home countries. Secondly, despite the fact that these investors cannot be argued to be either bringing in any intangible ownership advantages to the host companies or contributing to national investments in the medium term (since they are known to sell and move out), it is clear that they enjoy the freedom for capital repatriation enjoyed by foreign direct investors. Thus, the country’s ability to control inward and outward capital movements are being hampered, which can have detrimental consequences as we have seen in the recent global financial crisis.

These lead us to a more far reaching consequence. By defining FDI to include all sorts of foreign investment, the government could unwittingly contribute to a process that has been warned to be of serious consequences for the policy space of developing countries. It is important not to forget that in 1998, the OECD’s attempt to implement a Multilateral Agreement on Investment (MAI) was rejected because of the very fact that developed and developing countries could not agree on the extent of flexibility required by the latter in investment policies within a multilateral framework. With strong opposition from developing countries, investment was thus excluded from negotiations in the 2003 WTO Cancun Ministerial when a Multilateral Framework on Investment (MFI) was sought to be incorporated. Apart from GATS that brought in FDI in services under the WTO by defining trade in services through four modes including “commercial presence” of the foreign provider, the only major FDI-related regulation at the WTO level remained the agreement on Trade Related Investment Measures (TRIMS). The latter abolished a number of legitimate performance requirements that several governments (most successfully Japan and the East Asian newly industrialised countries) used to impose on direct investors in order to ensure that their investments contributed to meeting development objectives of the host countries. But unsatisfied with TRIMS, developed nations like the EU, US and Japan have been introducing the so-called Singapore Issues in bilateral FTAs and in particular, deepening investment liberalisation using bilateral and plurilateral negotiations (FTAs, EPAs, etc.) as a means to eventually re-introduce investment at the multilateral level negotiations.

Analysts studying investment issues in Bilateral Investment Treaties (BITs), RTAs and Comprehensive Economic Partnership Agreements (CEPA) have in the recent years been warning of the dangers involved in a broad definition of investment while negotiating standards for entry and operation of foreign enterprises in developing countries. Why exactly has a broad definition of investment been opposed in trade negotiations? It has been found that North-South FTAs and BITs often have provisions (typically under a Current Payments and Capital Movements section) requiring all transfers relating to the investment from the contracting parties to be allowed without delay into and out of their territories. Typically, these transfers cover contributions to capital, profits, capital gains, dividends, interest, loan repayments, etc. Use of capital controls as a policy measure is allowed only as defined under the safeguard measures in each agreement. In most investment agreements with developed countries, safeguard measures through restriction on capital flows are by definition to be used only under an emergency situations in case of “serious difficulties” with monetary or exchange rate policy or balance of payments and can only be used temporarily. Clearly, this prevents countries from utilising different capital control measures in order to ‘prevent’ a BoP crisis.

In this context, it is interesting to note that some years back, the IMF staff report for the 2003 Article IV consultation for the United States had questioned whether the investment provisions in US preferential trade agreements (PTAs) could leave the partner countries too vulnerable to surges in capital inflows. Apart from the US FTAs, the EU FTAs and Japan’s Economic Partnership Arrangements (EPAs) also increasingly include broad definitions of investment. Japan’s EPA with Malaysia is a case in point. Most EU FTAs with developing countries such as EU-CARIFORUM and EU-South Africa also include portfolio investment as a way to rule out host country controls over capital flows. A study on investment provisions in EU FTAs found that only in the case of the EU-Chile FTA, the developing country preserved the right of its
central bank to exert control over capital flows as stated by its constitutional law. During 1991-1998, Chile had imposed a 30% deposit over a period of one year for all incoming capital, which had great success in limiting short-term flows, currency volatility and contagion of external crises. Chile’s agreement with the EU allows it to impose restrictions up to one year which can be renewed indefinitely, but on the other hand established limits to the amount of reserves to be deposited in the central bank as a requirement for capital moving in or out the country of up to 30% and for only two years. As for other existing EU agreements, the case of EU-CARIFORUM agreement, the most recent to be signed by the EU, is revealing. Restrictions on capital flows can only be imposed as “strictly necessary” and for a maximum period of six months. It should be noted that Thailand’s central bank had also imposed a 30% withholding tax on inward investments to slow speculation on the Thai baht in 2006 and kept this in place for two years. It is clear that if we define investment to include investments other than FDI, these provisions seriously reduce the ability of developing country members to regulate the flows linked with speculative capital market transactions and hot money inflows.

Thirdly, the investment chapter in FTAs generally accords national treatment and most-favored-nation treatment to foreign investors. Both these provisions grant equality of treatment to national and foreign investors in “like circumstances”. This can create unforeseen problems as in the current crisis wherein a country’s ability to carry out stimulus measures and carry out bailouts aimed at ensuring systemic stability of the financial sector can also be challenged on grounds that they deny a foreign investor’s right to “fair and equitable treatment.”

Gallagher (2010) points out that such an argument was made against the Czech Republic, when a foreign firm said the Czech Republic had violated its rights by excluding a small bank in which it had invested from a bailout program made available to larger “too big to fail” Czech banks.

Another controversial provision in the investment chapters in US agreements in the context of investor-state disputes are those related to the issues of expropriation and compensation. For example, the investment chapter in the US-Chile FTA is practically identical to the controversial Chapter 11 of the NAFTA. NAFTA includes a list of rights for multinational corporations, which allow, among other benefits, for businesses to sue central Governments if they feel that actions which violate their rights have been taken. Similarly, the US-CAFTA FTA also prohibits direct and indirect expropriation (or nationalization). Direct expropriation is a well-defined term, which refers to the nationalization, transfer of title or seizure of private property by the host government. The legal texts mention the phrase “indirect expropriation by measures equivalent (or tantamount) to expropriation or nationalization.” Thus the actions of the State ‘measures’ are broadly defined, which permit a range of interpretations of these actions by which legitimate regulations on the part of the State can be brought under litigation for affecting the profits of the ‘investor’. This can include regulations at the sub-federal and local government levels.

These have been some of the most controversial issues under which broad investment definitions have been warned against by several analysts. By having such a broad national FDI definition and moving away from the ‘international best practice’ (which has maintained a critical minimum qualifying share of 10% in equity capital of a domestic entity by a non-national investor for it to be included as FDI), India is not only going against the stand it took in the investment negotiations at the WTO and making a mockery of developing countries’ successful fight against MAI-type multilateral rules, but it will also be doing a great disservice to developing countries in this ongoing battle. This is because if we retain such a broad definition of FDI, this will do away the need for developed country negotiators to define investment broadly! We would have already lost most of the leverage in investment negotiations by way of increasing engagement in RTAs.

There is continuing pressure on developing countries to enter into more bilateral FTAs on the often unjustified premise that they could otherwise lose market access in developed country
markets to competitors. But, once several groups of developing countries have made similar investment agreements under the framework of North-South FTAs, there is a clear danger that these become the benchmark in the future for extending liberalisation at the MFN level in multilateral negotiations. But, what is even more alarming is that South-South FTAs are also seeking to introduce such investment provisions. This is in fact linked to the fact that many developing countries such as India, China and Brazil have seen the emergence of outward investors. For example, if India pushes ahead with inclusion of such investment provisions in its proposed agreement with ASEAN, this can undermine the efforts put in by developing country negotiators over the years to resist multilateralisation of investment rules. This is because some of the ASEAN members already have deep investment liberalisation commitments under EPAs with Japan and are in the process of negotiations with the EU, apart from Australia, the US and many other countries. India is also negotiating with the EU on a proposed FTA. If the European Commission obtains non-discrimination rules in its FTAs with ASEAN and India in a manner similar to that it incorporated in its FTA with CARIFORUM, then, ASEAN and India will have to provide EU investors the same treatment that they may agree in more flexible bilateral agreements with third countries each of them sign even in the future. Thus, if both India and ASEAN agree to EU-CARIFORUM type MFN treatment to EU investors and if India and ASEAN include more flexible rules on investment in the ASEAN-India investment/services chapters in the name of South-South cooperation, all these countries will need to treat EU investors in a similar manner. While detailed analysis is required to understand the interconnectedness of the investment provisions as well as service sector liberalisation commitments in each of the existing and proposed FTAs and their implications for a country’s ability to maintain financial stability, it seems logical to conclude that if developing countries fail to arrest this trend of including other kinds of investments and instruments into FDI definitions at the national and regional levels, the next level of multilateral investment liberalization would have been achieved through these various FTAs without even mentioning it at the WTO!

Thus, if we define FDI within our national regulatory frameworks so broadly and allow instruments and flexibility that were earlier resisted, we would have already lost most of the leverage in investment negotiations at the regional and multilateral levels. This may well become the proverbial last nail in the coffin in the context of developing countries’ struggle to keep out ‘investment’ from liberalization at the multilateral level. Given that many of the consequences of the recent global financial crisis (that originated in the developed world and transmitted to the developing world) are yet to be understood, it does not hurt to reiterate that developing country policymakers would be wiser to err on the side of caution and avoid the entry of capital account liberalisation through broad FDI concepts.

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Notes
4 This sentence is missing in the Consolidated FDI Framework issued by DIPP with effect from 1 April, 2010. However, the fact that a criterion of 10 per cent equity holding is not followed while compiling FDI equity inflow is confirmed by RBI officials. See Gaur, A.P. (2010), “Trends in Direct and portfolio Investments in
India and Data Issues”, Presentation at the Symposium on ‘Concepts, Definition and Data Issues Relating to FDI in India’, jointly organized by ISID and RIS, New Delhi, March 16.


It can be argued that this can help in limiting actual foreign capital control & influence in a particular sector when most of the foreign investments included in calculating the sectoral limit are without voting powers. However, given the problems associated with this broad definition and macroeconomic implications, as we shall discuss later on, it would be better to regulate foreign control through traditional methods.

‘DR’ is negotiable securities issued outside India by a Depository bank, on behalf of an Indian company, which represent the local Rupee denominated equity shares of the company held as deposit by a Custodian bank in India. DRs are traded on Stock Exchanges in the US, Singapore, Luxembourg, etc. DRs listed and traded in the US markets are known as American Depository Receipts (ADRs) and those listed and traded elsewhere are known as Global Depository Receipts (GDRs). FCCBs are bonds issued in accordance with the Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt mechanism) Scheme 1993 and subscribed by non-resident in foreign currency and convertible with ordinary shares of the issuing company in any manner, either in whole, or in part, on the basis of any equity related warrants attached to debt instruments as equity.


For a detailed discussion on the different definitions of “investor” and “investment” under BITs and FTAs and their implications, see Thanadsillapakul, Lawan (2009), Investment Liberalisation under FTAs and Some Legal Issues in International Law, Paper presented at the IDEAs-ITD-GSEI Asian Regional Workshop on FTAs, December, available at http://www.networkideas.org/ideasact/dec09/pdf/Lawan_Thanadsillapakul.pdf


In fact, the OECD currently perceives that “as emerging countries integrate into the world economy and increasingly invest in other countries, the time is right to improve international rules for investment protection… In practical terms, the OECD is considering the feasibility of a non-binding “Model Investment Treaty”, building on converging understandings in OECD and partner countries and invites other organisations to join these reflections”. See Remarks by Angel Gurría, OECD Secretary-General, “The global economy and the global investment agenda - an OECD perspective”, USCIB Global Investment Conference, Washington, 10 March 2010.

See Minambres (2009) for the discussion on the MFN provision in EU-CARIFORUM FTA.