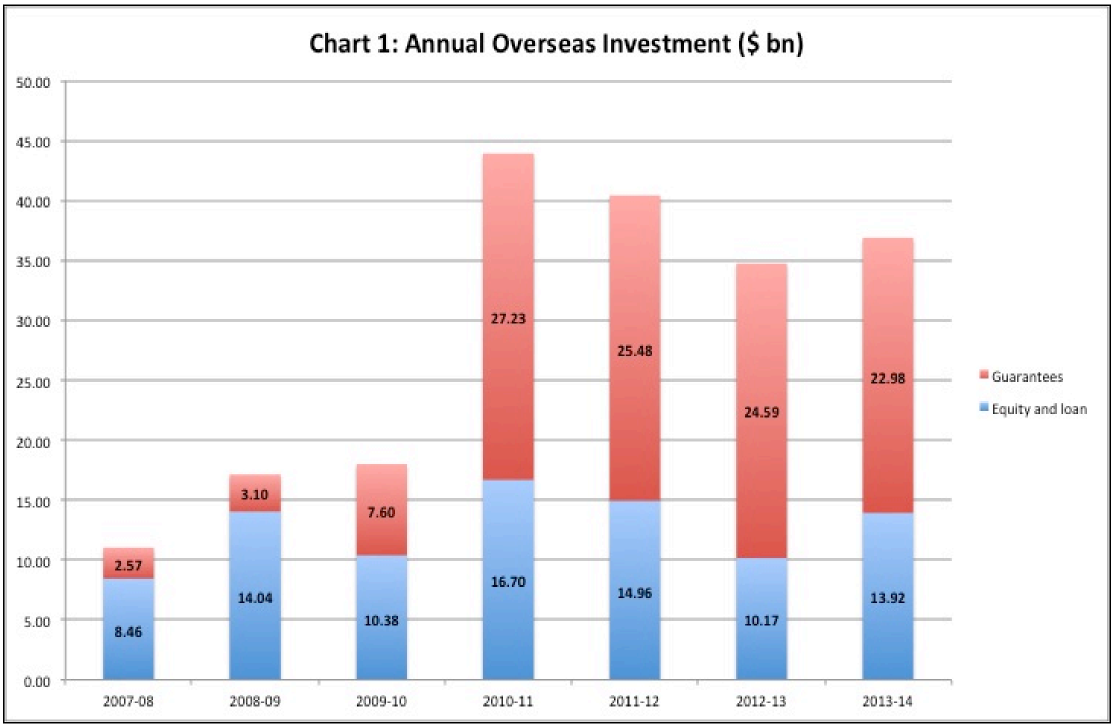
Incentivising Risk-taking Abroad*

C.P. Chandrasekhar

Early in July the Reserve Bank of India announced its decision to restore the limit on Overseas Direct Investment (or the financial commitment made for the purpose) permitted to an Indian party under the automatic route to that prevailing prior to August 14, 2013. On that date the RBI, concerned about a weakening India rupee and possible strain on reserves as a result of capital flight after the US taper, had reduced that limit from 400 per cent of a party's net worth to 100 per cent for investments under the automatic route. Overseas direct investments in excess of these amounts were not banned, but were to be considered under the approval route. The earlier automatic route limit has now been restored, but subject to a new absolute cap. "Any investment exceeding one billion US dollars (or its equivalent) in a financial year would require prior approval of the Reserve Bank even when the total financial commitment of the Indian Party is within the eligible 400 per cent-of-net-worth limit under the automatic route."

Soon after that announcement, in the budget for 2014-15, the Finance Minister chose to extend a concession that had been provided to those repatriating profits from such overseas investments. To quote: "The concessional rate of tax at 15 per cent on dividends received by Indian companies from their foreign subsidiaries has resulted in enhanced repatriation of funds from abroad. I propose to continue with this concessional rate of 15 per cent on foreign dividends without any sunset date."

Clearly, providing Indian private and public sector firms the flexibility to invest abroad as part of their corporate strategy is an important plank of development policy. The result of this has been substantial. While economist Deepak Nayyar estimated that investment abroad by Indian firms rose by just about $10 billion between end-March 2001 and end March 2006, the annual increase in commitments abroad by Indian firms in the form of equity, loan and guarantees issued stood at more than $10 billion in 2007-08 alone, touched an annual figure of about $17-18 billion during 2008-10 and then spiked to stand at $40-44 billion during 2009-11 and $35-37 billion during 2012-14 (Chart 1).



Needless to say, the liberalisation of rule governing investment abroad, encouraged by large inflows of foreign capital, which were well in excess of the sums required to finance the current account deficit in India's balance of payments, provided the background and incentive for this expansion abroad. Since capital inflows involve future payments commitments in the form of interest, dividend and the outflow of capital, this implied that acquisition of assets abroad by Indian firms was being financed with the foreign exchange liabilities of other agents in the country. If this process is to be sustainable, over time the asset acquisition abroad should lead to the repatriation of profits back to the country, adding to the pool of the nation's foreign exchange.

Whether such repatriation occurs or not would depend on: (i) how successful the operations of subsidiaries or joint ventures of Indian firms abroad is; (ii) the willingness of the firms concerned to repatriate profits from abroad rather than use it for further investment outside the country or hold it abroad for speculative reasons, given the trend of depreciation of the Indian rupee; and (iii) the motivation for investments by Indian firms abroad through acquisitions or new projects.

With respect to the first of these factors the expereince of the large investors who dominate total outflows of foreign investment by Indian firms has been varied. While the Tata group may have proved right with the acquisition of Jaguar Land Rover, it is not clear that it did the right thing by acquiring steel-firm Corus at what many considered an inflated price. There are other instances of success (such as the acquisition of Novelis by Aditya Birla group's Hindalco) and failure (such as Bharti Airtel's acquisition of Zain Telecom's African operations). While failure may be unavoidable in a world of atomistic decision making under uncertainty, caution is required when transfering a part of the risk of such faiure to the country as a whole through the use of its foreign exchange labilities to finance such investments. When foreign exchange commitments associated with inflows have to be met, foreign reserves may prove inadequate, have been partly depleted by investments abroad.

Moreover, even while profits were being earned, the evidence seemed to suggest that investors were reticent to repatriate profits from abroad. In fact, the government has been forced to go out of its way to incentivise repatriation by privileging profits earned abroad relative to those earned domestically. In the Finance Act for 2011, the then Minister of Finance declared that he had received a representation that "the taxation of foreign dividends in the hands of resident taxpayers at full rate is a disincentive for their repatriation to India and they continue to remain invested abroad." So in response, he announced the following: "For the year 2011-12, I propose a lower rate of 15% tax on dividends received by an Indian company from its foreign subsidiary. I do hope these funds will now flow to India".

Thus, in essence, the minister had decided to provide an amnesty to those resident investors who had been given access to foreign exchange to acquire assets abroad, but were unwiling to repatriate or bring back any profits earned from the same and pay domestic taxes on such earnings. This privileging of foreign profits over domestic profits in taxation appeared to be an amnesty not only because it, but because it condoned the practice of keeping such profits abroad in order to avoid taxation and because it did so for just a year, ostensibly with the hope of encouraging the once-for-all repatriation of profits accumulated abroad in the past. What is surprising is that this initial "amnesty" has since then been extended year-after-year for an additional one year period, and has now been extended for an indefinite period. "I propose to continue with this concessional rate of 15% on foreign dividends without any sunset date," Finance Minister Arun Jaitley said in his 2014 budget speech. This, in his view, "will ensure stability of taxation policy."

There is reason to believe that this major tax concession, where profits earned abroad were being taxed at 15 per cent rather than the regular 30 per cent plus applicable surcharges, was an important explanation for the sharp increase in investments abroad since 2010-11. As argued above, this increases the country's exposure to the risk of foreign exchange reserve depletion. What we are witnessing is a budgetary transfer to a few firms so that they can earn profits abroad, at the cost of an increase in the foreign exchange risk exposure of the country.

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