Foreign investment into India: An Explanation

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The anomaly

Trade and finance disconnect

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- The U.S. accounts for 16% of India's exports and 6.73% of investments
- Netherlands accounts for 6.58 of investments and negligible trade

India receives its foreign investments from tax havens

Country	2013-14	2014-15	2015-16	2016-17	2017-18	Total	Percentage
Mauritius	3695	5878	7452	13383	13415	43823	34.83
Singapore	4415	5137	12479	6529	9273	37833	30.07
U.S.A.	617	1981	4124	2138	1973	10833	8.61
Netherlands	1157	2154	2330	3234	2677	11552	9.18
Japan	1795	2019	1818	4237	1313	11182	8.89
U.K.	111	1891	842	1301	716	4861	3.86
Cyprus	546	737	488	282	290	2343	1.86
Germany	650	942	927	845	1095	4459	3.54
U.A.E.	239	327	961	645	408	2580	2.05
Others	2828	3681	4646	3723	6207	21085	16.76
Total	16053	24747	36067	36317	37367	125804	100.00

Countries India imports from			Countries India exports to		
Country	% of imports	Rank	Country	% of exports	Rank
China	19.056	1	United States	19.118	1
Saudi Arabia	7.016	2	United Arab Emirates	12.957	2
United States	6.781	3	Hong Kong, China	5.767	3
United Arab Emirates	6.732	4	China	5.150	4
Switzerland	5.575	5	Singapore	3.998	5
Iraq	4.309	6	United Kingdom	3.940	6
Indonesia	4.280	7	Germany	3.357	7
Korea, Rep.	4.127	8	Saudi Arabia	3.041	8
Germany	3.652	9	Bangladesh	2.849	9
Australia	3.271	10	Vietnam	2.801	10

India's trade with main sources of foreign investment					
Countries India imports from			**Countries India exports to**		
Country	**% of imports**	**Rank**	**Country**	**% of exports**	**Rank**
Mauritius	0.008	137	Mauritius	0.384	50
Singapore	2.418	18	Singapore	3.998	5
Netherlands	0.707	34	Netherlands	2.594	11
Cyprus	0.011	130	Cyprus	0.030	133

The prevailing explanation

- These entrepots are tax-havens
- They have low or no taxes
- That is why investments are routed through these countries

Our approach

- Foreign investment is driven by tax treaties
- We develop a measurement system to measure the investor friendliness of tax treaties
- We then measure tax treaties:
    1. Between India and its investor countries
    2. Between Organisation for Economic Cooperation & Development (OECD) countries
    3. Between other similar developing countries and their investors
    4. Between OECD countries and other similar developing countries

Source v. Residence

- There are two approaches to international taxation:

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- There are two approaches to international taxation:
  1. Source-based: The income is taxed in the country where it is generated
  2. Residence-based: The income is taxed in the country where the investor is resident

Measurement method

Identifying provisions

- We chose five provisions which are used to repatriate returns to an investor:
  1. Capital Gains
  2. Permanent Establishment
  3. Interest
  4. Dividend
  5. Royalty

Grading Methodology

- We score the tax treaties on their friendliness with respect to taxes on Income and Capital.
- We develop a grading scale from 1 to 5, where 1 represents a Source Based taxation treaty, and 5 represents a Residence Based Treaty

Grading

- Permanent Establishment
  - Building requirement
  - Other requirements
  - 2 step process
- Capital Gains
  - Is it a negative list?
  - How big is the list?

Grading

- Dividends
  - Tax Rate on Dividends
- Interest
  - Source based tax on interest income
- Royalties
  - Extent and Rate of source based taxation

Data Description

Sample

- We took the top ten investors in a nation as per OECD and UNCTAD Statistics for the preceding five years.
- Derived cumulative ranks for the investors
- Analyzed the treaties with the top 3 investors, along with treaties with global investors

Sample

- No. of Treaties

$$n = 69$$

Block	**Treaties** (n)	**Clauses** (n * 5)
India	17	85
BCSST	31	155
OECD	34	170
Total	69*	345

Table: Sample Size

*Treaties including South Korea and Turkey are included in both the BCSST and OECD block

Blind Review

- We conduct two blind-reviews of the grading for all 345 clauses
  - Reviewers were provided with the grading methodology and treaties
  - Any doubts are addressed by a third party
- We find variance in 19 clauses *(5.51%)* across the 345 clauses, that were marked thrice.

What do we observe?

What do we observe

Country	PE	Div.	Int.	Roy.	CG	Average
India	2.06	3.00	3.59	3.59	3.03	3.05
BCSST	3.47	3.61	3.80	4.00	3.08	3.59
OECD	4.16	3.77	4.01	4.39	3.90	4.05
OECD Convention	5.00	4.00	4.00	5.00	4.00	**4.40**

Table: Extent of Residence Based Taxation

India’s Competitors

Country	PE	Div.	Int.	Roy.	CG	Average
India	2.06	3.00	3.59	3.59	3.03	3.05
Brazil	3.20	3.10	3.00	3.10	1.10	2.70
China	3.13	3.50	4.00	4.00	2.44	3.41
South Africa	4.83	4.00	4.75	5.00	4.00	4.52
South Korea	3.31	3.69	3.75	3.81	3.88	3.69
Turkey	3.00	3.67	3.33	4.00	3.58	3.52

Table: Extent of Residence Based Taxation

- South Africa signs the most tax friendly treaties, especially in the cases of Permanent Establishments and Interest

Tax friendly treaties with Entrepots

- India's treaty signing approach with its entrepots (Mauritius, Singapore) is tax friendly.

Country	**Year**	**PE**	**Div.**	**Int.**	**Roy.**	**CG.**	**Average**
Mauritius	1983	3.0	4.0	4.0	3.0	4.0	3.6
Netherlands	1989	2.0	3.0	4.0	4.0	4.5	3.5
Singapore	1994	2.0	4.0	3.0	4.0	4.0	3.4
U.A.E	1993	4.0	3.0	4.0	4.0	3.0	3.4

Table: Extent of Residence Based Taxation

India signs tax unfriendly treaties with Capital Exporters.

Country	Year	PE	Div.	Int.	Roy.	CG.	Average
USA	1989	1.0	2.0	3.0	2.5	2.0	2.1
United Kingdom	1993	2.0	3.0	3.0	3.0	2.0	2.6
Japan	1990	2.0	3.0	4.0	4.0	3.0	3.2

Table: Extent of Residence Based Taxation

- Japan is the 3rd largest investor in India, accounting for 8.53% of Foreign Direct Investment since 2012

What do we observe

- All of India's friendliest treaties are with entrepots, i.e.
  - Netherlands: 3.60
  - Mauritius: 3.60
  - Singapore: 3.40
  - U.A.E: 3.40
- For e.g.:

United States	Mauritius
120	270

Table: No. of days for a building to be termed as a Permanent Establishment

India Signs Varying Treaties

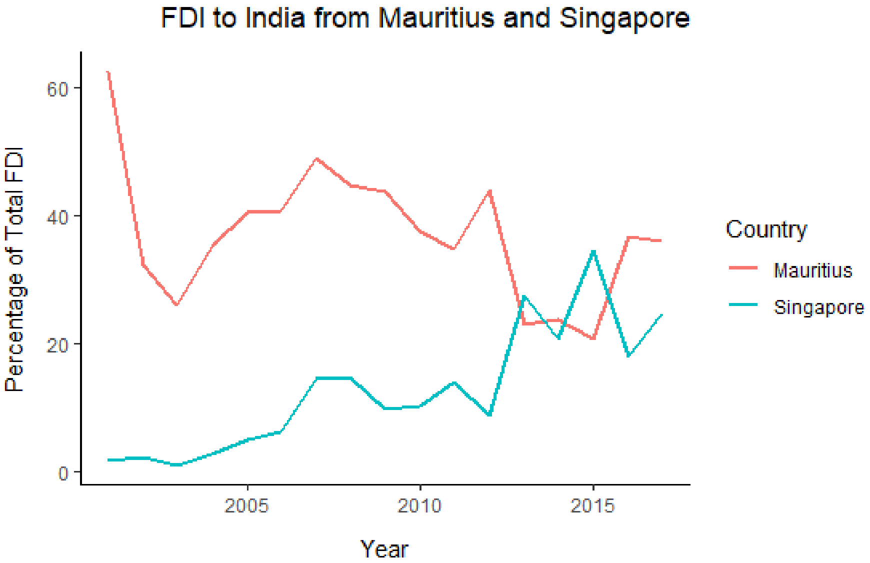
	PE	Div.	Int.	Roy.	CG.	Average
India	0.66	0.50	0.51	0.69	0.74	0.62
Brazil	0.45	0.74	0.00	0.22	0.22	0.33
China	0.83	0.53	0.00	0.00	1.45	0.56
South Africa	0.41	0.00	0.42	0.00	0.55	0.27

Table: Standard Deviation

Outcomes

Mauritius and Singapore

- Before 2005, the India-Singapore treaty was source based for capital gains
- After 2005, the India-Singapore treaty became similar to the India-Mauritius treaty for capital gains


FDI to India from Mauritius and Singapore
Percentage of Total FDI
60
40
20
0
2005
2010
2015
Year
Country
Mauritius
Singapore

2016 Correction

In 2016, India renegotiated its treaty with Mauritius to *align* with the rest of its treaties.

A new aribtrage

	Mauritius (Before)	**Mauritus (After)**	**Singapore (Before)**	**Singapore (After)**
PE	**3**	**3**	**2**	**2**
Dividends	4	4	4	4
Interests	3	4	3	3
Royalties	3	3	4	4
Capital Gains	5	4	5	4
Average	**3.6**	**3.6**	**3.6**	**3.4**

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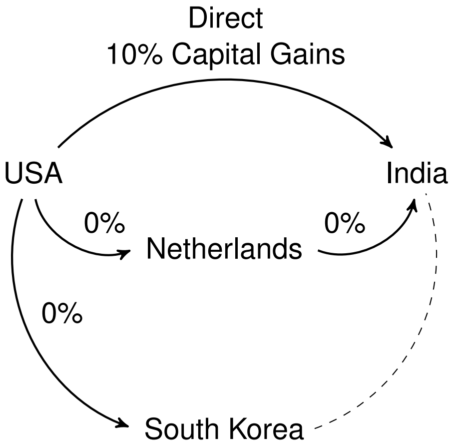
Figure: Inconsistent treaties may be driving investment



Implication

Factors of production

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2. *If Capital and Technology will be taxed higher in jurisdiction, land and labor **will have to be** compensated less to provide the same rate of return to the international investor.*
3. Capital and Technology are taxed at 15%
4. Wages and Rent are taxed domestically 50%

Move towards Residence Model

- Indian domestic taxation will take a long time to clean up
- Source based taxation makes foreign investors subject to the entire uncertainty and poor rule of law of domestic taxation
- Best solution is to move to a more OECD style *residence based taxation regime*