EXPERIENCE THE NEW

PAHLE INDIA FOUNDATION
FACILITATING POLICY CHANGE

Policy Brief

August – October, 2016
Vol 1 – Issue 1

Financial Sector Seminar Series

EXPERIENCE THE NEW

Established in 1875, BSE (formerly known as Bombay Stock Exchange Ltd.), is Asia's first & the Fastest Stock Exchange in world with the speed of 6 micro seconds and one of India's leading exchange groups. Over the past 141 years, BSE has facilitated the growth of the Indian corporate sector by providing it an efficient capital-raising platform. Popularly known as BSE, the bourse was established as "The Native Share & Stock Brokers' Association" in 1875. Today BSE provides an efficient and transparent market for trading in equity, currencies, debt instruments, derivatives, mutual funds. It also has a platform for trading in equities of small-and-medium enterprises (SME). India INX, India's 1st international exchange, located at GIFT CITY IFSC in Ahmedabad is a fully owned subsidiary of BSE. BSE is also the 1st listed stock exchange of India.

Pahle India Foundation (PIF) is an FCRA certified, not for profit policy think tank, established in June 2013 as a Section 8 company. PIF's motto is "Facilitating Policy Change." The motto guides all our activities. At PIF, we undertake research and disseminate its findings to contribute to the necessary paradigm shift in development thinking and practices in India. PIF is committed to enriching the public discourse and also to influence policy formulation that will help India successfully complete its triple transition in economic, political and social fields.

Our aim is to emerge as a credible, trustworthy and neutral bridge between economic agents like firms, farmers and professionals on the one hand and policy makers on the other and to contribute to bringing the three principle stakeholders viz government, industry and academia on the same page and pulling in the same direction - a key condition for ensuring India's success in global markets. PIF currently has an analytically strong team of dedicated researchers who are self motivated. PIF's highly qualified team specialises in analyzing India's political economy and its engagement across verticals that are relatively underworked areas that will permit PIF to create a niche for itself in the research and think tank space in the country.

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About the Seminar Series

India's financial sector compared to its counterparts is still nascent. Our capital markets have not yet developed completely. Our stock and commodity markets are seen by retail investors as a tool for speculation rather than for capital formation. Clearly there is a need for greater research and discussion around policy issues in capital markets space.

With this in mind, Pahle India Foundation (PIF) and Bombay Stock Exchange (BSE) have come together to organise a monthly seminar series, "BSE-PIF Financial Sector Policy Series". The objective of the Seminar Series is to contribute to policy advancement in this important area, by marshalling the available expertise and experience and publishing the proceedings as Policy Briefs.

We have always been committed to submitting a 'Policy Brief' that summarises the discussion after every session, to the regulators and other policymakers, to try and push the policy forward.

Asset Classes and Taxation: Tax Regimes for the Future

Nirupama Soundararajan & Saurabh Roy

Asset Classes and Taxation: Tax Regimes for the Future

Introduction

When an individual or corporate entity invests in an asset class in India, a cascade of taxes is applicable that determine the choice of assets they would prefer to hold (as the income is different from investment gains). An equity instrument, for example, is subject to a securities transaction tax (STT), an exchange transaction fee, a SEBI turnover fee and stamp duty. This is then topped up by service tax on the various service heads (brokerage, exchange and SEBI fee). When the equity instrument is sold there is a capital gains tax depending on the time period for which the equity was held. As of date, the short term capital gains (STCG) tax is applicable for gains booked within a period of 1 year and no tax is applicable for gains booked after a year of holding. If during the period of investment, a dividend is declared, there is a dividend distribution tax that is paid by the company. Every asset class attracts its own basket of taxes.

Tax revenue has been a major source of income for most economies. Many countries have sought to improve their economy by introducing a variety of tax incentives, for investment, for savings, for exports, for employment, for regional development, and so on. It is important to understand how particular tax instruments work in particular environments. Some taxes that appear to be anti-growth and pro-redistribution (such as personal income taxes with highly progressive nominal rate structures) may, at times, have neither of these characteristics, while other taxes, such as the VAT, may seem regressive compared to other tax alternatives, but actually may be mildly progressive (at least between lower and middle income groups).

Taxes in transactions apart from generating revenue for the government are used as a tool for government policy. Investment instruments are no different. Tax exemptions, tax reliefs, low tax rates, or even high tax rates have been used as a means to either increase retail participation, to drive market development, to control market volatilities, and to often steer money from one savings instrument into the other. For example, the argument made usually for any kind of financial transaction taxes (FTTs) has been that it reduces the amount of speculation in the market. However, on the whole, FTT does not necessarily lower the volatility of markets. There is also evidence that transaction taxes cause a fall in asset prices and an increase in the bid-ask spreads. Evidence from the London Stock Exchange indicated that share prices fell by 0.2 per cent and transactions volumes fell by 1.65 per cent for every 1 per cent increase in transactions costs. In the July 2014 budget speech, the Finance Minister increased the tenure of short term from one year to three years for debt instruments and also increased long term capital gains tax (LTCG) to 20 per cent with indexation. This ensured that large volumes of funds moved away from Fixed Maturity Plans (FMPs) to bank deposits, which at that time was losing out to FMPs. However, this move may have ensured that more funds flow into long term debt instruments.

There are a variety of reasons for a differential treatment of capital gains from normal investment. The use of a short term vs long term is generally to promote long term holding of assets. Though preference to LTCG is given due to inflation, lock-in, double taxation and consumption-savings trade-off the academic case that low capital gains tax promotes growth is shaky at best.

The transactions in listed equity stocks are subject to only the financial transaction tax and are exempt from long term capital gains tax. In its scrutiny, the regulatory authority SEBI, identified multiple such penny stocks that get listed on the exchanges. The price of the stock is manipulated to higher levels over the period of time and then post the minimum holding period requirement, the shares are sold in the market. This was identified under the SEBI scanner as transactions done with the intention of market manipulation and tax evasion. The LTCG exemption is justified on the grounds of attracting foreign capital. Since most Foreign Institutional Investors (FIIs) and Foreign Direct Investment (FDI) in India is routed via Singapore or Mauritius, due to the double taxation treaty with these jurisdictions, foreign investors will still avoid most taxation. There is a need for regulators to close this loophole for domestic investors.

The Current Tax Regime

By definition all taxes are distortionary; therefore, before we discuss what is an optimal tax regime, it is important to understand the objective of the tax policy. Tax policy can be designed for various ends some of which are:

- Maximization of revenue,
- Nudging consumer behavior,
- Social redistribution or
- Other ulterior motives.

In India, various taxes and tax breaks are designed to serve one or more of the above stated purposes. However, in our infinite wisdom, we have ended up with a plethora of taxes; the understanding of which eludes all but the most dedicated tax experts.

India, like most countries in the world has adopted a progressive system of direct taxation to serve a social goal of reducing inequality. But if we analyze tax revenues we see that the poor bear a disproportionate amount of tax liabilities. This is because India is an outlier when it comes to collecting taxes. We collect over two thirds of our tax revenue via indirect taxes whereas only one third of the tax revenue is collected via direct taxes on companies and individuals. This is the opposite of what happens in the rest of the world and negates any effect of the progressive direct tax regime. We are also among the least taxed countries in the world with tax-to-GDP ratio at 17 per cent compared to a world average of 35per cent.

The Indian financial system too is plagued by a plethora of taxes and tax exemptions the net effect of which is replete with examples of unintended consequences. A simple trade in a stock incurs four different taxes. Taking a historical look at taxes, the Mauritius tax treaty which allowed capital flowing from Mauritius to be taxed only in Mauritius was intended to drive increased capital inflows into domestic markets. The effective capital gains tax rate in Mauritius is 0per cent. This led domestic investors to demand a similar concession thereby reducing the capital gains tax in India to 0per cent for domestic investors. Similar exemption was granted to private equity as well. Essentially one treaty cascaded to the abolition of long term capital gains in India.

The securities transaction tax was introduced in 2004 with an objective to capture some of the value created by financial markets and to promote long term investing instead of speculation (We do not believe that trading or speculation is essentially good or bad. It serves a very important purpose of providing liquidity to the market which expresses itself in terms of actual reduction in the cost of capital. This is definitely good for the economy). This regime too was not uniformly applied. If investing is considered superior to trading, the transaction tax on derivatives should be more than on underlying products. India has among the most traded derivatives market in the world. The notional of derivatives traded is 17 times the value of underlying traded. This is behind only South Korea but in most developed markets, the ratio is around 2-3 times. The STT on futures is 0.01per cent of the notional whereas for options it is 0.125per cent of the option premium. This is very low compared to the STT on equity which is 0.1per cent of the notional. If the government is serious about promoting long term investing over trading, this needs to be rationalized. A similar situation exists for commodities. To begin with, commodities were exempt from CTT (commodities transaction tax; to promote development of the market) at that point the impact cost of gold futures in India was the lowest in the world. Since the introduction of CTT, the trading has shifted to other locales but the exemption on CTT for agricultural commodities remains.

The long-term capital gains tax on equities has been zero since 2004 when the STT was introduced. Since then, Indians have invested 18 times more money in gold and 21 times more in savings accounts than in equities. There seems to be no evidence that reducing long term capital gains tax to zero has promoted investment in equities. Most savings in India are in the form of physical assets viz. gold and real estate. There are two main reasons for this. Firstly, gold and real estate are vehicles of dirty money and secondly, Indians have been subjected to financial repression for the past few decades when interest rates have been below the rate of inflation. This forces savings towards real assets which maintain their value with inflation. A part of preference of non-financial assets is also explained by ease of access (bank distance/documentation).

Since India has a preponderance towards non-financial assets, it may make sense to incentivize financial transactions by taxing gains from physical assets over financial assets. According to current regulations, if gains from real estate are reinvested in real estate, it does not incur a capital gains tax. This leads to locking in of capital into real estate which never leaves the asset class. The money in financial assets in India is mostly clean money with a clear origination trace. This is not true for other assets like gold, real estate or national savings certificates which are cash investable.

A differential tax is acceptable if it serves some demonstrable purpose. In the absence of such a purpose a differential tax regime is not justified. For example, the National Pension Scheme (NPS) and insurance are very similar products with long term investment goals. However, they operate under very different taxation regimes and has led to an underdeveloped insurance market in India which has shorn the economy of much needed long term capital. The tax exemption for ELSS (equity linked savings scheme) led to an increase in flows into mutual funds in India. Such a tax exemption is possibly justifiable.

Finally, there is a broad consensus that financial intermediation is a very important function. Financial products are sold and not bought. Therefore, returns to intermediaries cannot be zero. There has been continuous regulation towards capping the cost of financial intermediation. This is not necessarily good for the market as Indian retail participants are not financially literate and intermediaries face a real cost in bringing them to the market.

Table 1: Taxes on Asset Classes

S.No.	Asset Class	Type of Taxes
1	Equity	**a. Security Transaction Tax:** STT on equity is charged at 0.1 per cent on each side of the transaction on the notional amount transacted **b. Stamp Duty:** Stamp duty on equity transactions are 0.01 per cent and is applicable only on cash transactions **c. Dividend Tax:** Dividend income is taxed at 10 per cent for dividend income above INR 1 million while companies have to pay a dividend distribution tax at 15 per cent. **d. Capital Gains Tax:** Equity transaction are charged a short term capital gains tax at 15 per cent if the sale transaction is within 12-months. There is no long term capital gains tax for listed securities to promote long duration investing and discourage speculation.
2	Equity Derivatives	**a. Securities Transaction Tax:** Futures are taxed at a rate of 0.01 per cent only on the sell transaction. Options are taxed at a rate of 0.125 per cent on the notional when it is exercised. Options are available for day-trade and taxed at 0.05 per cent on the premium. The option premium itself is a small fraction of the notional amount **b. Capital Gains Tax:** Income from F&O when treated as capital gains is taxed as short term capital gains at 15 per cent
3	Equity Mutual Fund	**a. Dividend Tax:** The dividend received by an individual for an equity MF is completely tax-free. The dividend is also tax-free to the mutual fund house. **b. Capital Gains Tax:** There is a short-term capital gain tax of 15 per cent if the holding period is less than 12-months. There is no capital gain tax when the holding period exceeds 12 months.
4	Debt	**a. Tax on Interest Income:** Interest received on fixed deposits when exceeds INR 10,000, is treated as normal income and taxed at the relevant tax slab. Interest income from Non-convertible debentures (NCDs), held till maturity is also taxed as per the tax slab. **b. Capital Gains Tax:** If the NCD is sold within 1-year, short-term capital gain is taxed as per the income tax slab. However, if the NCD is sold after 1 year, but before the maturity of instrument, long term capital gains from NCD is taxed at 10.3 per cent (including education cess of 3 per cent) without indexation.

S.No.	Asset Class	Type of Taxes
5	Debt Mutual Fund	**a. Dividend Tax:** dividends distributed by debt MF/money markets funds is taxable at 25 per cent **b. Capital Gains Tax:** Short-term (defined as less than 36-months) gains from sale of debt mutual funds are taxed as per the income tax slab, while long-term capital gains attract 10 per cent tax without indexation or 20 per cent with indexation.
6	Commodities	**a. Commodities Transaction Tax:** CTT is taxed at the same rate as equities i.e. 0.1 per cent on each side of the transaction. There are 61 agricultural commodities which are exempt from CTT. Some of these commodities are not yet traded in the markets but in general the reason for not charging CTT is to aid in market development. **b. Capital Gains Tax:** Income from commodity transaction are treated as business income and taxed at the tax slab of the individual.
7	Gold	**a. Capital Gains:** Short term for gold refers to a holding period of less than 36 months. Capital gains arising on account of sale within 36 months, are taxable as per the income tax slab while long-term capital gains are taxed at 20 per cent. However, for the recently introduced Gold Monetisation Scheme and the Sovereign Gold Bond, there is no long term capital gains tax applicable.
8	Real Estate	**a. Stamp Duty:** Stamp duty is a state subject. As an example it is 6 per cent in Mumbai. In addition to the stamp duty, a registration charge of 1 per cent of agreement value is charged. **b. Capital Gains Tax:** Short term for real estate refers to a holding period of less than 36 months. Capital gains arising on account of sale of assets within 36 months of holding period, are taxable as per the income tax slab. Long-term capital gains are taxed at 20 per cent. Since these assets when held for more than 3-years are eligible for indexation on account of cost of inflation, the capital gain reduces considerably. Reinvesting gains in the same asset class exempt the seller from any long term capital gain tax.

Recommendation

We believe that the labyrinth of taxes that we have created needs to be rationalized. While the introduction of GST has simplified the indirect tax regime, a similar exercise is needed for direct taxation.

India is a data scarce country but the data that is available with the government should be disseminated and made available to researchers so that debates can be had in a more robust and factual manner. The government should take the first step and release the tax collections under various heads. This will allow an analysis of whether the various taxes have achieved their stated purpose or have they resulted in unintended consequences that far exceed their utility. We also need to look at the historical reasons for introduction of various taxes and analyze if they are still relevant. All existing distortions in the current regime should be done away with.

- Taxes are imposed to meet certain objectives other than just increasing the tax collection by the government. Government should provide access to the tax collection data which can help to analyse if the objectives are being met by those taxes.
- It is suggested to either extend the tenure of short term investment into equity stocks or to take away the tax exemption and bring equity at par with Non-Convertible Debentures (NCDs) in terms of LTCG taxation.
- If the government wishes to focus on long term investment by the public rather than short term trading then it should reduce the STT on underlying products or at least equate it to the STT charged on the derivatives of such products. Presently, the STT charged on derivatives is much higher than that charged on the underlying products.
- Taxing the gains made from physical assets should take priority over taxation of gains made through financial assets. This will increase the flow of liquidity to the financial markets.
- Tax differentials in the system should be removed unless they serve a purpose to the economy. Otherwise they just limit the growth of the market with higher taxes.

Interoperability between Clearing Corporations

Gunja Kapoor

Interoperability between Clearing Corporations

Introduction

Technology has played a significant role in growth of global securities markets. With rapid evolution and adoption of technology, investors are empowered with tools that allow them to trade across multiple asset classes irrespective of their physical location. Increase in technology has improved market efficiency and reduced costs.

With momentous increase in trading volumes on the back of technology, the need for robust market infrastructure to support seamless transactions arose. Regulators felt the need to review the state of market infrastructure intermediaries (such as exchanges, clearing corporations, and depositories) and address issues that arose from their ownership and governance. In this context, SEBI framed the Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012 which defined a broad framework for regulation, supervision and monitoring of the Stock Exchanges and Clearing Corporations.

There are three SEBI recognised clearing corporations namely, Indian Clearing Corporation Limited (ICCL), National Securities Clearing Corporation Limited (NSCCL), and Metropolitan Clearing Corporation of India Limited (MCCIL). Under the existing infrastructure, margins need to be positioned at respective clearing corporations, till the time pay-ins are completed. Consequently, it was observed that capital gets locked for a particular duration of time (even if transactions are off-setting in nature), preventing markets from maximising capital utilisation. One of the ways of increasing capital utilisation was to introduce interoperability of clearing corporations.

Interoperability of clearing corporations is a lucrative phenomenon for trading members mainly because it permits members to clear their trade through a clearing corporation of their choice, irrespective of the stock exchange. This would reduce margin and collateral requirements when there are offsetting trades, or when a member has taken positions on multiple stock exchanges. Moreover, interoperability will allow the securities market to leverage on the economies of scale of a centralised infrastructure model. Nevertheless, it will still allow the stock exchanges to compete on the front end.

The benefits of interoperability of clearing corporations are:

a. Central management of default risks

b. Expansion of product offerings

c. Reduction in number of settlements per day leading to significant cost savings

d. Maximise capital utilisation

The risks of interoperability of clearing corporations are:

a. Lose their edge in terms of unique product offerings

b. Exposed to credit risk of other clearing corporations (this could precipitate into losses in the event of default on a particular clearing corporation).

c. Commoditisation would eventually lead to lack of product innovation

Report of the Committee on Clearing Corporations Securities, 2015

The Report of the Committee on Clearing Corporations Securities, 2015 chaired by Mr. KV Kamath studied the pros and cons of interoperability. The report made some notable recommendations to circumvent risks arising out of interoperability.

a. Clearing corporations may ask for margin and contribute to default fund to mitigate credit exposure on one another in normal and extreme market conditions

b. Clearing corporations may require additional resources, over and above the aforementioned margin and default fund contribution. This will further ameliorate counter party credit risk, in both normal and extreme market conditions

c. Clearing corporations may ask for margin only; no default fund contribution or pledging of additional resources

d. Assuming low probability of clearing corporation default, no margin is charged

e. Collateral is computed based on the expected loss. This algorithm takes into cognisance the resources available post using up all the funds available with the clearing corporation in the event of a default.

Some examples of markets that have allowed interoperability include:

Europe: Europe initiated interoperability between clearing corporations, as the European Union decided to steer towards integrated financial markets. There were more than 11 clearing corporations, and interoperability was seen as a way to reduce participation cost. Currently, interoperability is available for cash transactions only.

United States of America: There are multiple stock exchanges and trading interfaces that provide market information to the public. However, there is a single clearing corporation for the entire cash equity market.

According to the committee, single clearing corporation covering all asset classes would result in high concentration risk and dissuade competition. While the committee does acknowledge the advantages of interoperability of clearing corporations, it believes Indian securities market in its current form and size is not ready to implement the concept. Each clearing corporation is at a different point in the growth curve, and allowing them to function independently would lead to positive synergies, infuse competition and fuel innovation led growth.

Recommendations

- **On Equitable Markets**

  It is the choice of the participant to engage with the clearing corporation, based on balance sheet strength of the clearing corporation, default mechanisms, guarantee funds, and settlement mechanism. This will eventually breed competition; and with competition comes better practices and better mechanisms.

- **On Risk Management**

  - Admittedly, risks are high for clearing corporations as they also stand to bear risks of their counterparts in the market. This can be circumvented through a framework. When a particular clearing corporation breaches a predefined threshold, it is red flagged and kept out of the limits of interoperability till it resolves its books.

  - Clearing corporations will need to mutually agree on a pool of resources and guarantees to ensure all participants are exposed to levelled risk.

- **On Relationship between Clearing Corporations**

  Apart from the peer-to-peer relationship where the collateral flows between "n" clearing corporations, in both directions, there is another relationship that can be explored i.e. "n-1" clearing corporations become a member of one single clearing corporation or an amalgamation of both these structures. This way both risk and processes can be standardized, while clearing corporations continue to retain their intrinsic uniqueness.

Increasing Capital Flows into India

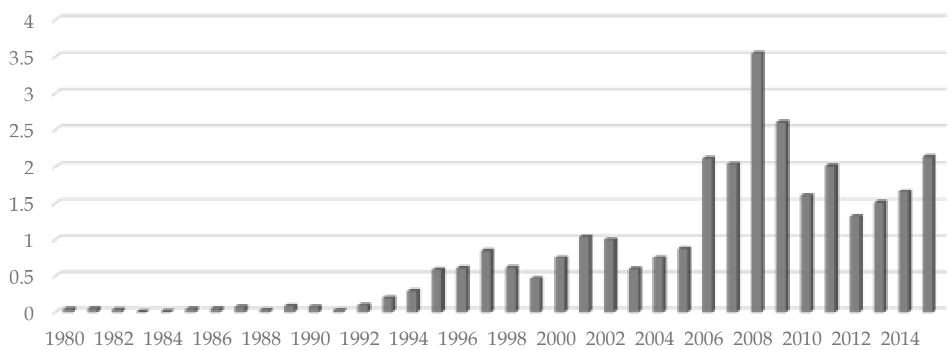
Nirupama Soundararajan & Saurabh Roy

Increasing Capital Flows into India

Prior to the liberalization of 1991, India was a closed economy, relying heavily on domestic investment and import substitution. In 1980s, with increase in oil prices, rise in imports and currency depreciation there was a pressing need for additional capital. Consequently, India began to supplement its capital requirements with international borrowing, thus began India's shift towards a market driven economy.

India began to encourage Foreign Direct Investment (FDI), portfolio investments by easing trade restrictions and adopting current account convertibility. There was a sharp increase in capital inflows between 1992-1997. Portfolio investments were higher than FDI, mainly on account of regulatory procedures that characterise the latter. As external assistance in the form of concessional aid declined, borrowing moved to foreign markets (these borrowings were under strict regulations to mitigate systemic risk). The investment climate in India has been propitious, on the back of an active domestic market, and sustained economic growth.

Figure 1: Foreign Direct Investment, net inflows (% of GDP)



Source: RBI

Non-debt capital flow stems from FDI and FPI. The FDI flow has predominantly been directed towards the services sector, more so towards information technology. While FDI is characterised by steady inflow for long term investments and employment generation, FPI is volatile and sensitive to domestic and international market trends. Thus most governments prefer FDI inflows over FPI. Capital inflow in the form of debt includes External Commercial Borrowings (ECBs), trade credits and NRI deposits (non-repatriable).

Table 1: Trends in Capital Inflow

Year	Foreign Investment	External Assistance, net	Commercial Borrowings, net	NRI
2006-07	29.74	1.79	16.44	4.32
2007-08	62.00	2.12	22.64	0.18
2008-09	27.88	2.79	6.65	4.29
2009-10	65.49	3.26	2.53	2.92
2010-11	60.50	4.97	11.83	3.24
2011-12	50.36	2.45	9.14	11.92
2012-13	54.72	1.27	8.58	14.84
2013-14	35.79	1.23	10.72	38.89*
2014-15	77.48	2.05	0.23	14.06
2015-16	41.26	1.97	-5.86	16.05

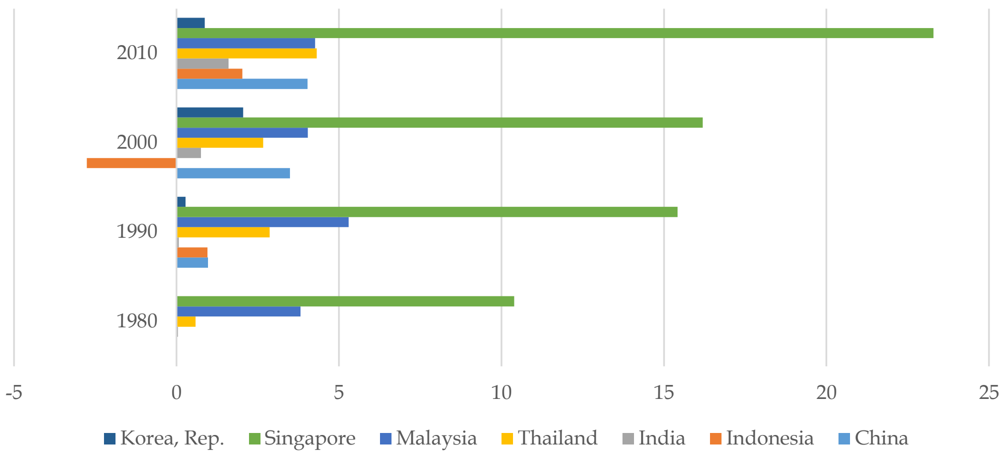
**special subsidy given to attract FCNR deposits*

Source: RBI

Increase in capital inflows in India, post 1991, may be ascribed to a host of factors. First and foremost, investors across the globe were diverting investments to emerging nations that promised a higher rate of return. Second, liberalisation overlapped with improved forex reserves, low inflation and investment grade credit ratings. Macroeconomic variables and economic policies bolstered investor confidence. Investor friendly policies for FDI and FPI, standardisation of accounting methods, establishment of regulatory bodies for investor protection also contributed to pulling investors.

India has a perpetual current account deficit due to its lack of energy resources and the need to import oil for domestic consumption. This deficit in the current account is financed by a surplus in the capital account. However, in times of stress in the international markets, or when the CAD exceeds 3 per cent of the GDP, the rupee has a tendency to become volatile and depreciate. Historically, the Asian tigers financed their growth by heavy reliance on external funding. Even though this led to a meltdown during the crisis of 1997-98, these countries were able to achieve a level of economic growth at which we look on wistfully.

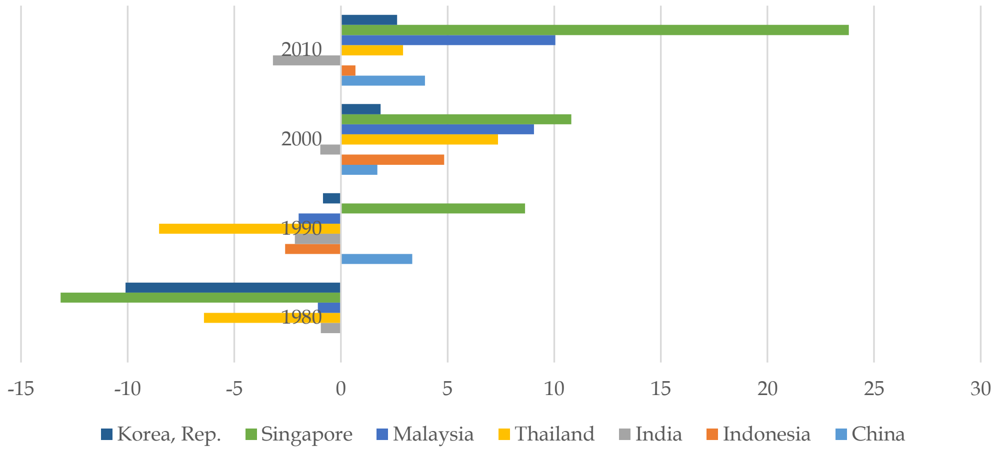
Figure 2: Foreign Direct Investment, net inflows (% of GDP)



Source: CEIC Data

As we can see in Figure 3, all the Asian tigers were current account deficit countries in the 1980s and 1990s. Their growth enabled them to develop and start exporting goods and services which has in turn turned them into current account surplus countries while India still languishes with a major current account deficit and the lowest per capita GDP among its peers.

Figure 3: Current Account Balance (% of GDP)



The Case of India

Capital flows into India in the following ways[1] :

a. Foreign Direct Investment

b. Advance against equity

c. Foreign portfolio investments (FIIs)

d. Foreign portfolio investments (NRIIs)

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1 http://www.bis.org/publ/bppdf/bispap44m.pdf

e. Issue of ADR/GDR

f. Investment in mutual funds

g. G Sec and T Bills

h. Corporate debt

i. Commercial paper

j. Investments in Upper Tier II instruments by Indian banks

k. Investment in other debt instruments

l. Foreign venture capital investors (FVCIs)

m. External Commercial Borrowings (ECBs)

n. Trade credit

o. Delayed import payments

p. Export advance

q. Bank borrowing overseas

r. Investments by NRIs in immoveable property

While capital inflows do burgeon the economy, it has a ripple effect for exchange rate, systemic stability and monetary policies. On the other hand, muted capital inflows can hamper growth, job creation and reduce forex reserves.

There are three policy options available for developing economies.

- Allow an increase in CAD and corresponding currency devaluation
- Restrict capital outflows, closed trade policies and high taxes
- Offset current account outflows through capital account inflows and long term growth

The infrastructure sector is expected to be around USD 1.5 trillion in the next 10 years. Against the backdrop of numerous development projects not being able to kick start solely due to lack of capital, capital inflows are of prime importance. Domestic savings are not adequate to finance investments of this quantum. However, capital inflows are inherently tricky, as they involve forex reserve management, liquidity, and financial markets. Unchecked capital inflow would give birth to inflation, CAD, and excess money supply.

Recommendations

1. Tax policy in India must be predictable. There has to be consistency in the policy to enable planning, especially for foreign investors. Retrospective taxation and “surprise” elements are detrimental to capital inflows.

2. We must re-examine our existing tax treaties to ensure that we minimise tax arbitrages. In the meantime we must constantly evaluate our tax policy to ensure that investor confidence does not diminish.

3. In the context of the approaching General Anti Avoidance Rule (GAAR) in April 2017, we must bear in mind that, when implemented, it will have the right to override any tax treaty, which may not necessarily be favourable. In this context, it is important to provide clarifications to foreign investors, especially to those who come through the P-Note channel, even if it is only 8 per cent of total market volume. This is also important, because it is these band of investor who are likely to change status from a P-Note holder to becoming a FPI.

4. We must ease our KYC norms. We have multiple KYC norms that can be very confusing to a foreign investor, not to mention time consuming. Meeting KYC guidelines alone can drive up the cost of compliance. Financial sector regulators must sit together and come up with a single KYC mechanism that is acceptable to all.

5. Our process of issuing PAN cards must be simplified. Two problems exist.

    a. It takes anywhere between two weeks to a month for issuing a PAN to a foreign investor. Furthermore, for unimaginable reasons, PAN cards have to be physically mailed to the home address of the investor, which means a foreign location, further delaying the process. This is ironic considering visas are issued within 24 hours and transmitted via electronic channels. We must reduce the time frame for issuing PAN cards and must move to digitise the process.

    b. Any foreign company that wants to set up business in India has to have their incorporation documents notarised by the home country and then also have them stamped by the Indian embassy. This process in itself can be a non-starter.

6. RBI must consider issuing guidelines under differentiated banking licenses for the setting up of Custodian Banks. Such banks exist internationally and can add much value to easing capital flows into the country. Many foreign banks act as custodian banks in India, but under the banner of a universal bank or as a sub-agent.

7. Assuming that the distinction between FDI and FII is important, we must consider amending the level. Currently, anything above 10 per cent is considered to be FDI. We must consider aligning this with the Takeover Code and increasing the limit to 25 per cent. It would be very rare for any FII to own more than 25 per cent in any company and even if his was considered, it would be looked at as a strategic investment.

8. SEBI could consider introducing a new product, Listed Warrants, into the markets. Listed warrants are an excellent way of attracting capital inflows. While they are no longer common in the USA, they are heavily traded in Germany, Switzerland

and Hong Kong. It is a means to allow greater and wider participation in the process. So far this idea has not quite fudged with the Indian market.

9. We must implement the Sahoo Committee Report on ADR/GDRs, "It should, therefore, offer a domestic DR framework which is commensurate with its ADR/GDR framework and is competitive vis-a-vis depository frameworks overseas(Recommendation 6, pg 56, Sahoo Committee Report)." This is necessary because ADRs/GDRs is good business. Furthermore, those to op for ADR/GDR are not usually the people who opt to come into the country. The reason one opts for ADR/GDR is because they want no exposure to the Indian settlement system.

10. The role and significant of Foreign Investment and Promotion Board (FIPB) must be re-examined. We may infact consider abolishing the same.

11. Bankers must be allowed to pay up to 1 per cent on the client's balances in the FPI space. RBI does not allow for interest to be paid on balances sitting in the account, but this must be considered in the interest of attracting capital. This will make India attractive by 100 basis points. Furthermore, the volumes that this move would attract will result in bring down the cost for the investor, rendering the Indian market even more attractive.

12. Needs to re-examine the philosophy of ruling making. In most countries, regulations are organic, that means, they are market driven. Regulations are not mandated by the government. Very specific to our point of discussion, in India, the government has infact decided through which routes capital must enter the country, instead of leaving it to the market to decide. India must consider gradually moving to a regime of self-regulation.

13. FDI restrictions in social sectors such as education and health must be removed to attract capital inflows. These sectors have the capacity to absorb capital.

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