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BUILDING CONFIDENCE, BIT BY BIT

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Foreign Capital, Foreign Trade & BOP

As Minister of Finance and Corporate Affairs Nirmala Sitharaman gets ready to present the first budget of the 17th Lok Sabha, she faces enormous challenges. The GDP growth rate is at a five-year low, domestic consumption is sinking, the business confidence index has plunged, and India has recorded its highest unemployment rate in the last 45 years. To add to this list of woes is a claim made by Arvind Subramanian, India's former Chief Economic Adviser, that India's GDP has been overestimated. Foreign direct investment (FDI) equity inflows to India in 2018-19 contracted by 1%, according to the government's own data. After an increase of 22% and 35% in 2014-15 and 2015-16, respectively, FDI equity inflows began tapering off since 2016-17 with the growth rate falling to 9% and then to 3% in 2017-18.

This contraction in FDI inflows comes at a time when global supply chains are shifting base as a result of the ongoing trade war between the U.S. and China. India has failed to attract firms exiting China. Many of these supply chains have relocated to Vietnam, Taiwan, Malaysia and Indonesia. India is clearly not the natural/first option for these firms for a host of reasons, such as poor infrastructure, rigid land and labour laws, a deepening crisis in the banking sector and a lack of structural economic reforms.

The decline in the FDI growth rate, despite the well-advertised improvement in India's ease of doing business rankings, interestingly, has coincided with India's decision, in 2016, to unilaterally terminate bilateral investment treaties (BITs) with more than 60 countries; this is around 50% of the total unilateral termination of BITs globally from 2010 to 2018. Unilateral termination of BITs on such a mass scale projects India as a country that does not respect international law. India also adopted a new inward-looking Model BIT in 2016 that prioritises state interests over protection to foreign investment.

In the absence of empirical evidence, one cannot conclude that termination of BITs and adoption of a state-friendly Model BIT adversely impacted FDI inflows. Nonetheless, since studies have shown that BITs positively impacted foreign investment inflows to India, an examination of the link between the two should be a high priority for the Ministry of Finance and Corporate Affairs — the nodal body dealing with BITs.

The decision to terminate BITs and adopt a state-friendly Model BIT was a reaction to India being sued by several foreign investors before international arbitration tribunals. The government concluded that these claims were an outcome of India's badly designed BITs, signed in the 1990s and 2000s that were based on a laissez faire template.

True, India's BITs gave extensive protection to foreign investment with scant regard for state's interests — a characteristically neoliberal model. This design flaw could have been corrected by India negotiating new balanced treaties and then replacing the existing ones with the new ones instead of terminating them unilaterally, which has created a vacuum. Importantly, the design flaw was not the real reason for the increasing number of BIT claims. A large number arose either because the judiciary could not get its act together (an example being inordinate delays in deciding on the enforceability of arbitration awards) or because it ruled in certain cases without examining India's BIT obligations such as en masse cancellation of the second generation telecom licences in 2012. Likewise, the executive — the Manmohan Singh government — got the income tax laws retrospectively amended in 2012 to overrule the Supreme Court's judgment in favour of Vodafone and cancelled Devas Multimedia's spectrum licences in 2011 without

following due process, thus adversely impacting Mauritian and German investors.

These cases are examples of bad state regulation. They also reveal an absence of full knowledge of India's obligations under BITs by different state entities. Thus, the Ministry of Finance and Corporate Affairs should invest extensively in developing state capacity so that the Indian state starts internalising BITs and is not caught on the wrong foot before an international tribunal.

In correcting the pro-investor imbalance in India's BITs, India went to the other extreme and created a pro-state imbalance as evident in the Model BIT.

Correcting this imbalance should be high on the reform agenda of the government. 'Progressive capitalism' (channeling the power of the market to serve society, as explained by Nobel laureate Joseph Stiglitz) provides the right template. Indian BITs should strike a balance between interests of foreign investors and those of the state. A certain degree of arrogance and misplaced self-belief that foreign investors would flock to India despite shocks and surprises in the regulatory environment should be put to rest. Clarity, continuity and transparency in domestic regulations and a commitment to a balanced BIT framework would help India project itself as a nation committed to the rule of law, both domestically and internationally, and thus shore up investor confidence. As the 2019 World Investment Report confirms, since India is fast becoming a leading outward investor, balanced BITs would also help in protecting Indian investment abroad.

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