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FOREIGN DIRECT INVESTMENT IN INDIA'S DEFENCE SECTOR – GO BEYOND 51%

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EXECUTIVE SUMMARY

Recent media reports suggest that a note circulated within the Commerce Ministry and sent on to the Cabinet Secretariat for discussion proposes to raise the cap for Foreign Direct Investment [FDI] in defence sector from 26 percent to 100 percent.[1] The proposal reportedly states:

> *"There need not be any commitment on procurement and these enterprises would have to participate in the RFP [request for proposal] to technologically qualify and also succeed in financial bidding. In case of such firms, we should permit 100 per cent FDI under the FIPB/CCEA approval route. ...For future RFPs by the Ministry of Defence, the country could impose a condition that the successful bidder would have to set up the system integration in India with a minimum percentage of value addition. The successful bidder should be allowed to bring equity fully through the FDI route without any restriction."*

This paper recommends that the Government of India raise the cap in FDI in defence sector beyond 51 percent. The cap can be raised by an executive order of the government, and does not require an amendment by Parliament.

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BACKGROUND

The production of defence equipment was, until relatively recently, entirely a government function. The Industrial Policy Resolution, 1948, restricted the entry of the private sector into this industry. **The defence industry in India was thrown open to the private sector in May 2001** (Press Note 4 of 2001 Series) when the government permitted 100 percent equity with a maximum of 26 percent FDI component, both subject to licensing. Subsequently, the Department of Industrial Policy and Promotion (DIPP) issued detailed guidelines, after consultations with the Ministry of Defence (MoD), for the issuance of licence for the production of arms and ammunition in January 2002 (Press Note 2 of 2002 Series).

However, **the policy of 26 percent cap on FDI has failed to attract any substantive FDI in the defence sector**, with only approximately Rs 70 lakh flowing in as FDI between 2001 and 2009[2]. There have been frequent calls by various industry bodies like the ASSOCHAM in 2008[3] and CII in 2010[4] to raise the FDI cap from 26 percent to 49 percent. In December 2008[5], the Parliamentary Standing Committee on Defence has also asked the government to consider enhancing the FDI cap to 49 percent. The US government has also pushed for the same[6]. In its Economic Survey for 2008-09[7], presented prior to the re-elected UPA government's first Union Budget in July 2009, the government had then suggested extending the limit of FDI to 49 percent from the current level of 26 percent. The Survey had also noted that foreign equity in defence production should be raised to 100 percent for high-technology defence equipment.

Notwithstanding these demands and suggestions, the MoD has unequivocally stated its view[8] that as defence is a strategic sector, the foreign investment in joint ventures in defence sector would be limited to 26 percent. Any FDI increase beyond 26 percent would be considered on a case-by-case basis. **Press Note 2 of 2009 series effectively permits higher FDI through multi-layered structures at the discretion of the MoD**, in which foreign entities can have a cascading holding.

But, in some exceptions, like the joint venture with Russia to manufacture the Multi-Role Transport Aircraft, MoD obtained dispensations from the Cabinet for 50 percent foreign equity. BrahMos missiles are manufactured with a 50 percent Russian equity while HAL and French company Snecma have also been allowed by the MoD to form a 50-50 partnership for manufacture of aircraft engines. But the MoD has recently rejected proposals[9] for 49 percent foreign equity in joint ventures between Mahindra Defence Systems and UK-based BAE Systems, and between L&T and European EADS. Evidently, these exceptions of allowing FDI beyond 26 percent have been few and far in between, and have involved public sector defence manufacturing units only.

THE NEED FOR MORE FOREIGN INVESTMENT

Greater FDI inflow in defence sector provides substantive economic advantages. Other than the increased flow of funds from a foreign source, greater FDI leads to more employment opportunities for the local population. It also means that taxes and other revenues will flow back to the local economy.

The cap is an inhibiting factor towards the entry of foreign firms into the Indian defence market. Few foreign firms are keen to invest resources in a venture where they have no significant control, strict capacity/product constraints, no purchase guarantees, no open access to other markets (including exports) and an unfair advantage to the local public sector. Moreover **when MoD is already buying directly from foreign suppliers there is no incentive for the foreign firm to create a 26 percent-owned company in this country.**

Most major defence manufacturing units need a transfer of technology. But no foreign major is comfortable with transferring proprietary technology to a company in which it does not own a major share. Advanced technologies cost billions of dollars to develop and the returns likely to be generated on the basis of current FDI regulations—coupled with the lack of control they would have over the technologies and know-how they are being asked to provide—make it unattractive for a foreign firm to enter the Indian market. Increasing the FDI cap will allow the foreign firms a larger share of the risks and profits and the confidence to transfer sensitive technology to joint ventures in India.

Furthermore, due to the current FDI restrictions, **India is losing out on a number of foreign companies who would be keen on developing India as a 'home market',** i.e. both as a major domestic sales market and a global manufacturing hub in its supply chain. United States remains home to some of the biggest and most advanced defence manufacturing firms in the world. Rather than being restricted to transactional defence deals with the United States, raising the FDI cap in defence sector will attract US firms and make India's relations with the United States truly strategic in nature.

Larger Indian firms seeking to diversify into defence production would also benefit from raising the FDI cap. Increase in FDI limits would help them secure the transfer of key technologies from foreign firms and boost the foreign capital investment available to them. Most importantly, it fulfils their need to mitigate commercial risks in the highly fraught development environment of defence production. Defence systems, which are usually at the cutting edge of technology, require enormous capital to develop and there are never any guarantees of actual orders. **Private Indian defence manufacturers in effect have little choice but to look abroad for partnership, funding and technology.**

VESTED INTERESTS

As reported in the media[10], the Commerce Ministry's proposal has been viewed unfavourably by the MoD.

More than the requirements of the armed forces and considerations of defence strategy, MoD's position is influenced by the interests of the Defence Public Sector Units (DPSUs). The latter were instrumental in blocking the proposal, initiated in 2006, to grant Raksha Udyog Ratna [RUR] status to select well-performing private Indian companies in defence manufacturing. The RUR status—which would bring private companies on par with DPSUs like HAL— would have provided them better access to foreign technologies and to substantial government investment of up to 80 percent for design, development and manufacture of defence products, including fighter aircraft, tanks and warships. Despite several promises, the RUR status has not been awarded to any company due to strong resistance to the proposal from the DPSUs and their trade unions.

Moreover there is significant opposition to enhancing FDI limits from private Indian companies with existing capabilities in defence manufacturing. These companies have been reported to be lobbying within industry bodies like the CII, and in the MoD to discourage any move to enhance the FDI cap to stave off new competition.

ADDRESSING CONCERNS

Those in favour of maintaining the status quo of FDI cap in defence sector highlight the offsets policy as a tool for attracting latest technology without compromising the national security interests. The offsets policy obliges every foreign company winning a defence contract to produce in India defence goods and services of the value of 30 percent of the contract.

Although offsets amounting to 30 per cent for contracts exceeding Rs 300 crore have been made mandatory since Defence Procurement Procedure-2005 (DPP 2005), they provide a poor alternative for greater FDI flow. India ostensibly does not have the industrial capacities and knowhow to absorb the offsets obligations, estimated to be about $9 billion by 2012. In such cases, foreign vendors, faced with significant offset obligations, would be forced to seek non-commercial and artificial offset trades with Indian businesses simply to meet these obligations. There is also the risk that offsets could be directed by the foreign vendor to its Indian offset partner for low technology components with a minimal technology value addition, just to discharge its offset obligations.

It is thus presumptuous to assume that the level of technology required by the country can be achieved within the existing FDI limits, merely by offsets. It is expecting too much for the domestic firms, including the DPSUs, to capture the "know-why" along with the "know-how" of manufacturing techniques, technology and efficiency within the offsets trades. In fact, greater infusion of FDI through technology transfer would help meet offset obligations in defence deals without the drawbacks that lead to padding up of offsets costs.

The case against increasing the cap for FDI, as argued by the MoD, is founded primarily in Indian sovereignty, security of supply issues and promoting organic industry development. It believes that allowing greater levels of FDI, even below 49 percent level, would increase the amount of control exercised by foreign partners and consequently reduce the actual level of indigenisation and maintain the reliance on foreign suppliers.

MoD has also argued[11] FDI levels of more than 50 percent would imply that the management control would be with foreign investors. Therefore due to the strategic nature of the defence industry, there is an apprehension that such ventures would fail at critical times given the possibilities of withdrawal because of embargoes, sanctions and pressures imposed by foreign governments or international agencies.

The concern over security of supply issues during war has been answered in the note circulated by the Commerce Ministry. The note says that **conditions could be imposed whereby the Government of India has the right to expropriate a manufacturing facility in case of need for reasons of national security** by paying suitable compensation. The note further states, "*There can be concerns about passing of the equipment, designs or source code to enemy countries. Such a possibility exists even in the case of imported equipment. In fact, in the case of indigenous equipment, we can control the production mechanism in a much better manner. The government could also reserve the right to inspect or control the production and dispatches in these facilities through deployment of necessary security agencies. Export to enemy countries could be banned through a negative list.*"

There are examples of other countries like the United States, the United Kingdom and some European countries which have allowed up to 100 percent FDI in defence sector without comprising on control, security and secrecy. Regulations such as physical and electronic access controls to sensitive information and manufacturing processes, limiting access only to employees who are domestic security cleared nationals, restricting the number of foreign nationals on the company board, and strict controls over end-use of products and export sales have allowed other countries to ensure that, except for foreign ownership and investment, the company is essentially a domestic entity serving the domestic military requirements with absolute security and secrecy where required. The same can also be implemented here, with suitable modifications.

51% OR MORE

Most industry associations, and foreign firms, have only demanded that FDI cap be increased to 49 percent since they believe that the Government of India will insist on Indian control over any defence manufacturing company. However, there is no significant difference in the control over a business with 26 percent and 49 percent FDI. An increase in the FDI cap from 26 percent to 49 percent would be largely ineffectual in achieving India's main aim of technology enhancement, as foreign vendors will not transfer critical technologies without ownership and management control of the Indian venture. An increase in FDI levels to 49 percent will thus overcome very few of the drawbacks currently faced by an FDI cap of 26 percent. **The FDI cap would have be increased to 51 percent, if not 100 percent, to make a significant difference to the Indian defence industry.**

CONCLUSION

With India becoming the world's second largest buyer of defence equipment, Indian policies in defence manufacturing, including the FDI cap, have attracted widespread international attention. Foreign firms are now keen on joint ventures with Indian private companies for setting up development and manufacturing facilities. This change has also been accelerated by India's defence offsets policy. Many foreign firms setting up joint ventures in India, within the existing investment limits, are doing so in the stated expectation that FDI limits will soon be increased.

The subject of higher FDI cap in Indian defence industry remains one of the hotly contested issues in the country. The case for raising the cap primarily rests on increasing investment and the transfer of foreign technologies which will kick-start the development of Indian defence sector. In contrast, those arguing for maintaining the FDI cap at 26 percent base their arguments on sovereignty and security of supply issues and promoting organic industry development; although all these objections can be overcome by strong government regulation.

The government must show boldness of vision to overcome vested interests of the DPSUs and its trade unions, existing private sector players and the old bureaucratic mindset of MoD, to raise the FDI cap in defence sector beyond 51 percent. It should also help that this cap can be raised by an executive order of the government, and does not necessitate amendment by an act of the Parliament.

It must be noted that the fears and objections being raised with respect to fully opening up the defence sector for FDI are not dissimilar to those expressed when the government was considering reforming the telecommunications and insurance sectors. The evidence from this experience clearly suggests that foreign investment has transformed the technological sophistication, generated employment, built local expertise and improved the reach and effectiveness of the services. **India's cap on FDI is stunting the process of modernisation of the armed forces. It is a cap that India cannot afford.**

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