FDI in Indian Defence

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***Abstract*:** India took the first step towards opening the defence sector to foreign investment in 2001 when foreign investors were allowed to hold up to 26% share in the equity holding of a joint venture (JV). Defence manufacturing being the bedrock of national security, a set of conditions was introduced with a view to ensure that resident Indians have the control over the JV. In the context of meagre inflows which amounted to $0.15 million. till 2009, efforts were initiated to review the FDI policy applicable to the sector. A Discussion Paper issued in 2010 by the Department of Industrial Policy and Development (DIPP) had put forward a case to increase the limit to 74%, if not 100%. Subsequently, the policy underwent a major revision in 2013. While the basic cap on foreign share was retained at 26%, reportedly at the insistence of the Ministry of Defence, an important exemption was made which virtually removed the cap in case the investment is associated with transfer of 'state-of-art' technology. But in the backdrop of the inflows remaining low ($4.94 million till the end of December 2013) the demands to raise the base cap did not cease and the new government raised the base cap to 49% in August 2014. The revised policy allowed foreign portfolio investments which were expressly disallowed earlier. Additionally, the condition with regard to local control was relaxed for proposals involving state-of-art technology. The government also pruned the list of items for which an industrial license would be required.

This research paper aims to highlight the various ways in which FDI is a part of Indian Defence.

Keywords: Government, FDI policy, Defence.

INTRODUCTION

The defence industry in any country is highly technology driven and capital intensive. Given India's requirements for defence equipment, the sector has attracted FDI from leading companies out of US, UK, Europe and Middle East. In terms of background, the Foreign Direct Investment ("FDI") Policy in the Indian defence sector was first allowed vide Press Note 4 of 2001. The Defence industry opened its doors to 100% participation by the private sector, and permissible FDI upto 26%, subject to compliance with licensing requirements and stringent conditions. In 2014, the FDI Policy was relaxed to allow FDI beyond 26% on a case-to-case basis, when the same was likely to result in access to "modern" and "state-of-the-art" technology in India subject to certain conditions. However, vide consolidated FDI Policy of 2016, the FDI Policy in defence was radically liberalized to permit FDI upto 49% under the automatic route i.e. without approval; and beyond 49% under Government route on case to case basis (approved by the FIPB), where FDI is likely to result in access to modern and stateof-art technology. Through Press Note 5 of 2016, the requirement of having access to 'state-of-art' technology has been deleted, while modern technology and other reasons for grant of proposals have been introduced. The DIPP offers little clarity on terms 'modern' and 'other reasons'. Yet, 'modern' technology appears to be capable of simpler determination and being less restrictive than 'state-of-art'. 'Other reasons to be recorded 'could range from creation of large number of jobs to setting up new manufacturing facilities in a backward region. The Government has widened the field for FDI beyond 49% through the Government route, making the policy for investment in defence sector broader and more pragmatic. With respect to manufacturing of small arms and ammunitions covered under Arms Act 1959, OFs were key sources so far. However, inadequate capacity of OFs has caused shortfalls in critical ammunition required by Indian army, coupled with gaps in the war wastage reserves of ammunition and other ordnance stores. Opening FDI in this area will plug these gaps and accelerate production. Until March 2017, each FDI proposal would be considered by the FIPB based on the security clearance of MHA and comments of Ministry of Defence. However, the FIPB has been abolished in early 2017, thereby removing a leg in the approval process. It has been recognized by the Government of India that the new regime for foreign investment needs to be simpler in execution and expeditious in disposal. As per the Standard Operating Procedure released on June 29, 2017, FDI proposals will now be directed by the DIPP to the concerned competent authority In the case of defence, the new Competent Authority for processing of FDI proposals has been identified as the Joint Secretary, Department of Defence Production, MOD. Security clearance will be sought in parallel from the Ministry of Home Affairs.

LITERATURE REVIEW

Mohanty (2004) examined India's defence industry in the 21st Century. It has been observed that India's defence-industrial strategy is directed primarily toward achieving self-reliance. Presently, there is a clear imbalance in requirements by the armed forces. India's decision to allow private participation in the defence industrial sector is seen as a dual aim, namely to achieve much-needed capital and production enhancement and, secondly, to open up to the external market through their presence.

Janu and Kaur (2015) exhibited that "Make in India" seems to be a promising initiative for promoting domestic manufacturing and increasing self-reliance in defence. Foreign Direct Investment (FDI) in defence was increased from 26 per cent to 49 per cent. There are only a limited number of private companies in India with the capital and resources required to produce and develop complex defence solutions and sustain business. All the major powers of the world are interested in working with India in all sectors including defence.

Dr Vijay Kelkar Committee Report (April 2005) identified the potential of private sector and the positive opportunities and possibilities that could happen if PPP model is implemented in Defence Sector. The Paper concludes that significant factors like fair play for competitors, Public Private Partnerships, foreign Joint Ventures can catalyse defence manufacturing and given necessary impetus to innovation and dynamism. The author has expressed appreciation for the Government efforts to make the system more transparent and streamlined. However, he opines that the private sector should be provided level playing field with DPSUs.

Kaushal (December, 2014) in his article about need of Public Private Partnership in the Defence Aviation Industry in India has brought out the various facets of Defence production. His article aims at bringing out reasons as to why Indian aviation industry depends heavily on imports, despite the fact that Defence PSUs like HAL are there. It has been recommended by the author that taking strategy based decisions instead of project based decisions, preparing a long term plan for technology acquisition and mid-life up gradation and harnessing public private partnership is the way forward.

NEW FDI POLICY

The new FDI policy, along with the revamped DPP of 2016, allows the Indian industry to work closely in collaboration with global companies with immense technological capabilities. The Indian government would be solely responsible for negotiating and concluding procurement contracts, which would also include mandatory indigenous content as well Moreover, the increased FDI caps would also ensure smooth functioning of the offset policy, which would in itself act as additional incentive for foreign OEMs to set up shop in India. It is touted that the aforesaid initiatives targeted at private sector participation will greatly help foreign original equipment manufacturers proposals, released on June 29, 2017 [OEMs] to strategically collaborate with Indian companies, in order to take advantage of the current economic climate. More specifically, such opportunities would cover both, equipment procurement, as well as those that come with vertically integrated supply chain. Given the sharp focus of the Indian government in bolstering homeland security as well, it is clear that there is great potential in the Indian defence industry, for years to come. Developed markets are willing to spend more in technological innovation. Consequently, it is extremely likely and evident now that foreign companies specializing in provision of complex equipment and machinery to defence forces around the world will consider India as a viable market for investment. This will ensure that India's defence forces have access to the latest technology and equipment, while attempting to offer commercially viable, profitable arrangements to foreign investors. The impact of this Policy on the domestic defence industry can be significant. In order to provide an impetus to the 'make' category of production, it is essential to have inflow of foreign technology. However, DPP 2016 Approved JVs Post-Increase of FDI cap (August 2014- March 2015) Foreign Investment Proposals Approved in the Defence Sector (as of July 2015) provides that companies with exposure to FDI beyond 49% will not be considered for projects in the 'Make' category. Further, Strategic Partners to be identified from the private sector in India by the Government for high-value projects are prohibited from having FDI beyond 49%.

Thus, the inflow arising out of foreign entities holding a controlling stake needs to align with the interests of the domestic defence industry.

EXPORTS AND FISCAL INCENTIVES

During Financial Year 2015-16, INR 2,059.18 crore worth of defence platforms, equipment and spares manufactured in India were exported to more than 28 countries. Some of the major defence equipment exported by Defence Public Sector Undertakings (DPSUs) and Ordnance Factory Board (OFB) are Patrol Vessels, Helicopters & their spares, Sonars & Radars, Avionics, Radar Warning Receivers (RWR), Small Arms, Small Caliber Ammunition, Grenades and Telecommunication equipment.

FISCAL INCENTIVES

In budget 2017-18, defence budget has received a boost of 6.2% as compared to budget 2016-17. INR 86,488 crore has been allocated for Defence Capital out INR 2, 74,114crore allocated for defence expenditure (excluding pension) in the budget. The preferential treatment given to Defence Public Sector Undertakings (DPSUs) in excise duty/custom duty has been discontinued to create a level playing field. As per the revised policy, all Indian industries (public and private) are subjected to the same kind of excise and custom duty levies (April 2015).

• Exchange Rate Variation protection has been made applicable for Indian private sector at par with Public Sector Undertakings for all categories of capital acquisitions (August 2015).

• The custom duty exemption on import of defence equipment has been removed to encourage imports and incentivize domestic manufacturing.

DEFENCE PROCUREMENT PROCEDURE

The Defence Procurement Procedure (DPP) of 2013 was amended w.e.f from April 2, 2016 to provide for the following:

• New most preferred acquisition category Buy Indian (IDDM (Indigenously Designed, Developed and Manufactured) introduced to encourage indigenous design, development and manufacturing of defence equipment. This category refers to procurement from Indian vendors of products that are indigenously designed, developed and manufactured, and have at least 40% indigenous content. If the product is not designed and developed indigenously, it will have to have 60% indigenous content.

• Indian companies are allowed for tie-ups with a foreign Original Equipment Manufacturer (OEM) for Transfer of Technology (ToT) under 'Buy & Make (Indian)' category.

• Under 'Buy & Make' Category of Capital Acquisition, the foreign vendor is required to transfer the Technology to Indian Production agency for indigenous production of the items.

• Foreign OEM can select Indian Production agency of its choice for transfer of technology.

• 'Services' as an avenue for discharging offsets was re-introduced in December 2015

• Defence products list for industrial licensing announced in June 2014, large number of parts/components, castings/ forgings etc. have been excluded from the purview of industrial licensing.

• The defence security manual for the private sector defence manufacturing units has been finalized and clarifies the security architecture required to be put in place by the industry while undertaking sensitive defence equipment.

CONCLUSION

The FDI policy, along with the new DPP 2016 and the relaxation of industrial licensing requirements, offers a great deal of assurance that the inflow of investment/technology would be commercially lucrative. There are several reasons to invest in the Indian defence sector, considering its extensive modernization plans, increased focus on homeland security, improved protection of intellectual property, removal of requirement of single largest Indian ownership of 51% as well as removal of the requirement of lock-in period of three years on equity transfer.

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