

Need for higher FDI in Defence

Introduction

The Indian defence industry witnessed a major change in 2001 when the sector was opened up for private participation and foreign investment. The Government of India (“GOI”), in an effort to upgrade the armed forces and establish manufacturing capabilities with the ultimate aim of achieving self-reliance for defence products, wished to attract foreign investors. However, by limiting the scope of foreign investment to a maximum of 26%, apart from imposing licensing requirements, this conservative approach of the GOI has seen limited foreign direct investment (“FDI”) inflows and has led to depletion of the strength of the armed forces.

According to recent government statistics, India’s defence expenditure is likely to increase by 25% making it approximately USD 30 billion in the next 15 to 20 years. Keeping in mind India’s massive defence needs, limiting foreign investors armed with cutting edge technology and expertise is no longer in national interest. The present bulletin focuses upon the need for a policy change for increasing the limit of FDI allowed in the defence sector.

1.0 Stringent control of defence sector

India presently is one of the largest importer of defence related products and goods. To promote indigenous production albeit with cutting edge technology, the GOI has been keen to seek transfer of technology from overseas defence OEMs within the current regulatory regime of up to 26% FDI in the defence sector. Even once the 26% threshold is met and a foreign company sets up shop in India for manufacturing defence products, there are several licensing requirements as well as export controls on the manufactured product. According to the GOI, this requirement of having entry level restrictions, as well as post investment regulation is required due to the sensitive nature of the sector.

The rationale of the GOI behind a 26% cap on FDI is to allow the foreign defence companies an element of direct ownership, albeit diminutive, where as keeping the operational control and management in the hands of the Indian shareholder holding majority stake. According to the Ministry of Defence (“MOD”), this ensures continuation of defence production and maintenance of production capabilities in times of need, where a foreign defence company which was invested in India may be influenced by political reasons to impede supply to the MOD.

2.0 FDI acting as a blockade

The rationale of the GOI in restricting FDI as well as foreign ownership, control or influence over the defence sector is governed by fear of losing defence production capacity in critical times and related to passing on of critical equipment or source code and indirectly arming India’s enemies, which will be detrimental to India’s national interest. This has influenced the export controls on such products, as is also the case with most countries.

The outcome of restrictive regulatory regime and the lack of purchase guarantee by the GOI is that foreign defence companies are wary of investing in India. This has caused a stalemate, with foreign companies becoming reluctant to release critical technology and the GOI unwilling to allow investment above 26% where the foreign vendor does not bring in the latest technology. Needless to say, due to this stalemate, the very national interest the GOI is trying to protect is being compromised. A change in the FDI policy and the GOI's outlook is the need of the hour.

3.0 Recommended policy framework

To appropriately address the concerns of the GOI as well as foreign companies, the FDI policy must be flexible to accommodate the interests of both. For example, in terms of technology procurement, where a foreign company has produced the most developed surveillance system, radar technology, avionics, high-tech equipment or artillery, the GOI may provide a purchase guarantee for sale to the MOD and the Indian armed forces as well as manufacture other equipment and export the same from India through the MOD. To avert delays, the MOD would need a cohesive unit to undertake these matters speedily. Further, this may be coupled with providing the foreign investor, on a case-by-case basis, ownership in excess of 26% where technology and know-how are released to the GOI, assuring the foreign company of better control over its proprietary technology.

In addition to this, the MOD may also consider and streamline the process of FDI in dual-use technology which has both civilian and defence application. In doing so, it will drive other sectors such as civil aviation, engineering, R&D etc. as well as defence. Impetus must also be provided to FDI by giving preference to domestically manufactured products as opposed to only public sector units. The Kelkar Committee had suggested some significant matters such as accreditation and fostering of Raksha Udyog Ratna within the private sector and it would be beneficial to re-examine some of these recommendations. This will not only cause foreign companies to examine the practicability of setting up shop in India in collaboration with domestic players, but will also bring accountability in the public sector units to be profitable in the long-run.

Conclusion

The time is ripe for the GOI to initiate changes to the FDI policy in the defence sector. It is common knowledge that FDI is a concept which is based on need. The Indian economy and the GOI need foreign companies to become a part of the defence sector to fulfill its technological and growth requirements. The GOI must consider taking advantage of India's favorable geo-political position and skilled man-power by inviting foreign defence companies to establish a solid base in India and use it to outsource and form partnerships for co-production of defence related products. The reasons for a foreign company to have a foot print in India are simply based on economic consideration. The FDI policy must address the anxiety of foreign companies and assure them that their commercial interests are safe.

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