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FOREIGN DIRECT INVESTMENT IN DEFENCE SECTOR: SECURITY CONCERN OR STRENGTHENING INDIA'S DEFENCE

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ABSTRACT:

India is surrounded by the hostile neighbors. The need for defence of its borders has been on priority since independence. For this purpose defence production has to be upgraded to make it at par with the military power of other countries. The Long-term Integrated Procurement Plan of the government gives out the planned procurement right up to 2027. To meet this requirement internally, the industry needs a capital of more than Rs 50,000 crore over the next three years. The defence Public Sector Units (PSUs) are in no position to make this investment and the Indian private industry may not find this high risk investment lucrative enough.

The Modi government, which came to power in 2014, aimed to bring more foreign direct investment (FDI) in different sectors. This process gave way to foreign investment up to 49% in the defence sector. This has now increased to 100% in 2016.The government's decision to liberalize FDI rules for the defence sector could force Indian companies to relook at their plans as it will reduce dependence on the domestic original equipment manufacturers (OEMs). India's decision to open its defence sector for 100% FDI is likely to result in more access to modern technology.

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The present paper highlights the scenario of FDI in Indian defence sector. It also exhibits the trends of FDI equity inflows The study reveals that FDI inflows in this sector have fluctuated from Rs. 2.36 millions in the year 2000-2005 to Rs. 6.40 millions in the year 2016 (up to September). The paper, in the end also dispels the myths associated with FDI in defence.

KEY WORDS: Foreign Direct Investment, Myths, OEMs, Trends

I. INTRODUCTION:

India aims to strengthen its strategic presence worldwide and become a member of the Nuclear Suppliers Group and the UN Security Council, but it imports nearly 70 per cent of its defence equipment and depends on imports for critical defence technologies. To meet its aims of self-reliance, therefore, the country needs top-end technologies and a vibrant defence manufacturing base. Of course, India has been spending an increasing amount of resources on defence. With the FDI equity in defence hiked to 100 per cent, the Indian defence industry is all set for a massive change.

Earlier, increasing the FDI limit to merely 49 per cent in 2014 had been largely ineffective in achieving India's objective of technology enhancement, and foreign vendors had hesitated to transfer technologies without ownership and management control of the Indian venture. Though FDI ceiling in defence in graded steps to 74 per cent and 100 per cent was allowed in case of technology sharing and state-of-the-art technology transfer, the July 2016 announcement of 100 per cent FDI in defence with modern technology transfers through government route is a big step for foreign investors, particularly original equipment manufacturers. Foreign investors would like this full liberalisation of the defence sector, as retaining control of a firm assumes importance, especially in the light of transfer of special technology. This would help India in setting up joint ventures to leverage critical technologies to shore up domestic capability in the Indian defence industry and, thereby, create jobs in the country.

India's cap on FDI was stunting the process of the modernization of the armed forces. The success of a liberal FDI policy depends critically on how it is managed for the benefit of the domestic private sector defence industry. Sometimes, the fear of national security being compromised was over-hyped, as a manufacturing facility within the country would have been governed by Indian laws and, therefore, a much better option than importing. Certainly, raising the equity cap in defence to 100 per cent will not only reduce India's dependence on imports but also provide the private sector a level playing field. The public sector defence companies in India are overburdened, and the responsibility of making the Indian defence industry self-sufficient lies with the private sector.

II. REVIEW OF LITERATURE:

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.

Singh (2010) argued that 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. 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. It has been suggested that the government must show boldness of vision to overcome vested interests of the DPSUs and its trade unions etc. to raise the FDI cap in defence sector beyond 51 percent.

Malhotra (2014) examined the impact of FDI on the Indian economy, particularly after two decades of economic reforms, and analyzes the challenges to position itself favorably in the global competition for FDI. The country is consistently ranked among the top three global investment destinations by all international bodies, including the World Bank, according to a United Nations (UN) report. It has been observed that FDI inflow supplements domestic capital, as well as technology and skills of existing companies. It also helps to establish new companies. All of these contribute to economic growth of the Indian Economy.

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.

The review of above literature helps in identifying research issues and research gap for the present study. This literature review study also helps in developing my research objectives.

III. OBJECTIVES AND METHODOLOGY:

The objectives and the research methodology are as follows:

OBJECTIVES OF STUDY:

The study has been geared to achieve the following objectives;

1. To highlight the scenario of Foreign Direct Investment in defence
2. To exhibit the trends of FDI inflows in Indian defence sector
3. To examine the myths associated with FDI inflows in defence sector

RESEARCH METHODOLOGY:

Type of Research: Quantitative and Analytical Research

Data: Data of FDI Equity inflows from year 2000-01 to 2016-17 (up-to September 2016)

Data Collection Method: This study has been carried out with the help of secondary data only, all the data has been collected from the various sources such as websites & reports and compiled as said by the need of the study.

Sources of Data Collection: The study is based on the published data. For the purpose of present study, the data was extracted from the various issues of Secretariat of Industrial Assistance (SIA) Newsletter, journals, newspapers and websites particularly from the

Department of Industrial Policy and Promotion (DIPP), Ministry of Commerce and Industry and Reserve Bank of India.

IV. EVOLUTION OF FDI IN DEFENCE:

Until May 2001, the Indian defence sector was closed to private players and was considered to be an exclusively governmental function. In May 2001, the Government of India, issued Press Note 4 (2001 Series) permitting foreign direct investment of up to 26% in the defence sector with prior approval of the Foreign Investment Promotion Board. This press note reflected a new policy of liberalization for participation by the foreign manufacturers. However, this cap has remained unchanged for a decade.

The debate in relation to the FDI cap in the defence sector was reinvigorated in May 2010, when the DIPP issued a Discussion Paper setting out the pros and cons in relation to increasing the FDI cap in the defence sector ("Discussion Paper"). The Discussion Paper, the first of several discussion papers put forth by the DIPP on important topics for public discussion, raised strong arguments for increasing the FDI cap in the defence sector from 26% to 74%, and stated that liberalizing the FDI cap to 100% would be desirable.

In Press Note 7 of 2014, the GOI raised the FDI cap in defence to 49% through the Government approval route. Press Note 5 of 2016 however again changed the equity caps and allowed for 100% FDI in the defence sector.

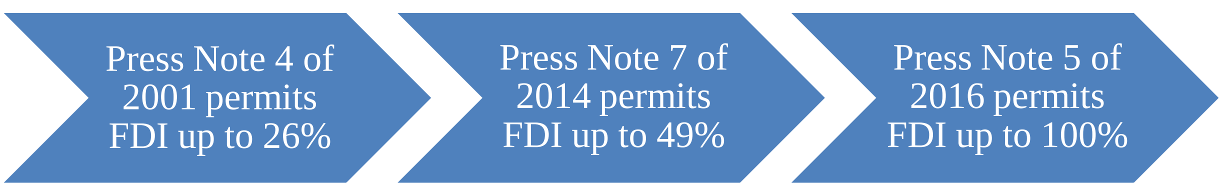

Figure 1: Evolution of FDI in Defence

Source: Author's own presentation

V. 100% FOREIGN DIRECT INVESTMENT IN THE DEFENCE SECTOR:

The defence sector was opened to FDI up to 26 per cent in 2001 through the government route. In September 2014, shortly after the present Government came to power, the policy was relaxed to allow it beyond 26 per cent on a case-to-case basis, wherever it was likely to result in access to 'modern' and 'state-of-art' technology in the country.

This case-by-case approval had to be accorded by the Cabinet Committee on Security (CCS). However, in 2015, the procedure for approving FDI beyond 49 per cent was eased by authorizing the Foreign Investment Promotion Board (FIPB) to approve such proposals. None of this helped however. The total FDI in the defence sector stood at a meagre Rs 25.48 crore ($5.12 million) in June 2016. Only the coir sector has fared worse with a cumulative FDI of Rs 22.05 crore ($4.07 million) which has remained static between September 2014 and June 2016. So insignificant is the cumulative amount of FDI in defence that it does not even work out to 0.01 per cent of the total FDI received by India between April 2000 and September 2016.

Previous FDI in Defence	**Changes Introduced From June 2016**
• FDI up-to 49 per cent allowed under automatic route. • Beyond, 49 per cent under approval route in cases where such FDI is likely to result in: a) Access to modern technology ; or b) State-of-art technology in the country	• FDI beyond 49 per cent under approval route in case where such FDI is likely to result in access to modern technology or for other reasons to be recorded. The condition of access to state-of-art technology in the country has been done away with • FDI limit has now been made applicable to manufacturing of small arms and ammunitions covered under the Arms Act, 1959

FDI has been slow in coming because of the uncertainty of returns on investment and the inability of the strategic investor to exercise decisive control over the management of the investee companies. The 2014 relaxation, which permitted the investors to go beyond 49 per cent FDI and consequently exercise decisive managerial control also, did not help because of such investment required access to 'modern' and 'state-of-art' technology.

In the latest round of relaxation, reference to ‘state-of-art’ has been deleted. This implies that the government will be willing to consider proposals for FDI beyond 49 per cent if such proposals entail transfer of ‘modern’ technologies, which do not necessarily have to be ‘state-of-art’.
The term ‘modern’ technology is less restrictive than ‘state-of-art’. This provides a greater flexibility both to the investors to make a proposal and for the government to accept it as long as the technology being offered is not downright obsolete or commonly available in India.

More significantly, a new provision now made in the policy will make it possible for the government to permit FDI beyond 49 per cent even ‘for other reasons to be recorded’. These reasons could range from creation of a large number of jobs to setting up of a manufacturing facility in a backward region.

With this, the Government has quite clearly created a greater space for itself for accepting FDI proposals without being hamstrung by considerations relating to the nature of technology being offered by the strategic investors. This makes the policy more pragmatic. The revised norms for FDI in the defence sector have also been made applicable to manufacturing of small arms and ammunition covered under Arms Act, 1959. This is very significant.

WHAT LEADS TO 100% FOREIGN DIRECT INVESTMENT IN THE DEFENCE:
Foreign investment in the defence industry is part of India’s broader FDI policy, and is intended to “bring attendant advantages of technology transfer, marketing expertise, introduction of modern managerial techniques and new possibilities for promotion of exports.”24 However, even after nine years of its being in existence, the defence FDI policy in its present form has not been able to bring in the intended advantages in any meaningful way. Despite all efforts, India’s defence production has not lived up to the expectations, necessitating the import of critical systems to maintain defence preparedness. India needs higher FDI in its defence industry to boost its local technological base, make the offset policy efficacious and derive economic benefits.

Moreover the capacity of the state-owned ordnance factories, which have so far been the main source of supply for these items, has proved to be inadequate, resulting in critical gaps in the war wastage reserves of ammunition and other ordnance stores.

A 2015 report of the Comptroller and Auditor General of India (CAG) pointed out the need for taking urgent steps to modernize ordnance factories and augment their capacity to produce items required by the Indian army so as to plug the shortfalls in availability of critical ammunition. With hardly any increase in the allocation for modernization of the ordnance factories in this year's budget, it is unlikely that they will be able to augment their capacity even to meet the requirement of small arms and ammunition. Opening up of this sector to FDI assumes a great significance in this background.

WHATS NEW IN FDI POLICY FOR DEFENCE:

There has been another significant change. For those applicants whose principal business is in the defence sector, it will not be necessary to obtain approval of the Reserve Bank of India, or a separate security clearance, for setting up a branch/ liaison/project offices or any other place of business in India. This will be applicable in cases where approval by FIPB (Foreign Investment Promotion Board) or license/permission by the Ministry concerned has already been granted to the investor.

The new FDI regime should make it more viable for global majors to manufacture a whole range of defence equipment and platforms in India but this may conflict with the government's efforts to promote indigenization of defence production by promoting the domestic defence industry under its 'Make in India' initiative. The Defence Procurement Procedure envisages production of defence equipment in India in collaboration with, or with the help of technology transferred by, the foreign equipment manufactures under four distinct categories: 'Buy (Indian Designed, Developed and Manufactured), 'Buy and Make (Indian)', 'Buy and Make', and 'Make'.

Of these four, 'Make' projects that entail indigenous design, development and manufacture of the prototypes of futuristic equipment, are not open to companies with FDI beyond 49 per cent, as per the eligibility criterion laid down in the Defence Procurement Procedure.

For projects under the remaining three categories, Indian companies, owned and controlled by Indians with FDI restricted to 49 per cent, will have to vie with joint ventures with more than 49 per cent FDI or wholly owned subsidiaries of the foreign manufacturers. This could queer the pitch for the former.

VI. TRENDS OF FDI INFLOWS IN DEFENCE SECTOR:

With the easing of conditions from time to time for defence FDI, the key question that now arises is as to whether the new provisions would bring in any palpable change in the flow of foreign investment/technology to the Indian defence industry. This assumes significance given the fact that defence industry has so far remained the most poorly explored sector by overseas investors (see Table), even though more than 16 years have passed since the sector was opened for foreign participation.

Sector Wise FDI Equity Inflows (April 2000 - September 2016)

Sector	**Rank**	**Amount of FDI Inflows**		**% of Total Inflows**
		(In Rs. crore)	**(In US$ Million)**	
Services Sector	1	293,722.25	56,080.38	18.08
Construction	2	114,350.25	24,249.79	7.82
Computer Software and Hardware	3	119,086.87	22,050.02	7.11
Telecommunications	4	111,388.19	21,169.09	6.83
Automobile Industry	5	86,258.79	15,793.24	5.09
Timber Products	53	846.24	148.46	0.05
Defence Industries	**61**	**25.48**	**5.12**	**0.002**

Table 1: Sector Wise FDI Equity Inflows

Source: Department of Industrial Policy and Promotion

Table 2 exhibits the comparative position of FDI inflows in defence sector with other viable sectors which have received FDI inflows in large quantity. It is evident from the table that maximum FDI inflows have been attracted by services sector followed by construction development and computer software & hardware etc. It is very disappointing that FDI inflows in defence sector are very much meager during the period of study i.e. Rs. 254.8 millions. This is a cause of concern for the Government of India also. Now the present Government has made efforts to bring FDI in this sector by taking measures like raising FDI cap to 100% and by launching 'Make in India' campaign. It is hoped that these measures would help in increasing FDI inflows in this sector. Still much is required to be done to motivate the investors to invest in this sector**.**

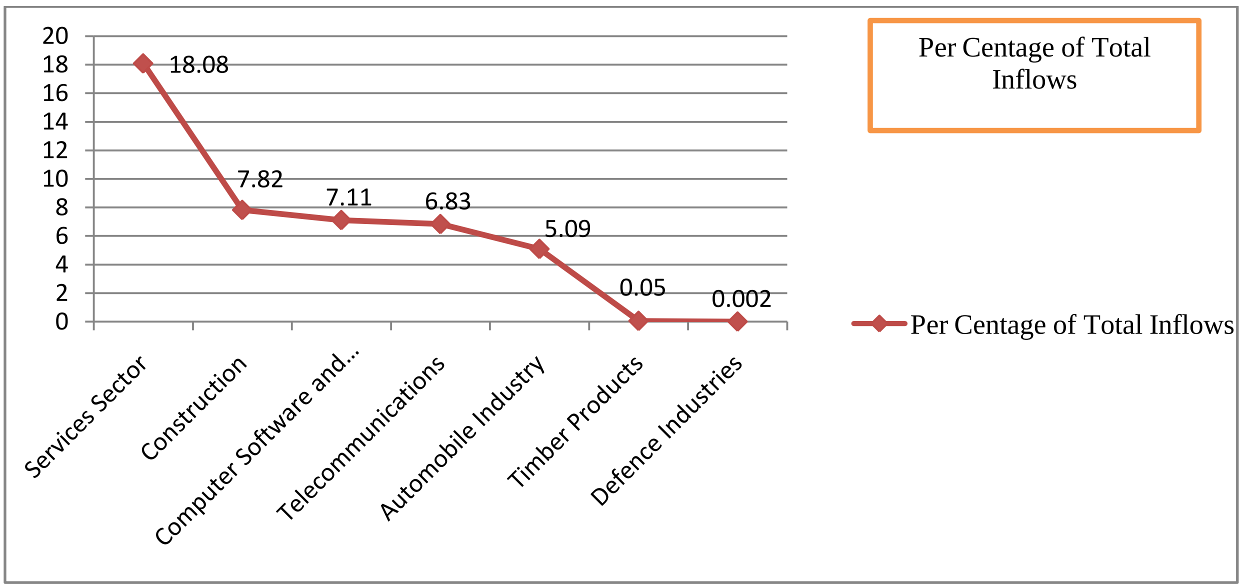

Figure 2: Sector Wise FDI Equity Inflows in percentage

TRENDS OF FDI INFLOWS INTO DEFENCE SECTOR DURING 2000-2016:

(Amount in Rs. Millions)

Year	**FDI equity inflows in Defence Sector**	**Total FDI equity inflows**	**Percentage share in total FDI equity inflows**
2000-2005	2.36	954,815.27	0.0002

2006	00	503,573	0.0000
2007	00	654,950	0.0000
2008	00	1,595,295	0.0000
2009	00	1,309,799	0.0000
2010	00	960,150	0.0000
2011	174.4	1,599,349.20	0.0109
2012	22.10	1,215,914.41	0.0018
2013	44.72	1,294,824.81	0.0035
2014	0.04	1,753,134	0.0000
2015	4.80	2,525,615	0.0001
2016 (Up-to September)	6.40	1,219,862	0.0005
Cumulative Total (2000 to September 2016)	**254.82**	**15,587,281.69**	**0.002**

Table 2: Year Wise FDI Equity Inflows in Defence

Source: Compiled from Various issues of SIA, Newsletter

Table 1 depicts FDI equity Inflows into defence sector in India during the time period 2000 to 2016 (up to September) and their percentage share in total FDI equity inflows. FDI inflows have fluctuated from Rs. 2.36 millions in the years 2000-2005 to Rs. 6.40 millions in the year 2016. It is apparent from the table that defence sector has not been able to attract a significant percentage of total FDI inflows up to 2010. Due to the impact of global recession there has been fluctuating trend in the inflows of FDI and its percentage share in the total FDI inflows in this sector.

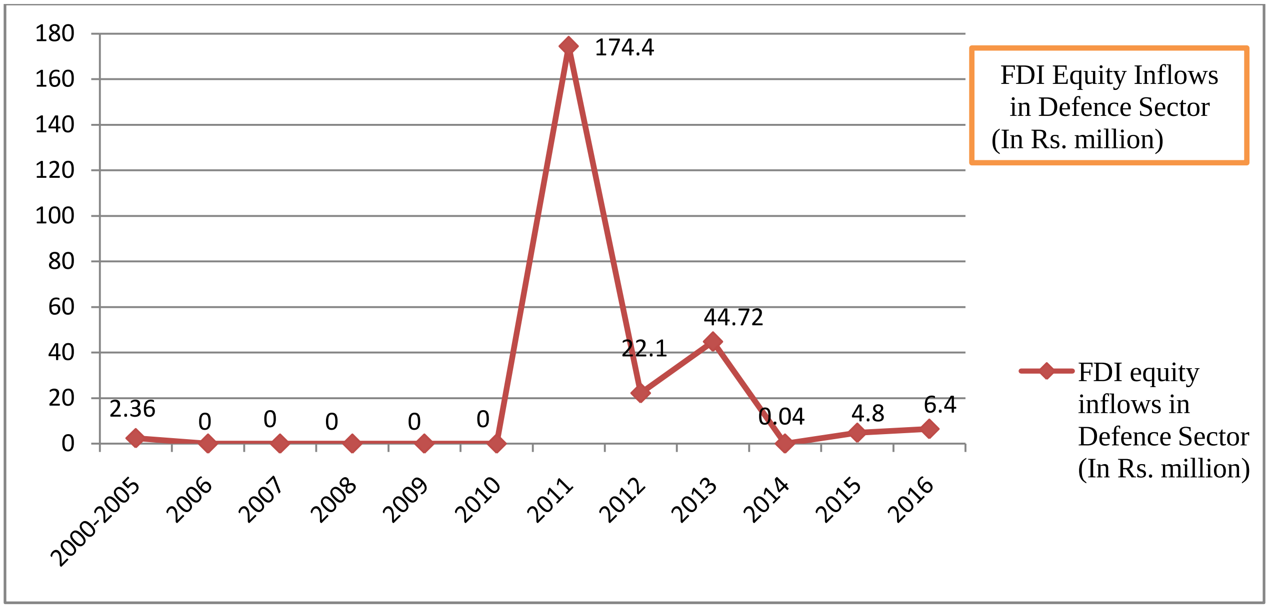

Figure 2: FDI Equity Inflows in Defence Sector in Rs. million

VII. LIKELY BENEFITS OF THE NEW FDI POLICY FOR DEFENCE SECTOR:

Allowing 100% FDI in defence is seen as a game changer for the following reasons:

1. Foreign investors will now have the confidence to invest into the defence sector as the ease of guidelines is beneficial to original equipment manufacturers (OEMs) as returns will be assured. This will create a situation whereby the defence forces and local industries benefit for this increased investment.

2. The move will also enhance overall R&D to develop and deploy solutions catering specifically to the country's security needs. Further, the domestic defence undertakings also stand to benefit from the entry of foreign players and there are already various joint ventures in place for production of defence equipment.

3. The removal of the requirement to transfer "state of the art technology" will see production facilities of foreign OEMs shift to India.

4. The procedure of investing for any foreign OEM has been eased drastically and it will lower the compliance costs.

VIII. FDI IN DEFENCE - DISPELLING THE MYTHS:

Every time the issue of increasing FDI limit comes up, the opponents resort to their time-tested subterfuge of raising the bogey of security concerns and threat to indigenous industry, thereby hiding their selfish reasons. In this paper endeavors has been made to remove some common misconceptions and put all issues in their proper perspective.

Misconception 1: Higher FDI limit is a threat to national security:

Presently, India is procuring all critical weapon systems produced/integrated abroad. It is not understood as to how India's security would get threatened if the same weapon systems are produced/integrated in India. Adequate safeguards can be incorporated while issuing licenses. India can reserve the right to take over the licensed facility under certain extraordinary circumstances of national emergencies. Most nations include such an enabling provision. It is ridiculous that imports are considered more reliable than production in India.

Misconception 2: India can do without foreign funds in defence

For an aspiring power like India, FDI is not just a question of acquiring funds, but more importantly, it represents access to the latest technologies. Most defence products involve a relatively high level of technology and this technology gets transferred only if the foreign partner has a long term stake in the company. FDI pre-supposes a long term commitment and lasting relationship between the foreign and local enterprise.

India needs defence technology desperately. It is lagging behind by up to twenty years. It is foolhardy to waste time and resources in trying to reinvent the wheel. India needs to import latest technology through FDI to bridge the current gap.

Misconception 3: FDI will stymie (harm) the growth of indigenous defence industry:

One has been hearing declarations of building India's own defence industry through indigenous efforts since early 1990s when confident predictions were made that defence imports would be reduced from 70 per cent to 30 per cent within a period of ten years. On the contrary, after two decades, imports have now climbed to close to 75 per cent.

Even the performance of the Defence Research and Development Organisation (DRDO) over the last five decades has been highly unsatisfactory belying all hopes of development of indigenous competence, it will be unrealistic to expect DRDO to change overnight and make India selfreliant. The defence public sector consists of nine defence public sector undertakings and 39 Ordnance Factories. Despite getting preferential treatment from MoD, it has singularly failed to keep pace with technological developments.

Misconception 4: Investment decisions are taken by foreign companies and India has no role to play:

It is often forgotten that FDI is a need-based concept. Whereas a host nation needs FDI for accelerated growth, prospective investors are guided purely by economic considerations. Therefore, every host country has to strive to project itself as the ideal FDI destination vis-à-vis other competing suitors. There are four factors which influence FDI decisions – availability of abundant raw material, skilled work force, low cost of production and lucrative market. It is the interplay of all these factors which influence an investment decision.

If India is serious about attracting FDI in defence, it has to position itself as the most lucrative FDI destination with improved 'FDI Confidence Index'. For that, it must make structural adjustment to provide functional freedom to joint ventures to respond to market dynamics.

CONCLUSION:

The previous policy with its 26 & 49 per cent limit has failed to elicit any positive response. Therefore 100% FDI was the need of hour. The new rule of 100% FDI could mean that Indian companies that were rushing to tie up with OEMs (original equipment manufacturers) in expectation of future business may find that their partners choose to enter the market on their own. Under the previous rules, foreign OEMs (original equipment manufacturers) were required to form joint ventures with domestic firms if they wanted to establish a manufacturing base in India. With the amendment, an OEM can independently plan and implement operations in India. This would save the time spent on lengthy negotiations with Indian companies. A 100% FDI in defence will create a win-win situation for the country's defence forces, local industries and international OEMs. It will ensure availability of cutting edge technologies for the defence forces, boost local manufacturing in India and provide assured returns for international OEMs. The move will also enhance overall R&D to develop and deploy solutions catering specifically to the country's security needs

On the issue that FDI might compromise our national security we need to adopt a cautious policy with the primary focus on national interest. Today, India has become one of the largest importers of military equipments. So, we need to understand that allowing foreign companies to manufacture in India is nothing worse than being dependent on imports. In fact in India suitable legislations can be imposed on the manufacturers thus giving more safeguards. Moreover, The Ministry of Defence has, on its part, made it clear that it wishes to exclude certain projects and companies from being owned/ controlled by foreign investors.

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