



A Case for Increasing FDI up to 100 per cent in India's Defence Industry



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Summary

Since 2001, India has allowed foreign direct investment (FDI) up to 26 per cent in its defence industry. The policy has, however, not been successful in bringing about any meaningful financial or technological inflows, primarily because of the lack of incentives in the policy for foreign investors. Although suggestions have been made in various quarters to increase the existing cap, there has been no consensus with regard to its precise limit. Keeping in view India's underdeveloped R&D and production base, and various defence industry-related policies and provisions whose success is contingent upon a liberal inflow of FDI, an increase in the foreign investment cap up to 100 per cent would be logical, instead of a fixed cap-based method, which may be a constraint to desirable inflows. However, given the sensitivity attached to defence-related FDI, each investment should be subject to wider review and impact analysis following which the FDI percentage could be determined varying between zero and 100 per cent.

Introduction

In a reply to a parliamentary question in July 2010, India's defence minister A.K. Antony said that his ministry is formulating a policy on foreign direct investment (FDI) in response to a discussion paper circulated by the ministry of commerce and industry (MoC&I), which suggested raising the foreign investment cap in the defence industry from the present 26 per cent to 74 per cent.¹ The defence minister's response assumes greater importance in view of the buzz generated by the MoC&I's paper among a cross-section of stakeholders. This Brief examines the perspectives of the various stakeholders, both at the government and industry levels. It also examines the international practices pertaining to foreign investment in the strategic sector, to draw inferences for the Indian context. This Brief argues that in view of the international practices pertaining to investment in the strategic sector; the constraints in India's present FDI policy regulating the defence industry; various defence industrial measures having a bearing upon FDI; and the economic benefits of higher FDI, there is a need to increase the FDI cap up to 100 per cent. The brief begins by examining the existing guidelines pertaining to the FDI in defence industry and their impact so far.



The Present Defence FDI Policy and its Impact

In a major policy change in May 2001, the government opened up India's defence production to the private sector as well as foreign participation. The decision, which was conveyed via Press Note No. 4 (2001 Series), was subsequently elaborated upon in Press Note No. 2 (2002 Series) by way of detailed "guidelines for licensing production of Arms & Ammunitions".² As regards FDI, the guidelines specifically mandate, among other things, FDI up to 26 per cent in the defence industry, subject to compulsory industrial licensing. The 26 per cent FDI cap is in consonance with the Indian Companies Act, 1956, which empowers the government "to regulate the formation, financing, functioning and winding up of companies."³ As per the Act, a company formed in India is required to



¹ Rajya Sabha, Parliament of India, "Cap On FDI In Defence Manufacturing Sector", Unstarred Question No. 306, Answered on July 28, 2010, <http://164.100.47.4/newrsquestion/ShowQn.aspx>.

² Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India, *Press Note No 4 (2001 Series) and Press Note No 2 2002 (Series)*, http://siadipp.nic.in/policy/pressnotes_main.htm.

³ "Companies Act", http://business.gov.in/starting_business/companies_act.php.

operate within the broad parameters of its Memorandum and Articles of Association while always staying within the scheme of law as contained in the Act. The 26 per cent cap on equity is to protect minority interests in all decisions of the company taken by its Board of Directors (who exercise their power collectively through resolutions) and its shareholders. According to the extant provisions of the Companies Act, shareholders with minimum 26 per cent equity share can block a 'special resolution'⁴ whose intent is to alter the basic premise on which a company is formed (50 per cent share is the minimum necessary to block any decision or resolution pertaining to the company).⁵



Apart from the FDI cap, the 2002 guidelines also stipulate a three year lock-in period for all defence equity inflows; no purchase guarantee from the Ministry of Defence (MoD); detailed particulars of the management to be furnished to the government; and strict adherence to export norms as applicable to the government-owned enterprises. The guidelines do not, however, mandate a minimum capitalisation for any defence company involving foreign equity.

Notwithstanding the detailed guidelines, the FDI policy has so far not succeeded in attracting any major financial or technological inflows into the country. It is primarily because the 26 per cent cap is viewed by many foreign companies as dissuasive, since it offers limited scope for meaningful returns on investment as well as little control over the technologies which they might want to transfer to the Indian joint ventures. The total inflow of resources to the defence industry between April 2000 and May 2010 amounts to a meagre US\$0.15 million, a fraction of the inflow into sectors that attract high-value FDI, namely services, computer software and hardware, and telecommunications, among others.⁶ Moreover, the defence industry ranks the last among the 62 indentified sectors where FDI has flowed in, even behind sectors such as soaps, cosmetics and toiletries, and timber products, among others (see Table).

⁴ A special resolution is required to alter the provisions of the memorandum, change the objects of the company, change the place of the registered office, omit the word "Limited or Private limited" from the name of the Company, alter or add to the articles, among others.

⁵ E-mail response from a Company Secretary of a defence joint venture in New Delhi.

⁶ It is, however, to be noted that FDI in defence industry was allowed in 2001, although comparison here is made with reference to 2000 due to the availability of coherent data.

Table: Select Sector-wise FDI inflow, April 2000 to May 2010

Rank	Sector	Amount of FDI inflows (US \$ million)	% of total FDI inflows
1	Services Sector	24,227.48	21.16
2	Computer Software and Hardware	10,168.37	8.46
3	Telecommunications	9,821.17	8.17
4	Housing and Real Estate	8,519.25	7.09
5	Constructions activities	8,190.85	6.82
41	Soaps, Cosmetics and Toilet Preparations	173.19	0.14
53	Timber Products	37.07	0.03
62	Defence Industries	0.15	0.00
Grand Total		120,155.25	100

Source: Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India, *Factsheet on Foreign Direct Investment from August 1991 to May 2010*, http://dipp.nic.in/fdi_statistics/india_fdi_index.htm.

Although from the technological point of view, the FDI policy has led to a plethora of partnerships between Indian and foreign companies, a closer scrutiny of the partnerships reveal that most are Memoranda of Understanding (MoUs), which in turn are related to the offsets linked to contracts already signed or anticipated in the future. Conspicuously absent in these MoUs is any mention about the inflow of defence technology which is subject to the licensing and export control rules of the originating countries' governments. This in turn indicates the lukewarm response of foreign companies to the FDI policy which has been in existence since 2001.

Differing Perceptions on Raising FDI Cap

The absence of any meaningful FDI inflows - financial as well as technological - has led to a robust debate, starting with the ministry of finance (MoF) at the official level. In its *Economic Survey 2008-09*, the MoF had suggested increasing the FDI cap to 49 per cent across the board and "up to 100 per cent on a case by case basis, in high technology, strategic defence goods, services and systems that can help eliminate import dependence."⁷

⁷ Ministry of Finance, Government of India, *Economic Survey 2008-09*, p. 32.

Although the recommendations contained in the *Survey* are only in the nature of suggestions, they were supported formally by the MoC&I, which circulated in May 2010 a comprehensive Discussion Paper on *Foreign Direct Investment (FDI) in Defence Sector*. The Paper made a strong case for increasing the present FDI cap by stating that the “established [global] players in the defence industry should be encouraged to set up manufacturing facilities and integration of systems in India with FDI up to 74 per cent under the Government route.”⁸ While making this suggestion, the Paper suggested that, “For future RFPs [requests for proposal] by MoD, a condition may be imposed that the successful bidder would have to set up the system integration facility in India with a certain minimum percentage of value addition in India. The successful bidder should be allowed to bring equity up to the proposed sectoral cap.”⁹



It is worth noting that the Discussion Paper’s main contention of enhancing the FDI cap to 74 per cent was premised on the fact that:

The present cap of 26 per cent in FDI has failed to attract the state of the art technology in the defence sector. Increase of cap from 26 per cent to 49 per cent will not give any additional say to the foreign investor in the affairs of the company as per the provisions of the Company Law. Therefore, increasing FDI cap from 26 per cent to 49 per cent as is being advocated by some industries associations will not really help us in getting the best technology partners to invest in India. By merely increasing the limit from 26 per cent to 49 per cent we may be accused by posterity of doing too little and too late. Therefore, in case we really want to have the state-of-the-art-technology, we have to permit anything above 50 per cent if not 100 per cent. It may be, therefore, desirable to allow either 100 per cent or 74 per cent as in the case of telecom sector. Since there is licensing provision also in the defence sector, we can refuse to permit FDI in the sector by refusing the license where the background of the company is suspect.¹⁰

The above argument for an FDI cap of 74 per cent has, however, not found broad support among industry and most notably the MoD, the key stakeholders in India’s defence industrialisation. Till the release of the MoC&I’s Discussion Paper, the MoD had clearly stated its intention of not increasing the present FDI cap. This is evident from the answer given by the minister of state for defence in parliament who had said ‘No’, in response to the question “whether Government is seriously considering FDI hike in defence

⁸ Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India, *Foreign Direct Investment (FDI) in Defence Sector* (Discussion Paper), http://dipp.nic.in/DiscussionPapers/DiscussionPapers_17May2010.pdf

⁹ Ibid.

¹⁰ Ibid.

production.”¹¹ Keeping in view the above answer and the MoD's perception with regard to the “sensitive nature of the defence sector”,¹² it does not seem that the defence ministry would favour an outright increase in the FDI (this is not to argue that the MoD would not support any increase in FDI limit).

In response to the MoC&I's Paper, a cross section of industrial stakeholders including industrial associations, labour unions, law firms, foreign companies, consultancy and law firms have come out with their own views.¹³ The views of these stakeholders, which are divided along three major lines, are as follows:

- FDI limit should be retained at 26 per cent.
- FDI could be allowed to a maximum of 49 per cent, subject to certain conditions, such as:
 - Minimum financial inflow is \$100 million.
 - Compulsory inflow of technology with approval of originating government with respect to items to be produced in India and their export to other countries.
 - Compulsory industrial licensing and government approval for the formation of such JVs.
 - JVs formed in India with more than 26 per cent foreign equity to be barred from participating in “Make”¹⁴ projects.
- FDI should be increased to 74 per cent.

The majority of the industry, as represented by the Confederation of Indian Industry (CII) and the Federation of Indian Chamber of Commerce and Industry (FICCI), has not favoured an increase in the FDI cap beyond 49 per cent. Moreover, the financial condition proposed by the associations – such as a minimum of \$100 million inflow – for 49 per cent FDI cap is stringent and highly discouraging for any foreign company planning to opt for this route to make an entry into the Indian defence industry. Even if some take this route with a minimum \$100 million investment in an Indian-owned venture, the JV in question would support only the big Indian companies since the mandatory minimum for the Indian equity share would be 51 per cent or \$104 million – a hefty investment from the

¹¹ Rajya Sabha, Parliament of India, “Hike In FDI limit in defence production”, Unstarred Question No. 4336, Answered on May 05, 2010, <http://164.100.47.5/qsearch/QResult.aspx>.

¹² Rajya Sabha, “FDI in defence production sector”, Unstarred Question No. 3561, Answered on April 28, 2010, <http://164.100.47.5/qsearch/QResult.aspx>.

¹³ These views are available in the official website of the Department of Industrial Policy and Promotion, Government of India, <http://www.dipp.nic.in/>.

¹⁴ “Make” projects are defined as “high technology complex systems” for which the Indian industry is responsible for research, design, development and production. In such projects, the MoD shares up to 80 per cent of the developmental cost.

perspective of the Indian defence industry. In other words, small Indian companies which are interested in getting into defence production will be debarred effectively on financial grounds from taking advantage of even the 49 per cent FDI cap.

The rationale behind the opposition of some stakeholders to an increase in the FDI cap is based on the assumption that higher investment would impinge upon national security, ruin domestic technological development and destroy the nascent indigenous industry. However, these fears do not seem to be based on sound logic. The fear of national security being compromised is overhyped since a manufacturing facility of a foreign company within the country, governed by Indian laws, is a much better option than importing complete systems from abroad. The government can exercise greater regulation on foreign companies operating in India than on those operating on foreign soil. Similarly, from the technological and industrial point of view, as pointed out in this Brief later, India lags far behind advanced countries in the 'technology standing index'. FDI, if channelled properly, could prove to be a catalyst for stimulating India's overall technological and manufacturing capability. The National Manufacturing Council, a group constituted by the prime minister to look into India's manufacturing sector, had in fact recommended FDI as one of the tools for facilitating technology transfer and enhancing India's manufacturing capability in key strategic sectors, including aerospace, shipping, IT and hardware and capital goods.¹⁵



Foreign Investment in the Strategic Sector: The International Practice

In the era of globalisation, FDI has been an important source of external finance. According to the United Nations Conference on Trade and Development (UNCTAD), global FDI inflows reached \$1.24 trillion in 2010, and are estimated to rise to \$1.4–1.6 trillion in 2013.¹⁶ The volume and growth of inflows notwithstanding, FDI inflows are often fraught by political issues, since the inflow of resources is invariably linked to control of assets, which the receiving countries are often reluctant to shed for a variety of reasons – national security being the critical one. In recent times there have been plenty of examples in which FDI inflows have been subject to wide and heated political debates. Notable among these is the one that surfaced in early 2006 involving the state-owned Dubai Ports World (DP World) and its planned acquisition of six US ports from the British-owned Peninsular and Oriental Steam Navigation Company (P&O). No sooner had DP World announced its intention of acquiring the ports, a Congressional as well as general public outcry erupted

¹⁵ National Manufacturing Council, *Measures for Ensuring Sustained Growth of the Indian Manufacturing Sector*, Report of the Prime Minister's Group (New Delhi: Government of India, 2008), pp. 18-19.

¹⁶ United Nations Conference on Trade and Development, *World Investment Report 2011: Non-Equity Modes of International Production and Development* (United Nations: New York, Geneva, 2011).

in America, leading, finally, to the Middle Eastern company's withdrawal from the acquisition process.¹⁷

In order to balance the need for foreign investment with national security concerns, many countries in the world, including India, have formulated laws and regulations to prevent/regulate investments in strategic sectors. The United States, which is the main source for both inward and outward flow of FDI, has one of the oldest laws in the form of Exon-Florio Amendment to the Defence Production Act of 1950, which was recently amended through the Foreign Investment and National Security Act of 2007 (FINSIA). Under the Act, the US president is authorised to "suspend or prohibit foreign acquisitions of U.S. companies if they are determined to pose a threat to national security." The presidential power to investigate such acquisitions is, however, delegated to a huge inter-agency, known as the Committee on Foreign Investment in the United States (CFIUS), which is headed by the treasury secretary and includes among others the secretaries of commerce, defence, state, homeland security, energy, and labour.¹⁸ Any application to the agency is investigated within a period of 45 days, for the possible impact of the proposed investment on national security with reference to a pre-identified set of factors, ranging from possible impact on national defence industrial base to commitment to non-proliferation by the FDI-originating country. It is to be noted, however, that an investigation is waived off if the lead agency and the Chair of CFIUS jointly decide against it.

A crucial component of the CFIUS investigation process is the 'mitigation agreement' under which further conditions are imposed on the "party to the agreement to mitigate any threat to U.S. national security."¹⁹ There have been cases where transactions have been approved or withdrawn on the basis of additional security measures. The Special Security Agreement (SSA), signed between the UK's BAE Systems and the US government is a successful case in which the former was allowed to start a wholly-owned operation in the American defence market. Under the SSA, BAE System Plc. (the US-based segment of BAE Systems Inc.) is run by "outside [non-British] directors who, in conjunction with other U.S. based board members, comprise a Government Security Committee. The Government Security Committee has the responsibility for overseeing the company's compliance with U.S. Government Security and Export regulations, and meets regularly

¹⁷ Ames K. Jackson, *The Committee on Foreign Investment in the United States (CFIUS)*, CRS Report for Congress, July 29, 2010, RL33388, p. 1.

¹⁸ The other members are: Attorney General of the US, Chairman of the Council of Economic Advisors, Director of the Office of Management and Budget, Office of Science and Technology Policy, The US Trade Representative, Assistant to the President for Homeland Security and Counterterrorism. It is, however, to be noted that the Chair of CFIUS can nominate heads of any other agency on a case-by-case basis.

¹⁹ US Government Accountability Office, *Foreign Investment: Laws and Policies Regulating Foreign Investment in 10 Countries*, February 2008, p. 34.

with U.S. Government oversight agencies to provide feedback on that compliance.”²⁰ According to the former CEO of BAE Systems, Mike Turner, the SSA allows BAE Systems to “operate in the US as an American company, providing the highest levels of assurance and integrity in some of the most sensitive fields of national security provision.” And he added that while the parent company in the UK “gets to see the financial results” of the US business, “many areas of technology, product and programme are not visible to us.”²¹

On the other hand is the example of a failed joint attempt by a private firm and a Chinese company to acquire a US-based network and software firm 3Com. In 2008, Bain Capital (the private investment firm) and Huawei Technologies (China’s largest networking and telecommunications equipment supplier) withdrew their joint \$2.2 billion proposal for acquiring 3Com as the “parties were unable to agree on security-related conditions.”²²

While the US has established strong institution-based rules and regulations, other countries are not far behind. As a 2008 GAO report noted, of the 10 countries (Canada, China, France, Germany, India, Japan, the Netherlands, Russia, UAE and UK) examined by the supreme auditor, eight have a formal review process, usually overseen by a government economic body with inputs from other government security bodies. Most of the countries studied have set a time frame for evaluation and put forth certain conditions for prior approval. National security is at core of the evaluation process, although the concept of security itself varies from one country to another, depending on each country’s sensitivity about its national defence industrial base, critical infrastructure, including energy sector, the investment by foreign state-controlled companies and sovereign wealth funds.²³

Although many countries have devised detailed mechanisms to filter foreign investment into the strategic sector, a very few countries have a blanket ban on inflows beyond a certain level. Among the 10 countries, India and UAE have a blanket ban on FDI beyond a certain threshold. While India does not allow more than 26 per cent FDI in its defence industry, UAE restricts all foreign investment to 49 per cent unless the investment falls in its Free Trade Zones. The approach adopted by other countries is that approval/disapproval is based on certain criteria. For instance, Germany requires prior approval of all investment in its defence industry if a particular transaction amounts to the acquisition of more than 25 per cent voting rights in a domestic company. France has indentified 11 sectors, including defence, in which an inter-ministerial approval is required. Investment in Japan is required to be notified to the government if it pertains to sensitive industries,

²⁰ BAE Systems, “Special Security Agreement”, <http://www.baesystems.com/WorldwideLocations/UnitedStates/AboutBAESystemsUnitedStates/SpecialSecurityAgreement/index.htm>.

²¹ BAE Systems, “Speech by Mike Turner to the Washington Economic Club,” May 10, 2006, http://www.baesystems.com/Newsroom/SpeechesandPresentations/autoGen_107128111230.html.

²² Stephanie Kirchgaessner, “US insiders point to Bain errors over 3Com”, *The Financial Times*, March 03, 2008, <http://www.ft.com/cms/s/0/9a35ca5a-e975-11dc-8365-0000779fd2ac.html>.

²³ US Government Accountability Office, note 19, p. 3

including the ones that deal with dual use technologies. Under a new law that is in the making, Russia plans to specify 40 strategic sectors for which prior government approval is necessary for obtaining a controlling stake.

Why does India Need Higher FDI in Defence and How Much?

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. While perceptions such as "national security" and the "strategic nature of defence industry" have prohibited any change in the policy, the fact of the matter is that India's larger goal of self-reliance in defence production continues to be a pipedream. 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.

Low Technological Base

The root cause of India's underdeveloped defence industrial production is its poor technological base in general and in military technology in particular. According to the Georgia Institute of Technology, India ranks low in the "technological standing" list of 33 countries. The contrast is with respect to China, which has progressed rapidly in terms of technological capability. In a matter of 11 years, by 2007, China's score has gone up from 22.5 to 82.8. Beijing now ranks first in the list, above the United States (76.1), Germany (66.8), Japan (66) and India (just above 20).²⁵ China's progress in advanced technology is also evident from its export of Advanced Technological Products (ATP), particularly to the United States. In 2008, it accounted for 28 per cent of US imports of ATP, compared with seven per cent in 2000.²⁶

²⁴ See Ministry of Industry, Government of India, "Statement on Industrial Policy", July 24, 1991, <http://siadipp.nic.in/publicat/nip0791.htm>.

²⁵ The 'technological standing' is defined as an "output factor that indicates each nation's recent success in exporting high technology products. Four major input factors help build future technological standing: national orientation toward technological competitiveness, socioeconomic infrastructure, technological infrastructure and productive capacity. Each of the indicators is based on a combination of statistical data and expert opinions." See Georgia Institute of Technology, "Technology Indicators: Move over U.S.-China to be New Driver of World's Economy and Innovation", January 24, 2008, <http://gtresearchnews.gatech.edu/newsrelease/high-tech-indicators.htm>.

²⁶ Alexander Hammer, et al. *China's Exports of Advanced Technology Products to the United States* (Washington, DC: U.S. International Trade Commission, 2009).

One reason for India's underdeveloped technological base is poor investment on R&D. For instance, for the period 2004-06, India's total R&D expenditure amounted to 0.88 per cent of GDP, compared to 1.42 per cent for China, 2.12 per cent for France, 2.61 per cent for the United States and 4.53 per cent for Israel.²⁷ India's poor investment on R&D efforts is across all sectors, including defence. In 2011-12, the total defence R&D budget as accounted for by the Defence Research and Development Organisation (DRDO) is Rs. 10,253 crore, which represents 6.2 per cent of the defence budget.²⁸ Compared to this, countries such as the United States, Russia, France and Spain spend over 10 per cent of their defence budget on R&D.²⁹ R&D investment by the Indian private sector is even more unimpressive. To put this in perspective, the total R&D expenditure by the Indian private sector in 2005-06, the latest year for which comprehensive data is available, is only Rs.15.67 crore.³⁰

Given the rapid progress in technological advancement in other parts of the world, India can least afford to lag behind. This is more so given the high gestation period – 25 years as per some studies³¹ – for technology investment and its translation into actual proven systems. In other words, even if India increases its R&D efforts in a big way, the benefits, in terms of equipping the armed forces with proven technologies, will not accrue in the near future.

In the short-to medium-term, there is, however, a possibility of raising Indian defence production, based on foreign technology. However, technology transfer is a complicated affair, given the strict export rules of many advanced countries. Nonetheless, given the size of the Indian procurement budget (nearly Rs. 43,800 crore in 2010-11), some transfers of technology can be induced provided a conducive atmosphere were created through a requisite policy framework.

Efficacy of Offset Policy, and “Buy and Make (Indian)” Procurement Provision

To energise the domestic defence industry, the MoD has in the last few years taken several measures. Among them are the offset policy and the recently announced “Buy and Make (Indian)” procurement provision, which have a direct bearing upon the FDI. The offset policy, which mandates a minimum 30 per cent offsets in arms import contracts valued at Rs 300 crore or more, allows FDI as a means of discharging offset obligations. The limited

²⁷ Ministry of Science and Technology, Government of India, *Research and Development Statistics 2007-08*, p. 65.

²⁸ Ministry of Defence, Government of India, *Defence Services Estimates 2011-12*.

²⁹ Keith Hartley, “Defence R&D: Data Issues”, *Defence and Peace Economics*, Vol. 17, No. 3, June 2006, pp. 169-175.

³⁰ *Research and Development Statistics 2007-08*, note 27, p. 90.

³¹ See, for example, McKinsey&Company, “McKinsey on Government”, *Special Issue on Defence*, No. 5, Spring 2010, p. 70,

FDI cap of 26 per cent, however, means that in a large defence contract, a foreign supplier is forced to take the non-FDI route - such as outsourcing work packages to the Indian industry - to not only fulfil its offset obligations but also to avoid making small and staggered investments in several Indian companies. As outsourcing is more by way of exploiting the existing capabilities, this option, unlike direct investment in new industrial infrastructure, has a limited role to play in enhancing India's defence industrial capability. Allowing higher FDI is, therefore, necessary to make the best use of the offset policy.



The Defence Procurement Procedure 2011's (DPP-2011) provision of "Buy and Make (Indian)" gives the Indian industry a major opportunity to work closely with the global defence industry. Under this provision, the Indian industry is solely responsible for negotiating with global defence manufacturers for technology and other assistance for products to be supplied to the Indian defence forces. The only mandatory requirement of the provision is that the indigenous content of the final item has to be a minimum of 50 per cent on cost basis.³² However, the FDI cap of 26 per cent means that the Indian partner would have to first make a heavy investment before tying up with its foreign counterpart. The investment requirement, under the present scheme of things, is thus a dissuasive factor, especially for the private sector which is risk-averse due to lack of exposure to the defence industry. Even if some companies commit the investment in setting up infrastructure, they will still be dependent on foreign companies for key technologies, which, the overseas partners, as mentioned earlier, are reluctant to part with because of the existing FDI cap. Allowing higher FDI would thus enable the Indian industry to take maximum advantage of the "Buy and Make (Indian)" provision.

Economic Benefits

As mentioned earlier, the FDI policy is a part of the MoD's broader reform towards the stated objective of achieving greater self reliance in defence production. The stated objective notwithstanding, there are plenty of economic benefits that could accrue simultaneously to the wider economy, if much of the defence requirement is sourced from the domestic industry. Although a precise estimation of FDI-generated benefits is a task by itself, a broad indication can be inferred from the Kelkar Committee Report (2005) *Towards Strengthening Self Reliance in Defence Preparedness*. The Report contained a comprehensive set of reform measures for enhancing India's defence production and, based on its suggested measures, the committee had calculated the overall 'economic impact'. Taking 2003-04 as the base year in which the domestic share of the total defence procurement

³² Ministry of Defence, *Defence Procurement Procedure: Capital Procurement* (New Delhi: Government of India, 2011), pp. 9-10.

budget was 58 per cent, the Committee was of the view that the reform measures proposed by it would lead to a progressive increase in the domestic share to 90 per cent over a period of five years. The Committee had identified three major economic benefits - higher manufacturing output, additional generation of employment and savings through relatively reduced procurement cost of indigenised products – that would accrue to the wider economy. The details of the economic benefits as identified by the Kelkar Committee are as follows:

- Higher defence production will accelerate the overall growth of the manufacturing sector by 8-14 per cent.
- Increase of employment by 120,000-200,000.
- Savings of 30-50 per cent as result of import substitution and cheaper cost on account of spares and maintenance. In absolute terms, this translates into savings of more than Rs. 4,000 core per year.

Given the immense benefit of indigenisation and the key role that FDI could play in achieving that, the current policy therefore needs to be revised.

How much FDI?

In the light of the above, the vital question is: what should be the ideal cap on FDI in defence. This Brief studies the various options within the existing framework of India's FDI policy, which allows foreign investment in four maximum limit-based categories: 26 per cent; 49 per cent; 74 per cent and 100 per cent.

Increasing the cap from 26 to 49 per cent would no doubt provide the foreign investors almost half the returns on their investment. Although this may sound attractive from the financial point of view, it may not be so attractive to foreign investors in terms of control and management. This is because increasing the FDI cap to 49 per cent does not provide them with any additional say in the affairs of the company, as pointed out by the DIPP and as per the provisions of the Indian Company Law. In other words, for a technology investor who is concerned more about control and management, the 49 per cent FDI cap offers little beyond what the 26 per cent cap. However, the same investor would certainly be tempted if the cap were to be raised to 74 per cent, thus giving not only more than majority control but also enhanced scope for return on investment. The question further arises whether the 74 per cent cap is the maximum cap that the FDI policy could offer to attract the best of the technologies. Probably not! For some niche technologies, foreign investors would like absolute control over management for which 100 per cent FDI is a prerequisite.

It is to be noted, however, that FDI cap above 49 per cent, which provides management control to the foreign investor, raises a degree of concern in terms of the impact on the national defence industrial base and broader national security. However, as the international practice, especially that of the United States shows, such concerns could be mitigated by not limiting FDI to a certain percentage of the equity flows but by adopting

a flexible path. This implies subjecting each defence-related FDI to a wider review and impact analysis with respect to a set of well calibrated parameters. Since India has a cap-based FDI approach, the ideal path would be to allow up to 100 per cent FDI, subject to a detailed review of each incoming investment. Based on the review results, FDI percentages could be assigned varying between zero and 100 per cent. If an investment were to be found unacceptable because of certain fears it may be rejected. If an investment were to be found beneficial only on financial grounds, the cap may be fixed either at 26 per cent or a maximum of 49 per cent; if it involves a meaningful technological inflow, the cap could be raised 74 per cent; and the cap may go up to 100 per cent, if the investment brings in high-end technology for the benefit of Indian industry and defence.



In order to follow a flexible path, the existing inter-agency, the Foreign Investment Promotion Board (FIPB), which is responsible for approving FDI based on the existing cap-based regulations, needs to be empowered to investigate all FDIs in the defence industry. The FIPB may also be empowered to stipulate additional security measures for the foreign investors in order to mitigate any concerns which may arise during the course of investigation. In case of FDI beyond 49 per cent, conditions can also be imposed on the proposed foreign investor so as to allow him to operate in India like an Indian company, and except for the financial benefit, no technological or other benefits be allowed to be transferred without permission from the Indian authorities to the parent or any other country. Thus, unlike a rigid and fixed cap approach, which may prevent some desirable inflows involving critical technologies because of its inherent rigidity, a complete yet case-by-case liberalisation of FDI policy would enable merit-based selection.

The success of a flexible FDI policy is critically depended on how it is managed for the benefit of the domestic industry. Some lessons in this regard can be drawn from the practices of other countries, and primarily of China which has used FDI as an instrument for developing its strategic industries.³³ China's FDI policy is geared towards enabling its industries to "integrate into the global value-chain...accelerate its industrial and technological transformation [while avoiding reinvention] of the technological wheel." The key elements of China's FDI policy are those of direction, domestic value addition and transfer of technology.³⁴ China is quite "explicit in the type of foreign investment that is 'prohibited', 'permitted', or 'encouraged', with the latter category focusing on advanced technologies." To induce foreign investors into its high-tech industries China provides various incentives such as tax rebates and lower tariff rates.³⁵ India's FIPB, while reviewing

³³ Nellie Zhang Yan, *China's Search for Indigenous Industrial Development: A Case Study of the Aviation Industry*, Cranfield University (2009), PhD Thesis, p. 8.

³⁴ National Manufacturing Council, *Measures for Ensuring Sustained Growth of the Indian Manufacturing Sector*, Report of the Prime Minister's Group (New Delhi: Government of India, 2008), p. 59.

³⁵ Bureau of Industry and Security, Office of Strategic Industries and Economic Security, "US Commercial Technology Transfers to the People's Republic of China", http://www.fas.org/nuke/guide/china/doctrine/dmrr_chinatech.htm.

the incoming FDI proposal, needs to adopt a similar approach in order to ensure that the FDI leads to technology transfer to Indian companies and their value addition is increased over the years. Various incentives such as tax rebates and the like could also be provided to induce higher technology through FDI.

Conclusion

Since 2001, India has allowed FDI up to 26 per cent in its defence industry. However, the policy has so far had a modest impact in terms of meagre financial (\$0.15 million till May 2010) as well as technological inflows as evident from the absence of any meaningful partnership between Indian and foreign companies. The major factor responsible for such a limited impact is the lack of incentives offered to foreign investors by the current policy. To overcome the constraints inherent in existing policy, suggestions have been made to increase the FDI cap although differences exist with respect to the precise level of the higher cap. The Indian industry's suggestion that the cap be increased to a maximum of 49 per cent with certain conditions - especially the mandatory capitalisation of \$100 million - is not likely to incentivise the foreign companies; and even if it does, it would at best help a handful of big Indian companies, while the small and medium sized companies would be effectively debarred from taking advantage of the FDI route due to limited equity.

Considering India's underdeveloped defence R&D and production base, the desire to enhance domestic defence production and the immense economic benefits that could flow in, an increase in the FDI cap would improve the prospects of technology transfer and the forging of meaningful ties between Indian and foreign defence companies. Increasing the FDI cap is also likely to facilitate the effective functioning of the offset policy as well as the "Buy and Make (Indian)" procurement provision. Keeping the above potential benefits in mind, the FDI cap in the defence sector could be increased to 100 per cent, instead of fixing it at a level of up to 74 per cent (as suggested by some) because a cap-based approach is marked by constraints, especially in terms of attracting high technology-intensive investments.

At the same time, given the sensitivity attached to the defence industry and national security, all defence-related FDI could be subject to a wider review by the empowered Foreign Investment Promotion Board. The FIPB may be empowered to recommend the precise level of FDI varying between zero and 100 per cent, based on a thorough investigation and detailed impact analysis of each investment. The agency may also be empowered to recommend additional security measures to investors in order to mitigate any concern that may arise during the course of the investigation. To ensure that FDI leads to an enhancement of India's technological base, the empowered FIPB may also mandate technology transfer to Indian companies and their value addition as a precondition for allowing external investment.