

FDI in Defence Sector: Re-shaping India's Military Industrial Complex

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"A nation with a strong defence industry will not only be more secure, it will also reap rich economic benefits – it can boost investment, expand manufacturing, support enterprise, raise the technology level and increase economic growth in the country".

— Hon'ble PM Narendra Modi at the Aero-India Show (2015)

Abstract

In the past few years, the prime objective of the government has been to make India a hub of manufacturing and global investments, to boost local production and deploy young talented population to lead the charge on indigenisation in the Defence Sector. The 'Make in India' mission has gained momentum to the extent that it is now embedded in the very hearts and minds of the population. The campaign aimed to "facilitate investment, foster innovation, enhance skill development, protect intellectual property and build best in class manufacturing infrastructure".¹ This article highlights the changes in Foreign Direct Investment (FDI) in the defence sector, how it is reshaping India's Military Industrial Complex and the positive framework for foreign investors to invest in India.

Introduction

The government is trying to lead the defence manufacturing sector for 'Make in India' while the second largest armed force

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is going through a technological transfiguration. The government has identified sets of areas where stakeholders can collaborate and solidify the vision under the 'Make in India' scheme, duly supported by a requisite research and development ecosystem. India is the third largest military importer with a defence spending of 2.15 per cent of the total GDP, and intends to spend a hefty \$ 130 billion on modernisation for all three Services. Accordingly, the government has trotted out a variety of reforms and rejigged procedures to support the domestic defence industry- domestic capital procurement share has been enhanced from 64 per cent to 68 per cent of the Capital Acquisition Budget of the Defence Services for the FY 2022-23; delicensing and digitising of procedures; import embargo on procurement of weapons that can be made by domestic industry; increased Foreign Direct Investment (FDI) limits to 76 per cent through the automatic route and, in some cases, upto 100 per cent after government clearance. It is centred on the following four pillars:

- **New Processes**
- **New Infrastructure**
- **New Sector**
- **New Mindset**

"A report by the International Monetary Fund (IMF) has pegged India to be a bright spot in an increasingly gregarious global environment and in a better position to deal with global headwinds than many other countries, as per the World Bank".² India has shown in the past three years its resilience to adverse situations and the numbers speak for themselves, India has been setting new records in terms of its FDI holdings.³

Liberalisation and the Scope for FDI

It was only in the year 2001 that the country opened up FDI in defence sector. Initially, the cap was put at 26 per cent in equity holding of joint ventures. Since defence is one of the most critical aspects of National Security, it was the forte of Ordinance Factories Board (OFB) and Defence Public Sector Undertakings (DPSUs). The private sector was not allowed to manufacture equipment and had a very limited role in some basic supplies to the armed forces. In 2001, private industry was permitted to manufacture and was

issued industrial licenses, but the primary concern of decision-makers was in letting them in the 'top-drawer'. Therefore, when the FDI was initially opened up, certain practices were induced to make sure that the Indians have control of the joint ventures/strategic partnerships for instance, higher Indian representation in the management/board could qualify the foreign company's candidature. India had been dependent on foreign technology/equipment/weapons for a long time and continued to falter in building a robust policy base that would promote its local manufacturing, e.g., despite its offset policy of 2005, the first case of offset agreement happened two years later. As policies evolved and liberalisation brought its touch, FDI policies transformed to inculcate diversity of the investors and, hence, in 2013, the government allowed for 26 per cent access in the equity shares on a case-to-case basis, only if they offered access to cutting-edge technology.

FDI in Defence and Transfer of Technology (ToT)

The concept of FDI inflow in an economy does not necessarily correlate to having funds only but being also able to cash on the latest technological innovation in any field. It is not merely the exchange of know-how but it acquires a purposeful association between the domestic and global entity. This also builds a pattern of cyclic relation wherein, the domestic manufacturers improve their techniques with the latest technology and, in the process, eventually attract more global partners, hence, if we look at the defence industrial base in India through the lens of FDI, perhaps the decision makers will be able to understand the need for higher FDI inflow.⁴ Moreover, FDI in defence becomes even more necessary in today's complex environment because:

- Technology is changing at an unprecedented rate, hence, the defence sector is more susceptible to obsolescence. This requires the decision-makers to carefully assess which technology will be applicable in the Indian scenario without delaying the acquisition and the timelines of a said project.
- One of the many problems associated with defence manufacturing is the complexity of the defence systems and because of the intricacies involved in the process, it makes it even harder to procure it from a single vendor. In addition, there are technological agreements/regimes that limit these

mergers/acquisitions keeping in mind the volatility of the geo-political environment. Therefore, to combine the systems/sub-systems/components, together we need 'system integrators'. This requires the government to bond with multiple global partners and accentuate the FDI framework to extract maximum benefits with suitable rewards for the foreign vendors too.

- Since the relationship between the countries is largely determined by the incentives or advantages that the alliance may provide, it is also exacerbated by the volatility of the global market. Foreign policy also plays a huge part in the entire dynamics as it will advance the nation's national interest by forging alliances with like-minded partners to provide opportunities to find common avenues for growth and look out for its domestic industries.
- Another predicament in the concept of FDI is strict regulations surrounding the definition of representation of a foreign entity. For instance, there has to be a majority in terms of Indian representation in the board of management of foreign firm, a necessity of an Indian company in partnership in order to qualify for FDI. In order to get access to any kind of technology, the Foreign Original Equipment Manufacturers (FOEMs) would want some kind of assurance of production of system/equipment at a large commercial scale and to become part of the decision-making.

FDI is the largest source of a non-debt financial resource for the economic development of the country. FDI is an important component of foreign capital as they create long-term sustainable capital, technology transfer, gives impetus to innovation and competition, assists in furthering the development of strategic sector, and, primarily, a huge source of employment. The current policy framework, is incorporated in a Circular for a consolidated FDI Policy 2020⁵, lays down the following conditions:

- FDI up to 74 per cent under automatic route shall be permitted for companies seeking new industrial licenses.
- Infusion of fresh foreign investment up to 49 per cent, in a company not seeking industrial license or which already has government approval for FDI in defence, shall require

mandatory submission of a declaration with the Ministry of Defence (MoD) in case change in equity/shareholding pattern or transfer of stake by existing investor to new foreign investor for FDI up to 49 per cent, within 30 days of such change. Proposal for raising FDI beyond 49 per cent from such companies will require government approval.

- Licence applications will be considered by the Department for Promotion of Industry and Internal Trade (DPIIT), Ministry of Commerce and Industry, in consultation with MoD and Ministry of External Affairs (MEA).
- Foreign investment in the sector is subject to security clearance by the Ministry of Home Affairs (MHA) and as per guidelines of the MoD.
- Investee company should be structured to be self-sufficient in the areas of product design and development. The Investee/ Joint Venture (JV) company, along with the manufacturing facility, should also have maintenance and life cycle support facility of the product being manufactured in India.
- Foreign investments in the defence sector shall be subject to scrutiny on grounds of national security and government reserves the right to review any foreign investment in the defence sector that affects or may affect national security.

Standing Committee Report on the Status of FDI (2021-2022)⁶

Responding to a query in the Parliament on the number of foreign companies who have shown interest in manufacturing defence equipment under FDI in the country, the Minister of State for Defence, Shri Ajay Bhatt said, "The government has given approval to 45 companies/JVs operating in defence sector with FOEMs".⁷

The three armed Services are now focusing on buying from domestic defence players, whether private or public sector. These higher percentages can be attributed to the multiple reforms being initiated to strengthen our defence sector; higher multipliers in the offset policy, periodic consultations with FOEMs, defence corridors, defence investors cell etc. The Committee has also lauded the MoD in this regard, "*Committee appreciates the efforts of the Ministry in this direction by bringing down the imports of defence equipments which is a step towards the goal of Self Reliance and Make in India*".⁸

The Committee noted that during the financial years (2017-18 to 2020-21), out of total 239 contracts, 87 contracts worth about Rs. 1,18,111.98 crore have been signed with foreign vendors including USA, Russia, Israel, France, etc. for procurement of defence equipment for the armed forces.⁹

Defence Spending and its impact on Strategic Choices

Although, strategic competition and conflict shape a nation's choices to deter an adversary, it also provides a platform to demonstrate the technology and manufacturing capabilities of a nation. Indian defence manufacturer, Kalyani Strategic Systems Limited (KSSL) obtained an export order for its 155mm artillery gun platform.¹⁰ The order worth \$ 155.5 million will be completed within three years. The 155mm artillery gun is capable of firing NATO standard shells. Previously, Armenia had also purchased four batteries of the Pinaka Rocket Artillery systems, including ammunition associated with the product. The commitment also involved the purchase of Konkurs Anti Tank Guided Missiles (ATGMs) manufactured by Bharat Dynamics Limited (BDL), and multiple range of ammunitions (mortar shells) as part of their replenishment of Armenian inventory. Armenia had also placed an order for the purchase of Swathi weapon locating radars which are manufactured by Defence Research and Development Organisation (DRDO) and Bharat Electronics Limited (BEL). As Armenia restocks its land force after the conflict in the Nagorno-Karabakh Region, it has also shown interest in purchasing BDL Akash Surface-to-Air Missiles (SAM), loitering munitions by Tata Advanced Systems Limited (TASL), and Economic Explosives Limited (EEL)¹¹

It seems now that FDI and export of defence systems are picking up in tandem. The Indian Government has been constantly putting in the fore-front its intention to make India an export powerhouse. Its ambitious \$5 billion worth of exports will progress through the trust that India has garnered over the years because of its ability to transform and its respect across the globe for a variety of reasons. Some of these are:

- Malaysia has shortlisted the Tejas light fighter jet for an order of around 16 planes, and Argentina, Egypt and Botswana have also expressed interest, Hindustan Aeronautics Limited

(HAL) Chairman and Managing Director CB Ananthakrishnan told reporters at a conference during Aero India, the country's biggest aviation event.¹²

- HAL has completed the delivery of an Advanced Light Helicopter (ALH) Mk-III and other deliverables to Mauritius as part of a ₹ 141 crore defence deal.¹³
- In a recent move, the Guyana has shown interest in the purchase of indigenously produced equipment, Dornier 228 and fast patrol vessels, Hindustan Turbo Trainer-40 (HTT-40), Light Utility Helicopters (LUH) and Light Combat Helicopters (LCH).¹⁴ The Guyanese President had separate bilateral talks with Prime Minister Modi on the sidelines of the 'Pravasi Bhartiya Divas'. Exports to Guyana can be a game changer for India not only in the defence sector but also Guyana is now emerging as an 'oil Power' with 11 billion barrels of reserves, it can be one of the answers to our energy needs as we transit amidst the war in Europe.

Sale of BrahMos to other countries not only pushes India's exports but also holds promise of strategic partnerships. Vietnam won't be the first country to buy BrahMos. Last year, India inked an export deal with the Philippines, signing a \$375 million contract for the BrahMos shore-based anti-ship missile system. Now Indonesia is also interested in BrahMos.¹⁵

Recommendations for adopting Smart Manufacturing in the Defence Sector

These recommendations are as enumerated below:

- India is a potential hub with its large demographic dividend in terms of availability of a large technologically laced labour, tech graduates, and low cost manufacturing. The government is already readying itself with a roadmap for building India into a hub for innovation with a growing startup community. Schemes and incentives for industry and global manufacturers need to support the industrial bodies to accelerate this vision.
- Creation of a dedicated wing under the Ministry of Commerce and Industry and the MoD for the adoption of Industrial Revolution Four (IR4), that will monitor the global changes and standards.

- Defence industry to re-evaluate its managerial roles, invest in developing skills for its employees in leadership roles as well, targeting soft skills like- critical thinking, creativity, emotional intelligence, judgement, and cognitive flexibility.
- Revitalising curriculums. Academia will have to align their learning to the needs of the industries, with a heavy emphasis on practical knowledge. Learners would need to unlearn and push themselves to develop original research. Vocational training is to be given importance to partner with industry. In the near future, the technological needs of the defence forces will provide abundant opportunities to the domestic defence industry and government run manufacturing units.¹² Other favorable avenues for domestic production include the following:
 - o Needs of the mechanised forces that operate with Main Battle Tanks (MBTs) and Infantry Combat Vehicles (ICVs), and Light Armoured Vehicles (LAVs). Although the T-90 Tanks are in wide use, yet their assembly and production have to reach the optimum level of indigenisation.
 - o Similarly, the Bofors gun (155mm medium) breathed its last and needs to be replaced with advanced systems and indigenously produced gun systems with a quantum jump in technology.
 - o Unmanned Aerial Vehicles (UAVs) are the future and would be required for providing an 'improved' level of battlefield transparency since our air defence systems are still being dominated by the use of old-generation technology.
 - o Combat engineers desperately need advanced bridging equipment, mines, minelaying and breaching equipment, armoured vehicle engineers, loaded with multiple capabilities, demolition guns, and self-neutralising attack mines on an urgent basis.
 - o Non-Lethal Weapons that can be used to disable military technology in urbanised terrain, stun grenades, and optical and acoustic weapons.

- o Artificial intelligence (AI) to build target identification and classification, image interpretation, and maintenance of sensitive weapon systems.

Conclusion

It can be concluded that in order to build a holistic defence industrial base and proactive manufacturing defence sector, it is essential firstly to implement the Defence Production and Export Promotion Policy (DPEPP) 2020, which is till date in a draft stage. Second, specific Production Linked Incentive (PLI) schemes and incentive clauses for Disruptive technologies, Cyber Security, AI, Semiconductors etc will attract greater FDI inflows and also become part of the national security ecosystem. Third, Smart Manufacturing also needs to be brought in early with foreign collaboration to ensure highquality reliable manufacturing of defence equipment under field conditions. As we work our way through an era of uncertainty and volatility in the geo-political environment which determines the relationship with allies, let us find the right partners to bring in their investment in our strategic defence sector in the following specific areas of niche technology, which is the need of the hour for India if it is aspiring to be a global power:

- Gas Turbine Engines
- Hypersonic Missiles
- Ballistic and Cruise Missiles
- Submarines
- Fifth Generation Fighters
- Transport Aircrafts to meet military requirements
- Secure communication devices, secure microprocessors and secure routers
- Cyber Security Infrastructure
- Surveillance Systems

Endnotes

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