FDI in Defence – The Impact of the Liberal Investment Views

What does increased FDI limits via automatic route in the Defence Sector mean for India? With cautious calibration, the country aims to move towards being truly self-reliant. Let's understand the caveats and challenges ahead.

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After its independence in 1947, the Indian economy remained fairly closed. During the mid-80s, the growth in the export sector turned negative, and industrial production recorded negative growth. In the latter half of the 80s, an attempt was made to liberalise the economy to overcome a deficit in the balance of payment, which, however, was futile. In the earlier 90s, China became an attractive destination for foreign investors, while India still faced difficulty. It was then that India liberalised its economy and opened it up to foreign investment. Initially, very few sectors, such as manufacturing and mining, were liberalised. Later, more sectors such as service, telecommunication and retail were liberalised. Since then, the country has welcomed many multinational corporations to invest; which resulted in a massive transformation of the economy in the last two decades.

A Liberal View of Defence Investments

Decades after liberalisation, Prime Minister Narendra Modi launched an initiative called Make in India, which was devised to transform the country into a global design and manufacturing hub. The initiative was not only a call to action to Indian businesses but also an offer to likely partners and investors across the globe. While the total FDI inflows in the country in the last 20 years (April 2000 to June 2020) were about 693+ billion US Dollars, nearly 50% of that was received in the previous five years.

Presently, there are two routes under which foreign investment can be made in India:

1. The automatic route – where foreign investment is allowed without prior approval of the Government of India or RBI in activities or sectors specified in the FEMA Regulations;
2. The Government route – where prior approval is required for foreign investment.

Under the automatic route, certain sectors such as Agriculture and Animal Husbandry, Air Transport Services, Biotechnology, Pharmaceuticals, Manufacturing and many more are permitted 100% of investment through FDI, while other sectors such as Insurance, Medical Devices, etc., are allowed a lower investment through the automatic route. While some sectors, such as Banking and Public Sector, Broadcasting Content Services, Multi-Brand Retail Trading etc., are permitted lower FDI under Government route, other sectors such as Print Media, Satellite Establishment and Operations etc., are permitted 100% FDI under the Government route.

The defence sector was previously permitted 49% FDI through the automatic route, and any investment above that was permitted through the Government route. This changed in mid-September 2020 when the proposal of the Finance Minister, Nirmala Sitharaman, was approved by the Union Cabinet – raising the maximum limit of FDI through automatic approval in the defence sector to 74%, to attract overseas investors and invite foreign original equipment manufacturers to shift operations to India. This would also help private Indian entities to play a more significant role in defence production through collaborative development with foreign entities.

The Stockholm International Peace Research Institute (SIPRI) reported in 2019 that India has among the world's top 5 arms importers since 2010. Steps have been taken to modernise the country's armed forces by acquiring helicopters, warships, submarines, combat jets, artillery guns and assault rifles from countries like Russia, US, France and Israel. Russia has been the largest supplier to India. But between 2015 and 2019, its deliveries fell by 47 %, and its share of total Indian arms imports went from 72% to 56%. In fact, India's arms imports from the US, which was its second-largest supplier, dropped by nearly 51% between 2015 and 2019. However, this reduction in procurement of arms only meant that India was diversifying its suppliers – arms imports from Israel and France went up by 175% and 715% respectively between 2015 and 2019. For a while, there were talks of self-sufficiency in defence production – however, little evidence was available to study the progress. Prime Minister, Modi, in his address to the nation spoke about building an Atmanirbhar Bharat, or a self-reliant, resilient India, in defence manufacturing. He spoke about how the Government was trying to boost defence production by breaking all the shackles historically associated with it. His vision is to increase production in India, develop new technology in India, and maximise the expansion of the private sector. Further liberalisation of FDI in the defence sector can be seen as one of the steps taken by the Government towards self-sufficiency in defence production.

Caveats in The Interest of National Security

The Government reserves the right to review any foreign investment that is likely to affect national security. The obvious reason for including the national security clause is that majority stake in the companies seeking such investments will be held by foreign investor/s. Consequently, the control and management of such companies would vest in the hands of foreign investor/s.

Press Note 4 (2020) issued by the Department for Promotion of Industry and Internal Trade stipulated certain conditions for the FDI viz.,

1. FDI up to 74% under automatic route shall be permitted for companies seeking new industrial licenses. Licence applications will be considered by the Department for Promotion of Industry and Internal Trade, Ministry of Commerce & Industry, in consultation with the Ministry of Defence and Ministry of External Affairs.
2. Infusion of fresh foreign investment up to 49%, in a company not seeking an industrial license or which already has Government approval for FDI in Defence, shall require mandatory submission of a declaration with the Ministry of Defence in case change in equity/shareholding pattern or transfer of stake by existing investor to a new foreign investor for FDI up to 49%, within 30 days of such change. Proposals for raising FDI beyond 49% from such companies will require Government approval.
3. Foreign investment is subject to security clearance by the Ministry of Home Affairs and as per guidelines of the Ministry of Defence.
4. Investee company should be structured to be self-sufficient in the areas of product design and development. The investee/joint venture company along with the manufacturing facility, should also have maintenance and life cycle support facility of the product being manufactured in India.

Challenges to be overcome

As the adage goes, one should make hay while the sun shines. Increasing the FDI in defence sector through the automatic route is definitely a good move. High-end technology should be obtained while foreign firms are eager to invest in India. Creating strategic defence partnerships through the FDI will not only build our capability but also strengthen our relations. Reduction of India's notorious dependence on imported military hardware and technology seems like the prime focus of this move by the Government.

However, nothing comes for free, and every good deed requires effort. It goes without saying that there are some challenges that need to be overcome. Extending the opportunity to manufacture defence equipment in India and spending on such defence equipment for domestic use are disparate matters, which require the Government to be ready with sufficient spare funds to afford these. Further, if the objective is to make India an exporter of defence equipment, a mere extension of the FDI threshold will not convince foreign manufacturers to relocate operations to India, especially when most importing countries look to the West for defence equipment. Also, India's relations with its northern neighbours will restrict the supply of defence equipment to those countries, even though our neighbours, too, are importers of defence equipment.

A little while before the Make-in-India program went live, it was reported that nearly 50% of the military's equipment holdings were obsolete. There were multiple critical voids in the system that was the result of sustained neglect for over a decade. In 2014, the Modi Government made the bold move of increasing the FDI in defence from 26% to 49% under the automatic route. Despite the bold move, the President of the Federation of German Industries refused investment in India since the 49% stake meant that they would not have control over selling the products.

There will always be challenges in any field – the key is to find the right solution to overcome the challenge. It has taken the Government a few years to build confidence and develop better relations with various foreign countries to raise the FDI under automatic route to 74%. The Government will strive to improve the sector further. FDI in the private sector, combined with the superior management culture of the sector will ensure better adherence to budgets and timelines. Money will be spent within the country.

Conclusion

The further liberalisation will, seemingly, not only boost employment opportunities in the country, increase export opportunities, contribute to exchange rate stability, stimulate overall economic development and strengthen relations across the borders, but it will also help in the development of defence technology, reduce the costs of arms by developing them domestically and help build a self-reliant, resilient India, an Atmanirbhar Bharat.