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FDI in Defence Sector: Legal issues and challenges

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Abstract
India is surrounded by hostile neighbors. The need of the hour is less reliance on import of defence equipment and focusing on the development of its indigenous defence production. Government recently eased FDI (foreign direct investment) norms in defence sector, amended defence procurement policy and eased out the industrial licensing requirement in defence sector and introduced changes in the legal and regulatory framework with regards to defence sector in order to achieve self-reliance in defence sector. The present study help us to understand the reason behind increase in FDI cap, amendment in DPP (Defence procurement procedure) and necessity for change in policies and introduction of new policies in defence sector with focus on FDI. In this study only current FDI policy in defence sector of other countries is analyzed and different joint ventures in defence sector with foreign firms is also taken into account for constructive suggestions and measures for future.

Keywords: defence sector, FDI (Foreign Direct Investment)

Introduction
According to IHS Jane's latest annual Defense Budgets report, India is the fourth largest defense spender. Due to an underdeveloped defense manufacturing sector, India is one of the largest importers of conventional defense equipment in the world. This makes India's defense sector one of the most attractive markets globally for both domestic and foreign defense manufacturers [1]. The government of India in the last few years have introduced a series of policy changes in attempt to simplify regulatory and legal framework in defence sector to project India as an attractive destination for defence manufacturing and attracting FDI in this sector. In 2016, government of India revised the FDI policy because of which FDI cap in defence sector increased from 26 percent to 49 percent through automatic route and beyond 49 percent through government route, "wherever it was likely to result in access to modern technology or for other reasons to be recorded". Industries (Development and regulation) Act, has been revised and defence products lists for the purpose of issuing Industrial licenses has been reduced to a greater extent, further the validity of industrial license granted has been increased from 3 to 15 years. To establish a level- paying field anomalies in excise and custom duty have been removed and various tax emptions under Income tax act have been provide in the defence sector. To create a level playing field between foreign and Indian industry the Exchange Rate Variation has been allowed on foreign exchange component to every Indian company. Ministry of Defence introduced A Security Manual for licensed defence industry to remove doubts regarding guidelines to be followed if the FDI policy states that the investment will be subject to adherence to the provisions of this manual. The DPP 2016 has introduced provisions and procedural measures which makes the defence procurement process more efficient and effective and promote greater collaboration between international defence manufacturers and the Indian private sector. changes introduced such as Offset obligations on foreign suppliers retained at 30%, guidelines for the appointment of an agent by a foreign vendor, leading to greater transparency in the defence procurement process, recently 'Strategic Partnership' model is introduced to identify companies as strategic partner who would tie up with selected Foreign original manufactures for manufacturing in key segments like helicopters, submarines, etc.

Research Question
What are the changes made in the legal and regulatory framework to increase FDI in this sector in defence sector?
What are the Loopholes and positive changes introduced in the current FDI policy and challenges concerning FDI inflows in defence sector?
What are the challenges or issues regarding transfer of technology and relevance of Intellectual property right?

Research Problem
The defence sector of India is governed by various policies which includes FDI policy, industrial licensing, import, export, security manuals, tax regulations and procurement policies. Unnecessary control and regulations imposed on the players operating in this field or want to operate will adversely affect the FDI inflow, efficiency and productivity in this sector. What changes and reason for these changes in policies to promote FDI in defence sector need to be identified?

Hypothesis
The new FDI policy, amended DPP 2016, relaxed industrial licensing requirements, revised taxation policy and introduction of security manual for license requirement will reduce unhealthy reliance on import to meet its defence requirements and taking India towards the direction of self-reliance in defence sector plus this will also act as green signal for foreign OEMs to set up shop in India.
It is further hypothesized that study of joint ventures with foreign firms in defence sector and study of regulation of FDI around the globe in defence sector will provide constructive suggestions and measures to improve FDI

inflow in defence sector.

Literature Review

Dr. Dinesh Mahajan, India Foreign Direct Investment in Defence Sector in India: Problems and Prospects [2], in this article author examined the impact of trend in FDI policy in defence sector, author complied the data from year 2000 to 2015 and presented them in form of table for better and comparative understanding the FDI flows in defence sector and comparison of FDI flow in defence sector with other sectors. This article also stresses upon the problem related to FDI inflows in defence sector and what is the prospectus of FDI in the Defence sector. This article does not offer any concrete or valuable suggestion and recommendations for improving future FDI inflow in defence sector.

Objective

- To analyse the new FDI policy in defence sector in India.
- To examine the reason for change in FDI cap, revamped DPP policy and other policy in defence sector?
- To study the joint ventures in defence sector with foreign firms.

Scope

This research is an attempt to clarify and find out reasons behind liberal FDI policy in Defence sector, change in regulatory and legal framework in defence sector and analyse current joint ventures with foreign firms. This type of research has not been carried out. Hence it is essential to work in this area. Finally the outcome of the study would suggest constructive measures to increase FDI inflow in defence Sector.

Methodology

Analytical and comparative type of Research have been conducted, 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 per the need of the study. For the purpose of present study, the data was extracted from the various Newsletter, journals, newspapers and websites and statues and government reports.

Limitations of Study

The limitations of the study are as follows:-

No Previous Detailed Research Work.

Access to Data: The subject matter is the defence sector, therefore, the restriction of access to data is there. Only unclassified data and information available on open forums can be used.

for the improving the future FDI inflows and making India self-reliant in defence sector.

FDI in India

To promote Foreign Direct Investment (FDI), the Government has put in place an investor-friendly policy, wherein except for a small negative list, most sectors are open for 100% FDI under the Automatic route. Further, the policy on FDI is reviewed on an ongoing basis, to ensure that India remains attractive & investor friendly destination [3]. Approval Route: Foreign Investment Facilitation Portal (FIFP) is the new online single point interface of the Government of India for investors to facilitate Foreign Direct Investment. This portal is designed to facilitate the single window clearance of applications which are through approval route. Upon receipt of the FDI application, the concerned Administrative Ministry/Department shall process the application as per the Standard Operation Procedure (SOP).Subsequent to abolition of the Foreign Investment Promotion Board (FIPB) by the Government, the work of granting government approval for foreign investment under the extant FDI Policy and FEMA Regulations, has been entrusted to the concerned Administrative Ministries/Departments. Defence/cases relating to FDI in small arms is one of the eleven notified sectors/activities requiring government approval mining [4].

FDI in Defence Sector

Foreign investment up to 49% in defence sector permitted under automatic route. Sectorial cap has been increased to 100%, but foreign investment in access of 49% has been allowed on case to case basis with Government approval in cases resulting in access to modern technology in the country or for other reasons to be recorded. The condition of access to state- of-art technology has been done away [5].

The 100 % FDI projects are allowed under government approval route. In such projects, additional scrutiny by the Cabinet Committee on Security is applicable. License applications will be considered and licenses given by the DIPP, Ministry of Commerce and Industry, in consultation with Ministry of Defence and Ministry of External Affairs. Similarly, foreign investment in the sector is subject to security clearance and guidelines of the Ministry of Defence [6].

“Foreign Direct Investment (FDI) Policy has been gradually liberalized in the last two years. Since defence projects involve long gestation period and investment inflow takes time even after the projects are approved and contracts awarded, there is always a time lag before the impact of FDI is visible. In the year 2014-15, FDI of US$ 0.77 lakh and US$ 0.01 lakh has been received from France and Israel respectively. In the year 2015-16, FDI of US$ 0.95 lakh has been received from France. In the year 2016-17, FDI of US$ 0.01 lakh has been received from Israel. In the current year, till May 2017, no FDI inflow has been received” [7].

Table 1

S. No.	Sector/Activity	% of FDI Cap/Equity	Entry Route
5.2.6	Defence		
5.2.6.1	Defence industry subject to industrial licence under the Industries (Development & Regulation) Act, 1951. Manufacturing of small arms and ammunition under the Arms Act, 1959.	100%	Automatic up to 49% Government route beyond 49% wherever it is likely to result in access to modern technology or for other reasons to be recorded.
5.2.6.2	Other Conditions: (i) Infusion of fresh foreign investment within the permitted automatic route level, in a company not seeking industrial licence, resulting in change in the ownership pattern or transfer of stake by the existing investor to new foreign investor, will require Government approval.		

	(ii) Licence applications will be considered and licences given by the Department of Industrial Policy & Promotion, Ministry of Commerce & Industry, in consultation with the Ministry of Defence and Ministry of External Affairs. (iii) Foreign investment in the sector is subject to security clearance and guidelines of the M/o Defence. (iv) Investee company should be structured to be self-sufficient in areas of product design and development. The investee/joint venture company along with manufacturing facility, should also have maintenance and life cycle support facility of the product being manufactured in India [8]

The stipulation contained that FDI in excess of 49 per cent may be permitted by the government 'wherever it is likely to result in access to modern technology or for other reasons to be recorded' is ambiguous. The term 'Modern technology' is not defined and it is difficult to define what constitutes 'modern technology' which leads to different subjective interpretation, and there is no indication as to which 'other reasons' will be considered valid by the government to permit FDI in excess of 49 per cent. This would create anxiety and uncertainty in the mind of the investor because investment proposal could be challenged for the reason that it does not entail access to modern technology or that the 'other reason' for the acceptance of proposal are not good enough.

It is difficult to understand the first condition mentioned in paragraph 5.2.6.2 quoted above. List of defence items can be manufactured only after obtaining an industrial licence had been notified by the government [9]. A company will not require industrial license if not engaged in manufacturing any of the defence items notified. Investment up to 100 per cent through automatic route can be made in these companies as there is no FDI cap prescribed for investment. It can be inferred that foreign investors should get permission if they intend to infuse investment in a company where 100 per cent FDI is allowed through automatic route, if such infuse of investment changes the ownership pattern or leads to transfer of stake to new foreign investor by the existing investor [10]. The second condition laid down in above paragraph 5.2.6.2 seems to be a mess as compared to notification of arm rule 2016 according to DIPP lost its licensing power and applicants were asked to apply directly to Ministry of home affairs for obtaining manufacturing license for defence item. Notification no S.O.1636 (E) dated 19.05.17 issued by MHA, where power to issue IL were again delegated to DIPP. The interested companies are now requested to apply in Form A-6 along with security clearance proforma and FDI annexure in 15 hard copies at industrial License Section, Department of Industrial Policy & Promotion, Udyog Bhawan, New Delhi. Online filing of IL application on E biz portal of DIPP has been ignored and now the number to visits to Udyog Bhavan with kilos of paper load is not convenient for doing business [11]. The third condition in paragraph 5.2.6.2 should be read in consonance with Security Manual which was issued by the Ministry of Defence in June 2014 [12]. to remove all doubts regarding 'guidelines' which are to be followed if the FDI policy states that the investment will be subject to adherence to the provisions of this manual. The FDI policy should also make it clear whether this condition applies only to units that require industrial licence under the Industrial (Development & Regulation) Act, 1951 or generally applies to all investment in the sector. The last condition mentioned in paragraph 5.2.6.2 may not even be practical in all cases ensuring that Investee Company itself also has the maintenance and life cycle support facility. This act does not clarify the situation in which such facilities are already being run by someone else or if some other company is prepared to set up a separate facility for maintenance and life cycle support, further it is also not clear whether these conditions are met where investment comes from automatic route. The investee company will operate under the perpetual fear that someday someone may point out that the investment was not in order as these conditions were not met [13].

Defence Procurement Policy 2016

The Government of India has announced several positive changes in DPP-2016 in order to encourage participation of foreign OEMs in the Indian market. It replaces the DPP-2013, and provides several recommendations for improving indigenous procurement.

According to DPP 2016, not just 'Buy Indigenous Designed Developed and Manufactured (IDDM)' but all the three categories in the 'Buy' group "refer to an outright purchase of equipment. "Under BUY (IDDM) category products which are designed, developed and manufactured in India - with minimum 40% Indigenous content and products which are not designed or developed but manufactured in India with minimum 60% Indigenous content [14].

Introduction of L1-T1 Methodology

DDP-2016 has introduced enhanced performance parameter, moving from L1 model to a L1-T1 model. This methodology for the first time introduced in DDP-2016 for selecting the suppliers of military goods. The essence of the new method is that final bidder would not necessarily be selected only on the basis of lower bid quoted (L1 model) but by a combination of price and superior technology offered by qualified vendor [15].

Appointment of Agents By Foreign Vendors

DDP-2016 includes specific guidelines for the appointment of agents by foreign vendors which will bring greater transparency in the defence procurement procedure. Subject to certain conditions, foreign vendors can appoint agents to market its product. Such conditions are (i) Disclosure of agents at the time of submission of the offer; (ii) the MOD retains the right to accept or reject any agent, at any point of time, and (iii) the foreign vendor have to ensure complete transparency in payment being made to agent, with a prohibition on conditional payment or penalties based directly or indirectly on the success or the failure of the award of a contract [16].

Strategic Partnership Model

The Strategic partnership model strives to create long term capacity in various strategic importance defence subsectors. This model seeks to identify selected Indian private companies as strategic partner who would tie up with selected foreign original equipment manufacturers (OEMs) to manufacture in the key defence subsectors of helicopter, submarines, fighter aircraft and armored fighting vehicles/ main battle tanks. This is the mode through which equipment not available in India are procured from foreign original manufacturer in limited so that rest of the quantity can be manufactured in India. The ministry of defence will be selecting the Indian industry and foreign industry to partner with each other in defence subsector [17].

Offset Policy

The Government of India in DDP-2016 modified its offset policy. According to which Offsets are now only applicable to procurements above INR 2000 crores (approximately USD 305 million). As compared to DDP-2013 amount of Rs. 300 crores (approx. USD 50 million) increase is significant. But an offset obligation on foreign suppliers has been retained at 30%. This means if the government is signing a contact or deal with a foreign vendor of worth more than INR 2000 Crore, then foreign vendor need to invest 30% of the deal into the domestic firms. The ministry of defence will list out various category of firm which are eligible for the foreign investment. Therefore it can be said that threshold for offset liabilities for foreign vendors in Buy (Global) (i.e., outright purchase from a foreign/Indian vendor) and the 'Buy and Make' categories of procurements has been liberalized [18].

Industrial License

As per the Industries (Development and Regulation) Act, 1951, an Industrial License is required to manufacture arms, ammunition and allied items of defence equipment, parts and accessories. The license is granted under Rule 15(2) of the Registration and Licensing of Industrial Undertaking Rules, 1952 (2) as provided under Section 30 of the Industries (Development and Regulation) Act, 1951. The Industrial License is a mandatory requirement for an Indian company with FDI or otherwise, under the FDI policy for the defence sector [19]. "Industrial licensing regime for Indian manufacturers has been liberalized and most of the components/ parts/ sub-systems have been taken out from the list of defence products requiring Industrial License. This has reduced entry barriers for new entrants in this sector, particularly SMEs. The initial validity of Industrial License has been increased from 3 years to 15 years with a provision to further extend it by 3 years on a case to case basis" [20].

Exchange Rate Variation

As per DDP-2013, Exchange Rate Variation. (a) Exchange Rate Variation (ERV) shall be applicable for Rupee contracts with Indian vendors, based on RFPs issued under the category 'Buy (Indian)'. ERV, however, shall not be applicable in cases categorized as 'Buy (Indian)' except for DPSUs in ab-initio single vendor or when nominated as Production agency [21]. According to amended DDP-2016 Exchange Rate Variation. (a) Exchange Rate Variation (ERV) shall be applicable for Rupee contracts with Indian vendors, based on RFPs issued under all categories of Capital Acquisitions, where there is import content. The indigenous and import components as also the various currencies (of the import contents) for ERV purposes, must be determined in advance. However, ERV clause shall not be applicable to contracts in the following conditions: - (i) The delivery period is less than one year; or (ii) The rate of exchange variation is within the band of +/- 2.5% [22]. Issues related to level-playing field between Indian & foreign manufacturers, and between public sector & private sector have also been addressed. These include Exchange Rate Variation (ERV) protection for all Indian vendors, removing anomalies in customs/ excise duty etc. as per the amended DDP-2016.

Tax Regulations

"To establish a level-playing field between Indian private sector and the public sector, the anomalies in excise duty/ custom duty have been removed. As per the revised policy, all Indian industries (public and private) are subjected to the same kind of excise and custom duty levies" [23].

The GST had put unnecessarily strain on the defence budget: The GST regime has a five-tier rate structure for goods and services– with the rates being Nil, 5%, 12%, 18% and 28%. Almost all military goods (except specified categories of revolvers and pistols), including military weapons, firearms, bombs, grenades etc. fall under the 18% tax bracket in the GST regime. In the erstwhile excise duty regime, the rates of central excise for most defence related products (arms and ammunitions) varied between 6 – 12.5%. Consequently, the introduction of GST may lead to some degree of inflation with respect to most defence good

IPR and Technology Transfer

In defence sector manufacturing, Inventions (protected by patents), Industrial designs and the creation of technology comes under the category of Intellectual property right. A functioning Intellectual property regime facilitates the transfer of technology in the form of joint ventures, licensing and foreign direct investment further it provides protection for the investment in the development of new technology, thus giving means of finance and incentive for research and development activities [24].

The strategic defence sector is now open for private sector participation which has further opened avenues for foreign OEMs to enter into partnerships with Indian companies. Transfer of technology agreements helps a country to bridge capability gap in technology therefore it can be said that there is need for Indian companies through partnership with global OEMs by transfer of technology agreements to bridge the abilities in technology and equipment development. The main reason behind bringing DDP-2106 was to bridge the capability gap between foreign OEMs and Indian companies. There are no specific guidelines laid in the DDP-2106 related to IP being transferred in TOT arrangements. Mostly TOT agreement are in restrictive license form with regard to the IP being transferred because of which Indian companies are not provided with the right to carry out domestic protection or development of such technology therefore it can be said that inadequate legal clauses protecting The IP rights of OEMs or technology sellers is one of the failure of such TOT agreement to fulfill the aim of self-reliance in the defence sector in India.

Another major challenge that arises with regard to TOT arrangements in India, is the capability of the IPAs to appropriately utilize the technology being transferred under such arrangements. In order to achieve the objective of self-reliance in the defense sector and to ensure that a level playing field exists between OEM's and IPAs, it is of utmost importance that the DPP focuses more on the domestic development of technology in the defense sector in India. This would ensure that TOT arrangements are more effective and attain their broader objectives. In transfer of technology the transfer is subject to approval from foreign government which tends to put restrictive licensing term and enormous price in TOT arrangements. The main benefit that occurs due to the absence of specific guidelines regarding pricing arrangements is that sellers are provided with the freedom to determine license terms and pricing. Thereby potential revenue can gained from TOT arrangements in India [25].

Indian Examples

India manufacture and export some of the advanced weapons but majority of weapons are imported. India is the only seventh nation to develop fighter craft Tejas (A4+ Gen fighter) independently, Advanced light helicopter for movement of troops and gunship (Dhruv).

Tata Advanced Systems has a joint venture with Boeing in India (Hyderabad) to establish a new facility for it joint venture named Tata Boeing aerospace limited, and co-produce Boeing AH-64 Apache helicopter fuselages and accelerate momentum for "Make in India". The JV will initially create a manufacturing center to produce aero structures for the AH-64 Apache helicopter and to compete for additional manufacturing work packages across Boeing platforms, both defence and commercial. Boeing and Tata Advanced Systems intend to grow the JV partnership in the future, with a focus on opportunities to collaborate on development and selling of integrated system. The Hyderabad production facility will eventually be the sole producer of AH-64 fuselages globally. The Apache has been selected for acquisition by the India, United States and 14 other nations [26].

In October, 2016, Reliance Aerospace announced a joint venture with Dassault to help construct and maintain 36 Rafale fighter jets, which France agreed to sell to India in September, 2016.In February 2017, Dassault Reliance Aerospace Limited a joint venture between Reliance Infrastructure Limited promoted Reliance Aero structure Limited and Dassault Aviation, was incorporated with joint venture of (51% Reliance Infrastructure and 49% Dassault Aviation). The facility will manufacture several components of the offset obligation connected to the purchase of 36 Rafale Fighters from France, signed between the two Governments in September 2016. The Joint Venture also represents a unequalled Foreign Direct Investment (FDI) by Dassault Aviation of over 100 Million Euros, the largest such Defence FDI in one location in India [27].

In Feb 2017, Larsen & Toubro Ltd set up a joint venture with UK-based MBDA, leading global players in missile systems, to develop and supply missiles and missile systems to meet the growing potential requirement of the Indian armed forces. L&T will own 51% of the Company and MBDA, 49%, complying with India foreign Direct Investment policy norms. The Joint Venture Company, named "L&T MBDA Missile Systems Ltd", will operate from a dedicated work Centre, which will include pyrotechnical integration and final checkout facilities [28].

Recommendations

The US has the largest defence market in the world and is also the largest exporter of defence equipment and it has largest defence R&D Budget in the world. This reflects risk reducing approach in the early stages of defence capability development that is very attractive to defence companies and investors [29]. In 2011-2015 arms import of china reduced by almost 25% and its arms export jumped by almost 88%. China spend on 2.09% of its GDP on R&D whereas India only spent 0.85% of its GDP on R&D [30] It is now imperative that R&D and structural reform to be greater attention as the means for achieving indigenization of defence manufacturing. Increase in defence expenditure The defence budget was increased by a mere 7.81 per cent to Rs 2.95 lakh Crore against last year's Rs 2.74 lakh Crore, belying expectations of a significant hike when the armed forces are facing a growing challenge on the borders with both Pakistan and China [31]. Therefore increase in defence budget would have become conducive to attract foreign investment. The FDI policy does not attempt to define "modern technology" nor does it provide any indication as to what "other reasons" will be considered appropriate for the government to permit FDI beyond 49%. The 'other grounds' could be specified in the policy. For example, the creation of a specified number of jobs or setting up of the manufacturing unit in a notified backward area could be two of the many 'other conditions' that will complement the government's development agenda [32].

The foreign collaborators should bring advanced specialized technologies which are not present in the country and joint venture should undertake to step up R&D facilities and IPR should vest with the Indian companies for all new technologies development.

Conclusion

The previous policy with its 26 per cent limit has failed to elicit any positive response. Therefore 49% through automatic route and 100% FDI through government approval mode was the need of hour. 49% and 100% FDI in defence will create a win-win situation for the country's defence forces, local industries and international OEMs and safeguard the national security of the nation. This will ensure availability of cutting edge technologies for the defence forces, boost to 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. In India suitable legislations can be imposed on the manufacturers thus giving more safeguard while issuing licenses like India can reserve the right to take over the licensed facility under certain extraordinary circumstances of national emergencies. It is ridiculous that imports are considered more reliable than production in India because India is one of the largest importers of military equipment's. So, we need to understand that allowing foreign companies to manufacture in India is nothing worse than being dependent on imports.

Measures must be taken by the government to attract FDI in the industry and promote the formation of Joint Ventures between Indian and foreign companies. This will increase the R&D and technical capabilities of the domestic industry. The current issue with the FDI flow in this sector has been that much of it has been directed at changing shareholding patterns rather than an investment of capital into the industry. Defence minister Manohar Parrikar has gone on record to state that the government would not mind giving 100 per cent FDI in a venture that would make manufacturing fighter planes in India possible.

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