LAW & POLICY UPDATE

DEFENCE & AEROSPACE

Defence Sector reforms – Boon or Bane

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As part of the stimulus package for Covid-19, the Government of India enhanced the Foreign Direct Investment (**FDI**) in the defence sector up to 74% under automatic route. Earlier, the FDI limit in the sector was up to 49% under automatic route and thereafter up to 100% under the Government approval route. While the detailed press notes and conditions are awaited on this enhancement of the limit, this action is viewed as Government of India's move to further bolster the 'Make in India' initiative as it would encourage multinationals to set up manufacturing bases in India or acquire local companies which would provide them access to technology. Although, the FDI Policy will now allow up to 74% foreign investments, the bible of all defence procurement by Ministry of Defence (**MoD**) i.e. the Defence Procurement Procedure, 2016 (**DPP**) still limits FDI up to 49%. Therefore, to bring this anomaly to rest the DPP will have to be amended which may take some time.

What needs to be seen is how the fine balance between encouraging 'Make in India' by liberalization of the sector on one hand and making India self- reliant in defence manufacturing is struck by the Government. While the initial liberalization of 26% in the defence sector was based on the premise that it may take some time for domestic companies to acquire a technical and there was an imminent need for accessing the technology through the modality of allowing foreign companies to set up production bases/ facilities within the country itself. It was considered that manufacturing within the country with full transfer of state-of-the-art technology will be a better option than importing the equipment from abroad. But the question remains that whether any of these policy initiatives have actually translated into ground realities.

It is noteworthy to mention that while there is a euphoria in the foreign players that they would now be able to gain controlling stakes in the companies, which is fundamental in terms of being liable for the quality and performance of the product was an issue for foreign original equipment manufacturers (**OEM**). It is not clear if the change in FDI norms will apply to big-ticket projects under the Strategic Partnership model like the Navy's P-75i submarine project. The raise in the FDI limit will only help if it is backed by good procurement policy. The Government had revised the FDI limit to 49 per cent in July 2016 via the automatic route and allowed 100 per cent on a case to case basis but it did not result in increased FDI. In 2016-17, India failed to attract any FDI in defence. In 2017-18, it received USD 0.01 million, and in 2018-19 that stood at USD 2.18 million. Not only has India failed to attract FDI in defence, but it has also failed to attract any substantial private sector investments.

India’s persistent track record for inordinate delays in taking decisions, revisiting orders, cancelling tenders and unreasonable qualitative requirements by the armed forces has deterred not only foreign but even Indian private players from venturing in this foray. Companies of likes of Tatas, Larsen & Toubro, etc. that have invested in defence production hoping for government support have been left disappointed. From warship building to Howitzers, they have suffered due to the lack of orders or inadequate orders. The private sector will thrive only if the government places firm orders and in quantities that make it viable to invest. Traditionally the Government has been nominating Defence Public Sector Undertakings (**DPSUs**) for manufacturing big-ticket projects. Private firms also cannot compete with DPSUs whose infrastructure has been created by public funds and are not considered from a commercial viability perspective. Private firms are required to consider the investment, the cost of investment and at the same time making a profit for value creation of shareholders. Lack of level-playing field will continue to hinder private investments in the defence sector.

While the Government has also announced the measure of corporatization of the Ordinance Factory Boards (**OFBs**) which seen as having potential but end up producing substandard products including shells for artillery. The highly bureaucratic decision-making process of the external agencies responsible for the OFB’s functioning and wellbeing, and their propensity to adhere to the rules and regulations rather than the outcomes, has made the organization risk-averse with little incentive to think out of the box. Corporatization of OFB would enhance functional autonomy, efficiency, increased growth potential and lessen control of the Government. That would require the OFB to maintain a balance sheet and a profit and loss account, with transparency about inputs, production costs and salaries. While corporatization of the OFB may help bring in some efficiency, but eventually privatizing it would bring in the ultimate reform as India has had it tryst with Air India and other public sector undertakings which have not been able to be truly autonomous despite corporatization.

Having said the above, the details and consequent changes to the FDI Policy are yet to be announced, it would be interesting to see as to how the Government pans out the policy reforms to implement the FDI limit enhancements and the actual impact on the FDI in defence sector could only be seen in the coming years.