April 2016 Vol. XI No. 1 IMPACT FACTOR 3.860 ISSN (P) : 0973-4503 ISSN (E) : 2454-1702 RNI : UPENG 2006/17831

http://EconPapers.repec.org/RePEc:jct:journl:v:11:y:2016:i:1:p:77-84
https://ideas.repec.org/a/jct/journl/v11y2016i1p77-84.html
http://jctindia.org/april2016/v11i1-8.pdf

Pages 77-84

Foreign Direct Investment in Defence Sector in India : Problems and Prospects

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Abstract

India is surrounded by hostile neighbourers. The need for defence of its borders has been on priority since independence. For this purpose defence production has to be upgraded to make it at par with the military power of other countries. A humble attempt has been made to exhibit the trends of FDI inflows in the defence sector and to examine the problems of FDI inflows in this sector in India. The prospects for FDI inflows in defence sector have also been highlighted. The time period covered herein ranges from 2001 to 2015 (upto September). The study reveals that FDI inflows in this sector have fluctuated from Rs. 2.36 millions in the year 2000-2005 to Rs. 4.80 millions in the year 2015 (upto September). The major problems in FDI inflows in this sector are the perception of viability, selection of private partner, insufficient FDI limit, safety of intellectual property rights, technology, availability of finance and quality of work force. The prospects for FDI in this sector are joint ventures, likely manufacturing hub, fighter aircrafts and helicopters, cost-effective manpower, government policy of reducing imports, increase in defence expenditure and submarines and naval vessels.

Keywords : *Defence, Foreign Direct Investment, Trends, Problems, Prospects.*

1. INTRODUCTION

India has been a closed economy for many decades which proved a major obstacle in the way of development of various sectors in India as per their potential. It was only during the last decade of 20th century that India took some bold initiatives to boost its economic growth. Many sectors were thrown open for foreign direct investment (FDI) during this period. This resulted in motivating the foreign investors and they gave positive response to the steps undertaken by Government of India. FDI can be a source of valuable technology and know-how while fostering linkages with local firms, which can help jumpstart an economy (Alfaro, 2003). In recent years FDI has gained renewed importance as a vehicle for transferring resources and technologies across the national border (Arshad, 2012). Now most of the developing nations are competing for FDI in the world to foster their economic development.

India has also become one of the important destinations for FDI. India has many hostile neighbours like Pakistan and China. India has been constantly facing threat of the terrorist groups based at Pakistan, Afghanistan, Bangladesh and in Bhutan. The more serious concern is for Islamic State of Iraq and Syria (ISIS) group, which is again and again issuing threats to Indian leadership and the citizens of India. This group is armed with latest heavy weaponry and strong militia of Arabian fighters. They have established their bases in countries bordering India. To cope with these security threats India needs to modernize its defence capabilities. This further requires huge amount of funds.

India ranks among the top ten countries in the world in terms of military expenditure. As per the estimates, nearly 70% of our defence requirements are met through imports and only 30% being met through domestic production (www.dipp.nic.in). India took the first step towards opening the defence sector to foreign investment in 2001 when foreign investors were allowed to hold up to 26% share in the equity holding of a joint venture. Further, unlike earlier, the U.S. is reported to have made some concrete proposals for co-production and co-development of certain advanced version of Javelin anti-tank missile (ISID, 2014). This shows the positive response given after the allowing of FDI in this sector.

Like China, India has one of the largest and most broad-based defence industries in the developing world. It produces fighter aircraft, surface combatants, submarines, tanks, armored vehicles, helicopters, artillery systems, and small arms. The country also has a huge defence research and development (R&D) establishment with considerable experience in indigenous weapons design and development going back more than 50 years (Bitzinger, 2014). The government restricted private sector participation in the past due to inherent security sensitive nature of the industry. Therefore the private sector is relatively behind the Defence Public Sector Units (DPSUs) in terms of infrastructure and Defence Research and Development Organization (DRDO) in terms of R&D capability. However, in recent years private sector has found favour with government and attracted huge interest from foreign systems integrators (FICCI, 2015).

2. OBJECTIVES OF THE STUDY

The present study concentrates on achieving the following objectives:

(a) To exhibit the trends of FDI inflows in defence sector in India.

(b) To examine the problems of FDI inflows in defence sector in India.

(c) To highlight the prospects of FDI inflows in defence sector in India.

3. DATABASE AND METHODOLOGY

In the present study secondary data has been used to attain the objectives of the study. The time period covered herein ranges from 2000 to 2015 (upto September). For the purpose of present study, various issues of Secretariat of Industrial Assistance (SIA) Newsletter, journals, newspapers and websites have been extensively used. The various statistical tools used in this study are tables and percentages.

4. REVIEW OF LITERATURE

Mohanty (2004) examined India's defence industry in the 21st Century. It has been observed that India's defence-industrial strategy is directed primarily toward achieving self-reliance. Presently, there is a clear imbalance in requirements by the armed forces. India's decision to allow private participation in the defence-industrial sector is seen as a dual aim, namely to achieve much-needed capital and production enhancement and, secondly, to open up to the external market through their presence.

Singh (2010) argued that with India becoming the world's second largest buyer of defence equipment, Indian policies in defence manufacturing, including the FDI cap, have attracted widespread international attention. Foreign firms are now keen on joint ventures with Indian private companies for setting up development and manufacturing facilities. The case for raising the cap primarily rests on increasing investment and the transfer of foreign technologies which will kick-start the development of Indian defence sector. It has been suggested that the government must show boldness of vision to overcome vested interests of the DPSUs and its trade unions etc. to raise the FDI cap in defence sector beyond 51 percent.

Malhotra (2014) examined the impact of FDI on the Indian economy, particularly after two decades of economic reforms, and analyzes the challenges to position itself favourably in the global competition for FDI. The country is consistently ranked among the top three global investment destinations by all international bodies, including the World Bank, according to a United Nations (UN) report. It has been observed that FDI inflow supplements domestic capital, as well as technology and skills of existing companies. It also helps to establish new companies. All of these contribute to economic growth of the Indian Economy.

Janu and Kaur (2015) exhibited that "Make in India" seems to be a promising initiative for promoting domestic manufacturing and increasing self-reliance in defence. Foreign Direct Investment (FDI) in defence was increased from 26 per cent to 49 per cent. There are only a limited number of private companies in India with the capital and resources required to produce and develop complex defence solutions and sustain business. All the major powers of the world are interested in working with India in all sectors including defence.

From the review of different studies it is clear that much work on FDI in defence sector has been done. Still it requires comprehensive analysis of the problems due to which FDI in defence sector has not been as per its potential. It will also be of much prominence to highlight the prospects of FDI in defence sector so that investors may be made aware about the economically viable opportunities available in this sector.

5. TRENDS IN FDI INFLOWS IN DEFENCE SECTOR

The pace of FDI inflows in India has been slower than China, Singapore, Russia and Brazil (Shah and Parikh, 2012). India imports nearly 70 per cent of its military equipment requirements. And despite public declamations for over two decades by successive governments of increasing private sector participation in the defence sector, the MoD has openly favoured the monopolistic and grossly under-performing state-run Defence Research and Development Organisation (DRDO), the 41 Ordnance Factory Boards (OFBs) and eight Defence Public Sector Units (DPSUs) in awarding design contracts and joint ventures (JVs) with foreign Original Equipment Manufacturers (OEMs) (http://defencesecurityindia.com). The Government of India has recently launched "Make in India", programme, a major national initiative that aims to make India a global manufacturing hub. The programme has identified 25 key sectors, including defence, and hopes to boost domestic manufacturing and attract foreign investment. It looks to be a promising initiative for promoting domestic manufacturing and increasing self-reliance in defence (Janu and Kaur, 2015). For this purpose many relaxations in FDI policy have been provided for this purpose.

The FDI limit has been raised from 26% to 49%. The World Economic Forum's Global Competitiveness Report 2015–16 puts India at the 42th place among countries worldwide in terms of innovation capacity (www.ey.com). This will further help India in boosting the confidence of the investors in defence sector and increasing the FDI Inflows.

Investor confidence in India has been strengthened by improving economic growth and investor-friendly moves by the new Government. But investors have generally been cautious. In 2015, the US and India also signed a 10-year defence framework pact toward joint development and manufacture of defence equipment and technology (including jet engines, aircraft carrier design and construction) in India.

Sector attractiveness propositions:

- Raised FDI limit to 49% from 26%.
- Equity holding greater than 49% permitted for "state-of-the-art technology" on CCS approval.
- Digitalized the application process.
- Removed its restriction of the minimum 51% holding by a single Indian entity in a defence venture.
- Announced tax and export incentives, such as a weighted tax deduction of 200% for both capital and revenue expenditure incurred on scientific R&D (excluding expenditure on land and building).
- Identified 16 broad categories of defence items that are now allowed to be exported, bringing India at par with international laws governing arms trade.
- Sharply reduced the number of products for which manufacturers require special licenses.

  Extended the duration of defence industry licenses from three to seven years (www.ey.com).

During the period under study FDI inflows have not been much encouraging. The trends in FDI inflows in defence sector are as follows:

Table 1: FDI inflows into Defence Sector (2000-2015*)

(Amount in Rs. Millions)

Year	FDI equity inflows in Defence Sector	Total FDI equity inflows	Percentage share in total FDI equity inflows
2000-2005	2.36	954,815.27	0.0002
2006	00	503,573	0.0000
2007	00	654,950	0.0000
2008	00	1,595,295	0.0000
2009	00	1,309,799	0.0000
2010	00	960,150	0.0000
2011	174.4	1,599,349.20	0.0109
2012	22.10	1,215,914.41	0.0018
2013	44.72	1,294,824.81	0.0035
2014	0.04	1,753,134	2.2816
2015 (upto September)	4.80	1,681,922.01	0.0003
Cumulative Total	**248.42**	**13,523,726.70**	**0.0018**

Source : Compiled from Various issues of SIA, Newsletter.
Note: * denotes upto September.

Table 2: Comparison of FDI Inflows in Defence Sector with Other Sectors (2000-2015*)

(Amount in Rs. Millions)

S.No.	Sector	Total FDI Inflows
1.	Services Sector (Fin., Banking, Insurance, Non Fin/Business, Outsourcing, R&D, Courier, Tech. Testing and Analysis, Other)	2,224,340.05
2.	Construction Development : Townships, housing, built-up infrastructure and construction-development projects	1,137,258.95
3.	Computer Software & Hardware	934,427.15
4.	Telecommunications	883,392.48
5.	Automobile Industry	749,492.74
6.	Drugs and Pharmaceuticals	667,406.10
7.	Chemicals (Other than Fertilizers)	524,470.91
8.	Trading	586,262.70
9.	Power	494,278.43
10.	Metallurgical Industries	421,178.26
11.	Defence Industries	248.42

Source : SIA Newsletter, October, 2015
Note : * denotes upto September.

Table 1 depicts FDI equity Inflows into defence sector in India during the time period 2000 to 2015 (upto September) and their percentage share in total FDI equity inflows. FDI inflows have fluctuated from Rs. 2.36 millions in the years 2000-2005 to Rs. 4.80 millions in the year 2015 (upto September). It is apparent from the table that defence sector has not been able to attract a significant percentage of total FDI inflows upto 2010. Due to the impact of global recession there has been fluctuating trend in the inflows of FDI and its percentage share in the total FDI inflows in this sector during 2012-2015. This sector is very much significant as it is concerned with security of the citizens of India. The Government has to follow a balanced approach while allowing FDI in this sector. Still, India needs tremendous FDI in this sector to make India self reliant in this sector and save the outflow of foreign exchange.

Table 2 exhibits the comparative position of FDI inflows in defence sector with other viable sectors which have received FDI inflows in large quantity. It is evident from the table that maximum FDI inflows have been attracted by services sector followed by construction development and computer software & hardware etc. It is very disappointing that FDI inflows in defence sector are very much meager during the period of study i.e. Rs. 248.42 millions. This is a cause of concern for the Government of India also. Now the present Government has made efforts to bring FDI in this sector by taking measures like raising FDI cap to 49% and by launching 'Make in India', campaign. It is hoped that these measures would help in increasing FDI inflows in this sector. Still much is required to be done to motivate the investors to invest in this sector.

6. PROBLEMS CONCERNING FDI INFLOWS IN DEFENCE SECTOR

(a) Economically viable only for big firms: It has been perceived by many firms that FDI in defence will only benefit the big firms. It would be detrimental to indigenous defence production by public sector units and would compromise national security. For some companies, the biggest concern with allowing complete foreign investment in defence relates to the intellectual property rights over technology. That's why companies at small scale are not showing much interest in the defence sector production.

(b) Decision regarding private sector partner : Another issue is that how to select a partner in private sector for defence production. Not much expertise is available with Indian companies and required experience is also not available in India. Due to these considerations investors are not much interested in investing in India in defence sector. Besides, R&D activity is also the limitation of Indian companies as they don't go for extensive R&D. Under these circumstances foreign investors are in in dilemma whether to invest in defence sector or not.

(c) Insufficient FDI limit : Government has kept defence sector closed for FDI due to security reasons for a long time. This has done very much damage to the progress of defence sector. It could not grow as per its potential due to the restrictive policies of the Government. But now some relaxation in FDI limits has been provided but still this limit of 49% FDI allowed is not much encouraging. The investors expect more in this regard. They want the cap on FDI to be raised to 100%.

(d) Problem of intellectual property rights: The investors are also concerned about safety of their intellectual property rights. As huge expenditure is done on the development of these advanced technologies and the equipments therefore investors expect assurance from Indian Government regarding this. The Government is also not having clear cut regulations to address this problem which is acting as an important hindrance in the inflows of FDI in this sector.

(e) Technology is main consideration : India needs more technology rather than foreign investment in this sector. India has unfriendly neighbours so it needs more protection of its borders. Due to this more sophisticated weaponry is required for our armed forces with latest up gradations. A huge expenditure is required to import this weaponry. Therefore Government has realized the importance to have manufacturing base for defence sector to keep control over the superior technology. The countries having superior technology are not much willing to share their superior technology with India to keep their monopoly intact in defence sector.

(f) Availability of finance : Finance is the biggest issue with the small industries. While one is going to do something new, it needs funds which are not easily available for Micro, Small and Medium Enterprises (MSMEs) and Government has to work on it. There should be priority lending to these MSMEs. Research and development (R&D) is necessary for the defence manufacturing sector. It requires huge funds (http://www.business-standard.com). Again a developing country like India is short of necessary funds for this purpose.

(g) Quality of work force : The major problem in the way of FDI in defence sector is the quality of work force. In India we don't have such highly technical workforce which is required for manufacturing activity in defence sector. It requires innovative technical persons who have extensive experience in this sector. The foreign players are not getting the requisite workforce in India even after much search and they are in a dilemma whether to invest extensively in India or not. Even after opening of this sector for FDI still not much FDI has come to this sector due to this reason.

7. PROSPECTS FOR FDI IN DEFENCE SECTOR

(a) Joint ventures : The present Government wants private sector to acquire technology from foreign companies and set up joint ventures in the country, with foreign manufacturers. Tata Group, Reliance Industries Limited, Larsen and Toubro Ltd. and Mahindra Group are forging partnerships with global defence companies, and enhancing their production bases in India (www.agora.mfa.gr). India is trying to strengthen its defence capabilities and South Korea is the genuine option for joint collaboration of defence equipment, mainly for the navy (http:// voiceof.india.com). This is a good opportunity for foreign players to have joint ventures with Indian companies and to take the maximum benefit out of this opportunity.

(b) Manufacturing hub : The major defence sector companies are eyeing at huge Indian defence manufacturing sector. They only want to have increase in FDI cap in this sector. U.S. defence major and integrated technology company Honeywell said it is positive on the defence outlook in India. Honeywell had partnered with Hindustan Aeronautics Ltd. (HAL) more than 40 years ago to manufacture the Honeywell TPE331 turboprop engines, the first fully manufactured engine in India which powers the Dornier 228 aircraft of the Indian Navy and Coast Guard, and for the global market (Das, 2014). Similarly companies from other developed countries can be attracted to this sector as India is going to be hub of manufacturing activity in defence in coming times.

(c) Fighter aircrafts and and helicopters : The Indian aerospace and defence market presents an attractive opportunity for companies across the supply chain as the country has the third-largest armed forces in the world with a defence budget of about 2.5 percent of its GDP. With the government gearing up to increase domestic production of defence equipment, global firms are entering this sector to reap the benefit (B2B Bureau, 2015). Indian Government lead by Congress party in the last decade has not done concrete for the security of India as usual except its petty politics of minority appeasement. This has resulted in demoralization of Indian defence forces. Now present Government led by Mr. Narendra Modi, has started a mission to produce defence equipments and other weaponary in India. Under this mission fighter aircrafts, helicopters and other artillery will be indigenously produced by having agreements with original manufacturers of these through FDI. These companies will have to establish their production bases in India for this purpose.

(d) Cost-effective manpower : We have a large pool of skilled persons. The average salary per employee is also very low in India as compared to other countries. The defence industry provides the potential for a very dynamic career. Graduates can get involved in solving complex problems using emerging technology. (https://targetjobs.co.uk). On the one hand India will be benefitted with employment avenues for the youth but on the other hand investors can save millions of dollars by manufacturing in India due to cost effective manpower here.

(e) Government Policy of reducing imports: About 70% of India's current requirements on defence are catered by imports. The Government has now decided to reverse these trends to save the foreign exchange reserves. The opening of the strategic defence sector for private sector participation will help foreign original equipment manufacturers to enter into strategic partnerships with Indian companies and leverage the domestic markets and also aim at global business. Besides helping build domestic capabilities, this will bolster exports in the long term. Opportunities to avail defence offset obligations to the tune of approximately INR 250 billion during the next 7-8 years (http://www.makeinindia.com). This would result in self-sufficiency of the country in this sector and in reducing imports in defence sector.

(f) Increase in defence expenditure : With the country expected to spend an estimated $100 billion over the next 10 years on arms, the opportunity before the private sector is unprecedented. A recent report by the Confederation of Indian Industry (CII) and the Boston Consulting Group (BCG), underlines the fact that India is set to become a global leader in defence. Manufacturing Companies such as Tata Motors, Tata Power, Mahindra and Mahindra, Ashok Leyland, L&T, Wipro and Infosys are all part of consortia bidding for these contracts (Mitra, 2012). This will ensure the effective utilization of the resources in the public sector as well as private sector.

(g) Submarines and naval vessels : Eyeing big-ticket investment opportunities in the defence sector under 'Make in India' drive, engineering and construction giant Larsen & Toubro sees huge scope in areas like submarines. It has listed indigenisation thrust for defence equipment, interceptor boats, naval vessels and submarines for Indian Navy and Coastguard as investment opportunities. Its shipbuilding arm has global scale heavy manufacturing facilities (Press Trust of India, 2016). This is a positive development on the domestic front which will again boost the morale of Indian naval forces and reduce their dependence on foreign companies.

8. MANAGERIAL IMPLICATIONS

In the light of the environment which is being created by the present Government for indigenous production of the defence equipments and weaponry, the companies in private sector in India should gear up their efforts in becoming the front runners for grabbing these contracts so that domestic production in this sector may be enhanced and self reliance may be achieved. This will not only help them in becoming main suppliers for the government but they can develop themselves as global leaders for supply of defence equipments. This would further enhance their business interests in a big way.

9. CONCLUSION

Defence sector is very crucial sector as it is concerned with the safety of a nation. The present study exhibits the trends of FDI inflows in the defence sector and to examine the problems of FDI inflows in this sector in India. The prospects for FDI inflows in defence sector have also been highlighted. The time period covered herein ranges from 2000 to 2015 (upto September). The study reveals that FDI inflows in this sector have fluctuated from Rs. 2.36 millions in the year 2000-2005 to Rs. 4.80 millions in the year 2015 (upto September). The major problems in FDI inflows in this sector are the perception of viability, selection of private partner, insufficient FDI limit, safety of intellectual property rights, technology, availability of finance and quality of work force. The prospects for FDI in this sector are joint ventures, likely manufacturing hub, fighter aircrafts and helicopters, cost-effective manpower, government policy of reducing imports, increase in defence expenditure and submarines and naval vessels.

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