

## **Institute for Defence Studies and Analyses**

### **PRIVATE SECTOR PARTICIPATION IN DEFENCE PRODUCTION: ISSUES OF INDUSTRIAL LICENSING AND FDI February 28, 2012**

#### **Concept Note**

It is more than decade now since the Government of India in a major policy initiative liberalised the defence industry in 2001, by allowing 100 per cent participation by the private sector with foreign direct investment (FDI) permissible up to 26 per cent, both subject to licensing and security clearance. The initiative was taken to harness the expertise of the private sector, and facilitate its participation through infusion of foreign capital and technology for enhancing self-reliance in India's defence production. By October 2011, the DIPP has given 200 Letters of Intent/Industrial Licenses (LoI/IL) to various private entities, with proposed investment totaling Rs. 11,773 crore and employment opportunities for 38,579 people. And by November 2011, a cumulative FDI of Rs 17.68 crore (\$3.72 million) has flown into Indian defence industry.

The above developments notwithstanding, there are certain grey areas in both industrial licensing and FDI policy, which need further improvement to facilitate private sector's participation in defence industry in a more meaningful manner. As regards industrial license, the first major issue that intrigues the domestic private industry is the definition of defence items. Unlike some other countries and international arms control organisations, which define defence item through a comprehensive list (e.g., the Munitions List of the Wassenaar Arrangement), in India there is no such list to give clarity of what constitute a defence product. The lack of clarity becomes an issue when industry is required to provide the 'item code' and 'item description' while filling up the application form for industrial license. As per the current practice, the industry is required to provide the 'item code' from the National Industrial Classification (NIC) Code list of 1987, which has only one code ( 359.4: 'manufacture of arms and armaments') for entire defence manufacturing. The NIC code does not tell about what constitutes arms and armaments and if dual-use items are also covered by it. It also does not tell about if parts and components that go into arms and ammunition but may or may not have dual-use application, fall under this head.

The issue with 'item description' is more nuanced. There is not a single dedicated list on which the Industry can rely on to describe the defence nature of its production. Rather, they have to depend on at least three different lists, depending on which list best describes their production. Apart from NIC list (which is most generic among the three), two others are Indian Trade Classification (Harmonised System) ITC (HS) Code, as maintained by the Director General of Foreign Trade (DGFT) of Ministry of Commerce for the purpose of India's external trade; and the 'Product List' as articulated in the

Ministry of Defence's (MoD's) Defence Procurement Procedure (DPP), for discharge of offset obligations by the foreign vendors. The DGFT list, gives some broad sub-details of the items which can be covered under the defence industry. For instance, under the broad HS Code 93 (arms and ammunition; parts and accessories thereof), there are 16 sub-categories. The MoD list similarly provides some broad details of items in 27 categories under three broad headings: Defence Products, Products for Internal Security, and Civil Aerospace Products.

Although more elaborate in comparison to NIC list, the lists of DGFT and MoD are still not defence specific. They cater to items of defence, dual-use and even commercially off-the-shelf in nature. For instance, under HS Code 88 (aircraft, spacecraft, and parts thereof) there are sub-categories such as 'gliders', 'balloons', and 'under carriages and parts thereof', which are commercially available products or at best dual-use items. But a company producing any of the above items is at freedom to apply for a defence license and once it gets becomes a part of the defence industry, even though the item in question may not be defence in nature.

Given the above lack of clarity, the Indian defence industry in the private sector comprises of companies having a defence industrial license. Even this loosely defined industry is not free from other issues. It is noteworthy that as per the guidelines of the DIPP, defence falls under the 'Manufacturing' sector. So the companies in manufacturing business can apply for license and get it (subject to approval) and be formally part of the defence industry. However this is not the case for companies in the services sector (such as engineering, design and software, etc) which do not come under the purview of 'Manufacturing', and hence do not require a license for their services. Consequently they are not formally part of the defence industry, even though their services have direct application in defence products.

The only way companies in the services sector become, in a way, part of the defence industry is by becoming Indian Offset Partner (IOP) – an Indian company partnering with a foreign company for discharge of latter's offset obligation. However the path toward becoming IOP is not very clear in the existing policy framework. It is because the term 'Indian' in IOP in the context of a company in the services sector is interpreted differently from the one in the manufacturing sector. The difference is because of the foreign equity that is allowed in these two sectors. For defence manufacturing, FDI is allowed upto 26 per cent where as it is upto 100 per cent in case of services sector. In other words, in defence manufacturing sector a company will be called an Indian company only when it owns minimum 74 per cent of total equity share of that company. For the services sector, the equivalent minimum equity share (with the Indian shareholder) is 51 per cent to be called an Indian company. However it is believed that the Defence Offset Facilitation Agency (DOFA) – the single window agency under the Department of Defence Production of MoD responsible for facilitating offsets in defence contracts – does not buy this argument and insists that companies in the services sector must have minimum 74 per cent domestic equity share so as to participate as an IOP.

Apart from the above ambiguity caused by the FDI policy, the way foreign investment in a company in India is calculated also creates confusion in the industry. As per the current guidelines issued by the DIPP, foreign investment in an Indian company is calculated by taking into account both the direct and indirect investments (the direct investment is the one that comes directly from a foreign source whereas the indirect investment is one that comes through another company in India having a foreign equity). The tricky part is that technically and as per DIPP rules, if an indirect investment comes from a company in India in which the foreign partner has a minority share, the said investment is not considered as foreign investment. As an illustration, if a company X in India with a foreign equity holding of 49 per cent invests 70 per cent in the equity of another company Y (which is 'owned and controlled' by resident Indians), the resultant foreign equity share in Y ( $49\% \times 70 = 34.3$ ) is not technically considered foreign investment. The said rules notwithstanding, the MoD has a different view, which is based on actual equity owned by the foreign partner. In the above illustration, the MoD views 34.3 per cent equity share in Y as foreign investment. At least on one case, the MoD has prevailed over the DIPP's stipulated technical rules, giving a message that when it comes to defence industry, it is the actual foreign holding that matters rather than the technical calculation as suggested by the DIPP. However given the different approach adopted by two ministries of the government, it is ideal to clarify once and for all which approach is correct.

Keeping the above in view, the Institute for Defence Studies and Analyses (IDSA) is organising a round table discussion. Senior officials from the MoD, DIPP, armed forces, industry representatives, and consultancy firms are invited to discuss and debate the following issues.

- Doing away with the mandatory requirement of industrial licensing: Merits & demerits
- Issues of industrial licensing
  - Timeframe
  - Eligibility/definition of product
- Issues of FDI – Existing ceiling & need for revision
- Institutional and procedural Issues of defence exports