The Hurdles in Technology Transfers in the Defence Sector

Introduction

Majority of India's present day weapons and war machinery is obsolete. India is looking to revamp its defence capabilities and consequently making the country one of the largest military spenders in the world.[1] The mammoth proposed expenditure in the defence sector has led the Indian Ministry of Defence (**"MoD"**) to reconsider its defence strategy. With imports averaging 70% of the total defence procurement, India is looking to reverse the spate and has established a notional target for 70% of new acquisitions in the future to be sourced from indigenous production. To achieve this target of self-sufficiency, it is imperative for India to develop its local industry. Through the Buy and Make (Indian) policy Defence Procurement Procedure, 2009 (**"DPP - 2009"**), the MoD has already put in motion a programme to indigenize and modernize India's defence capabilities.

One of the significant aspects involved in establishing a local industry is transfer of technology (**"ToT"**) under the DPP - 2009. This newsletter highlights the hurdles faced by the defence sector in the transfer of technology and attempts to suggest possible solutions to overcome the existing hurdles.

Why India needs technology?

The Indian defence industry is at a nascent stage and has opened itself to participation from private players only since 2001.[2] In order to meet the mordernisation requirements of the armed forces, cutting edge and sophisticated technology is the need of the hour, which the local companies presently do not possess. As India aims to achieve a high level of self-sufficiency in the defence industry, it requires importing technology and procuring specialized training from foreign shores. Since this industry is a capital intensive industry, it is not reasonable to expect a complete ToT without a controlling stake in the investment.

Why is India unable to obtain ToT?

The FDI Concern

The present FDI cap of 26% has discouraged many original equipment manufacturers (**"OEM"**) from bringing in proprietary technology to India. Understandably, they are reluctant to license their technology to a domestic company in which their equity is restricted to a minority. In view of the FDI cap, a large number of the OEMs are providing, at the best, a partial ToT.

[1] The Union Budget for 2010-11 has earmarked USD 32.03 billion as expenditure for national defence

[2] Press Note 4 of 2001 series permitted 100% Indian Private sector participation with FDI permissible up to 26%

On the contrary, the MoD argues that defence is a strategic industry and, for security reasons, a company established in India in the field of defence should be governed and operated by an Indian management. Furthermore, the MoD is uncertain whether any increase in the FDI cap to 49%[3] would lead to an increase in ToT received by India. FICCI, an industry body, has raised similar concerns in its response to a Discussion Paper floated by the Department of Industrial Policy & Promotions (**"DIPP"**) in May this year on *FDI in the Defence Sector* citing that an increase in FDI in the telecom sector to 100% did not guarantee indigenous capabilities or ToT.

Export Embargo

Another significant consideration for the OEMs is the fact that at present, the defence market in India is a monopsony market where the Indian Government is the only buyer. This attains even more importance in light of the fact that the Indian Government, while promoting FDI and OEM participation in the defence sector, still does not provide a purchase guarantee. Further, there is also a restriction on the export of the manufactured product/technology from India. This implies that a company would not be able to generate adequate returns on its investment. These restrictions are a big deterrent for the OEMs.

Keeping in mind the low FDI limit, the aforementioned export embargo and the no-purchase guarantee, OEMs are not provided any incentive to transfer technology. More often than not, the capital procurement by the Indian Government is with either partial ToT or of outdated technology and therefore not a real "value add" for the defence sector. The recent acquisition by the Indian government of six obsolete Sikorsky UH-3H helicopters from the US government foreign military sales, which has burnt a hole worth INR. 1.82 billion (*US$ 39 million*) in the Indian tax payers pocket, proves this point.

Possible Solutions

The MoD has on several instances considered an increase in FDI higher than 26% on a case-by-case basis, if it is convinced that the technology being offered is "cutting edge". For example, the Brahmos missiles are manufactured with a 50% Russian equity,[4] while Hindustan Aeronautics Limited (**"HAL"**) has been allowed to form a 50-50 partnership with Rolls-Royce and others for manufacturing of aircraft engines and compressor shroud rings for defence aerospace.[5] But these exceptions have been far and few in between and have mostly involved defence public sector units only.

The case for higher FDI rests considerably on the ToT receivable. To ensure that the foreign OEMs have a controlling stake in the Indian investment and that limited embargos are imposed, the OEMs must demonstrate their willingness to transfer technology and provide the Indian Government with a support letter from the country from which the technology is being sourced. The Indian Government, to promote investment and also secure its interest, can go a

[3] Proposed by Department of Industrial Policy and Promotion under the Ministry of Commerce and Industry
[4] http://www.brahmos.com/content.php?id=1, visited on August 17, 2010
[5] http://economictimes.indiatimes.com/articleshow/5743824.cms, visited on August 17, 2010

step further by offering a higher FDI once the desired technology is transferred and released by the host country. Such special dispensation may be granted only upon supplying proprietary technology.

Conclusion

The FDI cap is indeed an inhibiting factor towards the entry of foreign companies into the Indian defence market, as foreign companies do not have any effective control, no purchase guarantees from the Indian government for their products, as well as no open access to other markets.[6] Clearly such restrictions will not allow foreign companies to set up manufacturing units in India to cater to global demands, thereby making investments in India unattractive. India will have to change its position from being a defence focused country procuring capability in times of need to a country self-reliant with defence manufacturing and export capability to bring any effective changes in this field.

While, the case of a higher FDI has been made to the Indian Government by DIPP and the industry bodies, at this stage, it is difficult to assess whether a change in FDI solely will guarantee full ToT. In our opinion, it is important for the Indian Government to open its doors to foreign investment, with monitoring of end-usage, incentives in capacity expansion, development of R&D centres and equally important for the OEMs to show their keenness to transfer the state-of-the-art technology. This opportunity to change is particularly significant at this stage since the US and Europe have become weaker markets for the global defence companies. Additionally, India has a considerable advantage over other developed countries due to the relatively lower cost of manufacturing and labour which would be cost-competitive. Therefore, it is important to capitalise on the prevailing opportunities and take steps forward with the policy makers to hopefully liberalise the defence investment regime in the near future along with suitable measures to address the concerns of the MoD.

Authored by:
Divij Kumar

[6] http://mod.nic.in/dpm/welcome.html, visited on August 13, 2010