

# Chapter 1

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## 1 INTRODUCTION

Over the past decade, the Indian Ministry of Defence has put into motion, plans for an unprecedented modernisation program of its defence capabilities. Following the Kargil conflict in 1999, India realised that much of its Soviet-era equipment was outdated. India faces a prospect of a war on two fronts, one with a major power rival (China) and the other that poses potential threats to its homeland security (Pakistan). Both China and Pakistan have significantly expanded their military capabilities in the past decade.

Consequently, India has embarked on a major defence acquisition program, to increase the size, capability and self-reliance of its Armed Forces. The scale of the planned investments reflects its need to make up for lost time. India has seen its economic capacity expand almost exponentially over the past two decades. India has been increasingly moving towards a more open-market economy, reducing historic controls on foreign trade and investment and privatising a range of government-owned companies across a range of sectors, from airports to electricity generation to telecommunication firms. This has catalysed India to be one of the fastest growing emerging markets, with its GDP growing by more than seven per cent each year on an average since 1995. The IMF in 2009 projected India's GDP would grow in real terms by more than 7.5 per cent on an average from 2010 to 2014. India's economy is projected to be 60 per cent of the size of the United States economy by 2025 and second only to China by 2050 (Deloitte-CII, 2010). As a result, a larger quantum of resources can be funnelled into defence modernisation.

India's acquisition plans include a substantial procurement program for the Army, Navy and Air Force. The government is seeking to develop a flexible, mobile and



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networked defence force with substantial power projection capabilities. Many of the assets India is acquiring are at the leading edge of technology, including 126 Medium Multi-Role Combat Aircraft, 180 Sukhoi Su-30 MKI aircrafts, Scorpene class submarines, advanced Russian T-90 main battle tanks and state-of-the art information and communication systems. More than USD 42 billion in total defence expenditure is targeted by 2015, of which approximately USD 19.20 billion would be expected to be spent on capital equipment for the Defence Armed Forces (Deloitte-CII, 2010).

The parallel challenge for India in meeting its policy objectives will be expanding its indigenous production capabilities at the same time as meeting its ambitious acquisition agenda. Historically, India has imported more than 70 per cent of its defence assets from Russia, on which it continues to have a strong reliance. Over the past decade, the Ministry of Defence has implemented a series of reforms to its procurement policy with the aim of reversing this historical spending pattern, including through the introduction of offsets requirements for designated equipment.

As its military spending has grown, the Indian government has introduced an offset policy, which requires foreign suppliers to reinvest 30% of their total procurement spending in Indian defence related industries. The offset policy, which has been implemented with varying degrees of success in other countries, springs from the government's understandable desire to develop indigenous defence capabilities.

Introduced under the Defence Procurement Policy ("DPP") 2005, the offsets policy was modified in DPP 2006. An offset arrangement possesses inherent contractual obligations. The negotiated package consists of the primary contract and the compensatory offsets. DPP 2006 contained three principal features – an offsets clause, no single vendor purchases and compulsory transfer of technology in all the big transactions.



The offsets clause has attracted the biggest attention. It will be applicable to procurement proposals where 30% of all defence deals above Rs 300 Crores must be invested in the Indian defence industry and could be in the form of setting up training facilities, sourcing components, technology sharing, or making use of IT services from Indian service providers.

India was, however, late in adopting an official offset policy though it had obtained some compensatory benefits since Independence through a series of bilateral arrangements. The policy introduced in 2005, has been continuously amended to give it greater clarity and direction. The latest policy was issued in 2011. As a late entrant in the field, India's policies are yet to be fully tested against the complex process of managing offsets.

The introduction of an offset policy presents as many challenges as opportunities. Examples of setbacks abound all over the world: Under Japan's offset policy, for instance, domestic manufacturers produce goods on licence from international firms, but not at cost-competitive rates. Australia finally abandoned its offset policy after 10 years in which the policy did not deliver on expected objectives (Booz, 2009).

A well-crafted offset policy can help India's domestic defence industry avoid these mistakes. Optimising India's defence capabilities will require an inflow of skills and knowledge from the experienced industry players, as well as strong coordination across the armed forces, industry, academia and defence research institutes.

India already has a limited experience on the pitfalls that can come from an inadequately considered offset policy. Mistakes from the first offsetting exercise – such as lack of clarity and specificity surrounding policy rules – are now being addressed. The function of the Defence Offset Facilitation Agency (DOFA), which is taking on a prominent role in linking international vendors with domestic firms, has



been redefined in hopes that pace of defence industry development and formation of partnerships can accelerate. Between 2006 and 2008, only three deals were made (Booz, 2009).

As it develops its own defence offset policy, India can learn from the past successes and errors of other countries. An important first step is to focus on targeted areas and a longer-term outlook for domestic defence industry growth.

### 1.1 Statement of the Problem

Under the policy, foreign vendors had the liberty to discharge their obligations either through the execution of defence exports of Indian items and services or through investments in India's defence infrastructure. They also had the option of selecting Indian firms in consultation with an industry associate of their choice to implement their offset obligations.

The offset policy is in the nascent stage and it lacks clarity in many areas. It also suffers from the absence of any designated agency in the Ministry of Defence (MoD) for guiding, overseeing, executing and monitoring the implementation of the policy. In reality, confusion reigns in equal measure in the corridors of South Block as in the minds of the vendors on how to implement the offset obligations. Consequently, the offset policy did not yield any major dividend in the past.

There is almost complete unanimity among defence economists, who have analysed the impact of defence offsets on the development of the defence industry in various countries that the process is highly complex and therefore defies easy conclusion. Their efforts have been stymied primarily by the absence of data relating to offset implementation and the notorious level of secrecy with which defence firms guard such details. Offsets have been termed as "smoke and mirrors", with nobody being sure as to "who benefits" (Markowski, 1994). In addition, almost all of them have questioned the economic efficiency of offset transactions.



There is an economic cost to offsets. For instance, in a survey conducted in the UK, it was concluded, “evidence suggests that offsets do cost more than off-the shelf purchase and, not surprisingly, that vendors seek to include most of this premium in the selling price” (Dumas, 2004). In a study of defence offset implementation in Belgium, it was estimated that the nation had to pay between 20-30 per cent in increased costs in connection with offsets tied to its military procurement (Mathew, 2009). Depending on the economic conditions prevalent in the offset applying nation, its industrial base or its capacity to absorb technology, vendors hike the cost of their goods/services to compensate for the inefficiency, which is inherent in the nation seeking offsets. Therefore, an offset implementing nation pays more for the import of defence items than it would otherwise have to do if it did not impose mandatory offset obligations.

Among offsets, mandatory offsets have been further estimated to yield less economic dividends. In view of this, it has been commented, “there is no good reason for a mandatory offsets scheme” to be introduced, as such schemes “merely shift the initiative away from the purchaser and give suppliers’ scope for opportunism at the expense of the buyer” (Hall, 1996). From the above, it is seen that India may have opted for the use of an economically inefficient vehicle to promote its domestic defence industry. Therefore, the moot question is whether India has carefully calibrated its regulations and put in place a system that can optimise the benefits of an offset policy that in the first place comes at a cost.

## 1.2 Study Aim

The aim of this study is to evaluate the effectiveness of defence offsets in the Indian context and recommend measures towards an effective offsets model and connected government procedures to maximise the benefits that can accrue to the nation from capital acquisition of defence equipment.



### 1.3 Study Objectives

This study's objectives are to:

- Evaluate various offset models in other selected developed and developing countries.
- Determine the factors that contribute towards an 'effective' offsets strategy.
- Critically analyse India's current national offset policy outlined in Defence Procurement Procedure 2011.
- Propose policy recommendations towards an effective offsets model and connected government procedures to maximise the benefits that can accrue to the nation from capital acquisition of defence equipment.

### 1.4 Rationale for the Study

An analysis of the situation in India, however, reveals that the mandatory offset obligations will yield greater dividends, if necessary changes are made in all relevant rules and guidelines that have a bearing on the success of the policy. Some of the extant rules are archaic and not formulated to encourage the absorption of the benefits that offsets offer. Some of the areas that are glaringly deficient and where new initiatives may be needed are the following:

- Foreign Direct Investment (FDI) in Defence Sector.
- Involvement of Domestic Industry in Defence Planning.
- License Requirement for Defence Items.
- Offset Credit Trading.
- Directing Offsets.
- Use of Multipliers.
- Strengthening DOFA.



At an appropriate time, though not in the distant future, GoI may also consider revising the offset requirement for contracts. It can be lower than Rs 300 Crores as the world average today is US\$ 15 million (Rs 70.5 Crores). It can also consider increasing the offset requirement from the present 30 per cent to say 60 per cent, and fix a percentage for dual use technology inductions, a strategy that Singapore and Japan have adopted with remarkable success (Mathew, 2009).

### 1.5 Research Questions

- Will the policy outlined in DPP 2011 contribute substantially to the development of a military-industrial base in India?
- What are the shortcomings of the policy?
- What modifications are required in the offset policy and connected government procedures to maximise the benefits that can accrue to the nation from capital acquisition of defence equipment?

### 1.6 Research Limitations

Several limitations of the research process are expected. Following are the research limitations:

- Obtaining up-to-date information and data on offset programmes due to security of issues involved.
- Paucity of time to undertake detailed surveys and sending questionnaires.
- Limited availability of detailed data, due to sensitivity of the subject matter.
- Unavailability of systematic and structured data on offsets projects before 2006.



## 1.7 Research Methodology

The methodology proposed to be adopted is exploratory type and will involve the following:

- Undertaking a critical review of the secondary literature to establish both the theoretical foundations as well as the literature gap.
- Evaluating the archival sources, encompassing books, journal articles, newspaper clippings, specialist reports and published government reports.
- Using the literature base to explore the theories relating to economic development, industrialisation, technological development and the role of offsets.

## 1.8 Scheme of Chapters

The dissertation is being presented as per the following Scheme:

- Chapter 2            Introduction to Defence Offsets
- Chapter 3            Global Offset Practices
- Chapter 4            Existing Policy
- Chapter 5            Challenges and Barriers
- Chapter 6            Emerging Opportunities for Indian Defence Industry
- Chapter 7            Policy Recommendations
- Chapter 8            Conclusion.

