Essential Elements of India's Defence Offset Policy - A Critique

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Offsets have been variously defined. In essence, offsets in defence, as in civil trade, are compensations that a buyer seeks from the seller for the purchase of goods and/or services. The demand for offsets in defence has exhibited an upward trajectory since the 1950s.[1] It gained further momentum in the 1980s and has been growing ever since. From around 20 nations about two decades ago, this practice has now been now adopted by more than 130 nations.[2]

European nations have been able to generate more offsets than others. During the period 1993-2004, European countries were able to obtain offsets valued at 99.1 per cent of their defence imports while non-European countries achieved 46.6 per cent of their imports.[3] Significantly, 72.9 per cent of the offsets obtained by European nations were 100 per cent or more of the value of the weapon systems imported by them. The data on arms sales and offsets show that demands for offsets "are increasing over time in all regions."[4]

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. It was only in 2005 that the nation, through its Defence Procurement Procedure (DPP), announced an official policy to secure offsets for its defence imports. The policy was amended to give it greater clarity and direction in 2006 and again in 2008. Consequently, as a late entrant in the field, India's polices are yet to be fully tested against the complex process of managing offsets and it is yet to traverse the path of achieving its declared objective of creating a vibrant military-industrial base.

Objective of Paper

This paper seeks to critically examine the salient features of India's offset policy and answer the following questions.

- Will the policy outlined in DPP 2008 contribute substantially to the development of a military-industrial base in India?
- What are the shortcomings of the policy?

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- 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?

In order to understand the basic arguments contained in this paper, a few concepts relating to offsets in general and in defence trade in particular are explained.

Offsets Explained

Offset, as the term implies, is an element that counterbalances or compensates an act. It is a set-off from a development, in this case, military acquisition. However defined, the term offset primarily signifies an element of 'compensation' as the predominant import of the term. It occurs "when a supplier places work to an agreed value with firms in the buying country, over and above what it would have brought in the absence of the offset."[5]

As is commonly understood, in trade, offsets have been classified as direct or indirect offsets. Direct offsets are those that are directly connected with the item being sold by the seller and can take the form of co-production, component production, licensed production, etc. Indirect offsets are those not directly related to the product being imported and here compensations can be secured in any other area with the aim of obtaining for the economy what would otherwise have not been available to the buyer but for the purchase.

Though the above two forms characterise the two widely-accepted compensatory strategies, it is necessary to add a new terminology to describe a hybrid form of offsets that is between the direct and indirect offsets that India is seeking to obtain. This may be termed as quasi-direct offsets. It can be defined as compensation given in the sector under which the purchase falls, but is not directly connected with the product that is being imported. For instance, when tanks are imported, and the offset is obtained in the form of assistance for the co-production of a warship, then it will fall within this definition (quasi-direct) as it enhances the defence capability of the importing nation, though the compensatory arrangement is not directly connected with the item being imported. Therefore, though analysts have largely described India's policy as seeking direct offsets, it would be more accurate to describe it as quasi-direct offsets.

History of India's Defence Offset Policy

India inherited some defence industries from Great Britain. They included Hindustan Aeronautics Limited (HAL), which is today India's largest defence public sector undertaking (DPSU), Mazagon Docks Limited (MDL), the largest shipyard in the nation, and more than half a dozen ordnance factories. The growth

of the domestic defence industry has, however, been sporadic since Independence. It did not follow any definite plan though emphasis was placed on enhancing indigenous defence production capability.

Some analysts have also traced certain vigorousness in the Indian effort at developing an indigenous defence capability to the early 1960s spawned by the 1962 India-China war.[6] The war is seen as having underscored the urgency of building a domestic defence industry through foreign assistance. It was also in consonance with Nehru's policy of building a strong industrial base patterned on the Soviet model. But while the war with China has been identified as the catalyst in the effort at developing a domestic defence base, there was no concerted, systematic and well-orchestrated effort towards the achievement of this goal.

There were many factors that stood in the way of India building a strong military-industrial base. India's comparatively easy access to various types of defence equipment from the former Soviet Union (FSU) and their purchase against deferred rupee payments and on "friendship" price were some of them. Sophisticated defence equipment was transferred to India under the favourable rupee-rouble arrangements from FSU. Some license production facilities were also established in India, for instance for the Mig-21 aircraft. The Cold War also ensured that India continued to have a favourable and preferred source of defence systems and equipment from FSU. It did not find the superpower wanting in any critical manner in fulfilling India's defence requirements. However, this had the unintended consequences of dampening any sense of urgency in India to develop an indigenous defence industry. Coupled with this was the reluctance of the US to help in India's effort to develop a domestic defence production base. Nevertheless, trudging along, India was able to develop the largest defence industry among developing nations.

However, with the collapse of the FSU, India lost easy access to sophisticated defence equipment at cheap prices. The problem was compounded by the absence of an alternate source of modern defence equipment. The situation became worse with the almost complete disruption in the supply of services and spare parts necessary to maintain the predominantly Soviet-equipped Indian armed forces. The navy was particularly affected, as it was dependent on Soviet designs and equipment for some of the ships that were under construction in India. This led to huge cost and time overruns in the indigenous construction programme of naval vessels.

Ironically, the need to service and maintain various kinds of equipment imported from FSU compelled India to seek ways and means to develop some level of indigenous capability. Towards this goal, certain technologies and know-how were obtained, both for the repairs and for the local production of some critical spare

parts. These efforts were, however, largely case-specific and were not components of any systematic strategy for the comprehensive development of an indigenous defence industry. They were also service-driven in the absence of any coherent strategy to achieve self-reliance. However, the liberalisation of the Indian economy that almost coincided with the collapse of FSU and promised to unlock India's productive capabilities gave impetus to the goal of developing a domestic military-industrial complex.

It was, however, not until 2005 that India formulated a defence offset policy to contribute to the nation's goal of developing its domestic defence industry. This policy was incorporated in the Defence Procurement Procedure (DPP) 2005. The policy introduced a 30 per cent offset in contracts valued above Rs 3 billion under "buy" and 'buy and make" categories.

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 hallmark of this policy was its non-obligatory nature, or in other words, these offsets were non-mandatory. It was left to the Services Capital Acquisition Plan Categorisation Committee (SACPCC) to recommend the incorporation of offset obligation in acquisition proposals.

The offset policy was, however, in the nascent stage and it lacked clarity in many areas. It also suffered 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 reigned 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 dividend.

The absence of any offset benefit to the Indian defence industry led the Government of India (GoI) to make significant changes in DPP 2006 and they included the following:

- offset was made mandatory in defence contracts of the size and nature as prescribed in the 2005 policy;
- foreign firms were allowed the flexibility of forming joint ventures (JVs) with Indian firms, and;
- a new organisation called the Defence Offset Facilitation Agency (DOFA) was established comprising of representatives of all stakeholders; the Services, DPSUs, Defence and Research Organisation (DRDO), etc.

Offset Policy in DPP 2008

The limited success of the offset policy of 2006 led to its elaborate revision in 2008. India had by now become one of the largest importers of defence equipment, with nearly 70 per cent of its requirements being met by foreign suppliers. The demand of the armed forces also resulted in the high growth of India's defence budget. During the period 2003-07, it registered the fourth highest growth in real terms amongst the 10 largest military spenders in the world.[7] Therefore, the 2008 policy aimed at the creation of conditions for assisting in the development of a domestic military-industrial complex.

The salient changes introduced in DPP 2008 include:

- the introduction of a list of products which would qualify for the discharge of offset obligations (Annexure-VI of the DPP);
- the removal of the requirement for private industry to obtain industrial license to participate in offset programme unless stipulated by the regulations of the Departmental of Industrial Policy and Promotion (DIPP);
- offset credit banking;
- banking of surplus offset credit with a validity period of two years after the conclusion of the relevant contract, and;
- exemption of acquisitions under fast track from offset obligations.

Will the 2008 offset policy facilitate the creation of a military-industrial base in India?

With the defence outlay steadily increasing and with only around 30 per cent of the requirement being met indigenously, emphasis has been laid on utilising the growing sophistication of the domestic industrial base to achieve self-reliance in the defence sector. It is now seen as both a necessity and an increasingly achievable goal. But the introduction of the 2008 policy in itself is no guarantee that it will contribute significantly to this goal. Offsets though beneficial, come with certain inherent risks. The offset policy, therefore, has to be carefully calibrated to reduce its negative impact and maximise its yield.

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".[8] Also, almost all of them have questioned the economic efficiency of offset transactions.

Offsets are no free lunches. They are neither freebies. There is an economic cost to offsets. For instance, in a survey conducted in the UK, it was concluded that "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."[9] 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."[10]

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 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 concluded that "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."[11]

From the above, it is seen that India has opted for the use of an economically inefficient vehicle to promote its domestic defence industry. By opting for the mandatory offset scheme, it has further bartered the leverage buyers have in sale and purchase of competitive goods. Given the overwhelming evidence that offsets are generally not welfare enhancing, implicit in the Indian offset policy is the assumption that it is willing to forsake economy in the acquisition of weapons for the long-term goal of creating a defence-industrial base (which according to existing studies is difficult to achieve) through the induction of technology, co-production, license production, etc., that the policy may compel. 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.

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 were not, in the first place, formulated to encourage the absorption of the benefits that offsets offer. Such rules and procedures that were formulated prior to the incorporation of the policy of offsets (licensing policy requirement for private firms to produce defence items, for

instance), it is argued, cannot but reduce the benefits the policy can yield. 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

"Direct foreign investment in Indian defence industries for industrial infrastructure for services, co-development, joint and a production of defence products and components" have been identified by DPP 2008 as a method to discharge defence offset obligations.[12] But in order to encourage investment and transfer of technology to India, it will be important to give foreign defence firms the confidence that they will have greater share in the profits and larger say in the management of the entities they create. Larger stakes should be allowed to foreign firms in such entities whose creation would not have been possible but for these foreign companies. Ironically, Foreign Investment Promotion Board (FIPB) guidelines do not encourage this.

According to the FIPB guidelines, foreign firms that may tie up with Indian entities are allowed only 26 per cent equity in such ventures. The remaining equity has to be owned by Indian entities. The ceiling of 26 per cent is a major impediment to the success of the offset policy.[13] First, foreign firms are reluctant collaborators in any mandatory offset arrangement. Otherwise, these firms would have tied up with Indian entities for the production of defence equipment without any compulsion. But as offsets have been made mandatory in cases involving acquisition over Rs 300 crore, foreign firms can nevertheless be expected to collaborate with Indian firms, as otherwise they will lose the opportunity to profit from the contract that can only be signed with the offset obligation. But, if the created entity has to survive on a long-term basis, the collaborating foreign firm should have a stake in it. This can only come through the creation of attractive prospects for the foreign firms to make greater profit than investments made elsewhere. Therefore, there is a need to make them, not reluctant parties, but willing and enthusiastic partners in JVs by increasing their stake in such collaborations. An example of how higher stakes in companies can help add value to the offset policy is the Boeing purchase of 34 per cent of Aero Vodochody, a Czech firm, as an offset deal. Boeing's subsidiary Ayers bought LET Kunovice, a Czech plane manufacturing firm, with plans to move part of the production line for its own planes to LET.[14]

Second, if the balance of the 26 per cent that a foreign company brings has to be raised by Indian partners, it can lead to many difficulties. Since 26 per cent equity is the upper ceiling that a foreign vendor can invest in India, it has to find an Indian firm that is willing to raise the balance 74 per cent. This raises two difficulties. First, it has to find an Indian partner willing to find resources for this high level of

investment. Second, if the foreign firm decides to use a JV as the sole means of fulfilling its 30 per cent obligation under offset, then it will have to find an Indian partner or partners willing to invest more in terms of equity. To illustrate, if a company X enters into a contract for Rs 1,000 crore, it will have to invest Rs 300 crore to discharge its offset obligations. But since a foreign vendor is only allowed 26 per cent equity, to invest Rs 300 crore, it will have to form a JV that involves a total investment of Rs 1,153.8 crore (Rs 300 crore by the foreign vendor and Rs 853.8 crore by the Indian entity or entities). Both the choices are difficult, as is would not be easy to find Indian entities that can make such high investments.

Conversely, increasing the equity may benefit the nation in several ways. Given the above dampeners (arising from the upper ceiling of 26 per cent), it may encourage greater participation by foreign firms in JVs if they have larger share of the equity. Also, foreign vendors will be reluctant to invest 26 per cent in equity and transfer proprietary technology that may have been developed at high research and development (R&D) cost. There is always a stubborn resistance to transferring technical capability and it can only come at a price as "the transferring country does not simply stand still while its 'beautiful princess' (Williamson, 1983) is shipped abroad and effective competition is created."[15] Therefore, a foreign firm will be less reluctant to grudge competition from an entity established in India in which it has substantial stakes and from whose sales it stands to profit.

Given that comparatively cheap factors of production exist in India, the foreign parent company may even chose to outsource components/items from their Indian JV. Though not in the defence sector, the export performance of Hyundai Motors in India should give India reasons to allow more liberal FDI in the defence sector also.[16] Second, a foreign firm that invests higher equity will have a stake in the success of the project. It will be more willing to outsource items from India to its other holdings to make the project a success. Otherwise, there is a danger of the interest of the foreign vendor dissipating once the contract is completed, as without a reason to retain their interests, they will shut shop and return. This point can be illustrated with the instance of armoured personnel carriers purchased by the Philippines Army from the UK. After eight of these were imported from the UK and the remaining 142 were assembled in Philippines, the assembly line was closed, with only minimal offset benefits to the nation.[17] Third, as offset banking has now been allowed, it will give such vendors incentive to accumulate credits for discharging their obligations in future contracts by making value additions and introducing new products. (For this to yield optimum results, the validity of the bankable credits will have to be enhanced. This aspect is discussed in more detail subsequently).

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There should be further transparency in dealing with prospective foreign vendors. At present, GoI does consider higher investments on a case-to-case basis. This concept of case-to-case approach is indeed intriguing to a foreign vendor who in any case finds Indian procedures, bureaucratic control and the penchant for secrecy rather perplexing. The recent reports that the GoI turned down a joint venture proposal of Mahindra and Mahindra with the British defence giant BAE Systems has not helped convey the right message, coming as these did only weeks after the revised offset procedure was announced.[18]

This rejection has even raised doubts on the seriousness with which India is pursuing its policy to attract foreign investment in the defence sector. Perhaps, GoI may have had strong reasons to reject the proposal. But explaining the reasons to the firms may have limited the damage. There should be more transparency in expressing our views and this will result in increased vendor confidence in the nation.

It may also be difficult to argue that increasing the limits of equity participation for foreign firms will impinge on national security. The only danger perhaps is that such foreign firms may end up buying Indian entities (a view expressed by one of the large Indian entities in response to the questionnaire sent by the author). If this is a serious concern, the problem can be addressed by making it a requirement to obtain the approval of GoI before the takeover of any defence establishment by a joint venture.

Involvement of Domestic Industry in Defence Planning

Private entities are answerable to their shareholders and are in the business to make profits, whether in defence or any other sector. Attractive return on investment, more than what can be expected in non-defence sectors, is the only mantra that can make them divert their finite resources to the defence sector. Gestation period is also quite high in defence sector as establishing a defence venture can take more time than other commercial ventures. Therefore, advance information of the acquisition plans of the government can give potential domestic investors the lead time and the opportunity to study the prospects of raising funds and also seek foreign collaborations. This is a necessary pre-condition for creating the right atmosphere for developing an indigenous defence industry.

At present, private players do not have prior knowledge of the defence plans of the country. Though we have 15-year long-term integrated perspective plan (LTIPP) that flows into the 5-year Services Capital Acquisition Plan (SCAP), which in turn flows into the 2-year roll-on plan for Capital Acquisitions, the acquisition proposals are most often than not guarded as secrets. The Indian domestic industry is not privy to these plans. As a consequence, information is sent to them only

when requests for proposals (RFPs) are issued. Potential Indian investors, therefore, lose the lead time that is required to plan and prepare for such large investments.

The solution may lie in sharing with a select group of Indian industries the LTIPP and the SCAPs to the extent they relate to items proposed for acquisition. The argument that revealing in advance what the nation seeks to acquire will be detrimental to national security also does not hold much water. Private companies have been involved in the development of closely guarded defence projects in India. Further, details of almost all acquisitions, even those relating to some of the most sensitive projects, find their way into leading arms publications sooner than later. Again, there is no reason to believe that private sector can be less trusted in keeping state secrets than the public sector. In any case, we lose some of our eminent public sector personnel to private sector. Like in the US, we should involve the private sector at the planning stage itself. To ensure secrecy of information, suitable regulations may be put in place, like in the US. If necessary, in very sensitive projects, the information need not be shared.

Abolish License Requirement for Defence Items

As argued above, private entities will not embark on any manufacturing venture, defence or otherwise, unless they are confident of reaping dividends from it. Therefore, prudence lies in opening up this sector. Let the market forces regulate the industry.

Defence contractors are most often not large. Even large entities source components and subcomponents that make up complex systems from countless small enterprises. In India too, there are thousands of small and medium producers. Several of them do not have licenses as many of the items used in defence equipment also have civilian application. Therefore, the requirement of licenses for the manufacture of defence-related items not only complicates the existing situation but also destroys individual and entrepreneurial initiatives.

Introduce Offset Credit Trading

The 2008 procedure has introduced offset banking. According to the guidelines, offset banking is permissible for a maximum of two-and-a-half years. Given the lead time available from the time RFPs are issued, this time-frame may be around 5 years or even 10 depending on the completion schedule of the project. This is a very positive step and has been very widely welcomed. But the bankable years should not end with the end of the project as “rather than linked to the life of a specific offset project, the technology strategy needs to embrace productive opportunities across the broader economy. Offset policy thus needs to be framed accordingly."[19] It has been estimated that credit transfers account for around 7.5

per cent of all offset transactions and that the banking of offsets has resulted in a trend to permit offset commitments over longer periods of time covering several projects rather than limited to specific projects.[20] This will undoubtedly give confidence to foreign firms hoping to bag Indian contracts get a return for their investment. But this alone is not enough. The most encouraging step will be to introduce offset trading.[21]

Offset trading is the sale of credits accumulated by firms over a defined period. The introduction of this provision will make it possible to sell offset credits to any firm that bags a contract in India and has certain offset obligations to fulfil. It will yield several benefits. First, every prospective firm that is hopeful of bagging any defence contract in India will be assured return on their investment even if they are unsuccessful in securing the contract they may have targeted. It may at least ensure that they may have no losses and also obtain profit in many cases. This may motivate firms to shed their fears of investing in the military sector in India. Second, India has attractive factors of production. The prospect of offset trading will only increase the willingness of foreign firms to capitalise on these advantages and invest in the defence sector in India. While allowing offset trading, government can also consider prescribing diminishing value to credits over a period of time unless there is value addition to the product. This will encourage firms to sustain their investments in India over a longer time horizon. Third, a firm that is already discharging its offset obligations can continue producing defence equipment over a longer period of time, hoping to accumulate credits for future contracts. Even if it does not bag the contract it may have hoped to, it will be able to trade the offsets. This policy can lead to a win-win situation for both foreign firms and India. The key to success is the prosperity of all the key stakeholders and hope of future profits for investors. Nothing else will succeed. Success will come from giving foreign firms the incentive to sustain their interests in India by encouraging innovativeness and hope of profits through it.

Directing Offsets

The 2008 procedure (Annexure-VI) lists the defence products that qualify for the discharge of offset obligations. This list is generic in nature and ranges from small arms to directed energy weapon systems. In effect, there is no precise direction in which offsets are channelised. Any vendor will be well within his right to produce any item related to the aforementioned list to fulfil its offset obligations. But this will not yield optimum results. For instance, it has been concluded that the Netherlands and Switzerland have been able to displace jobs in the US through offset arrangements by transferring production facilities to themselves. To achieve this, the two nations exercised careful control to ensure the "precise direction in which offset-resources are steered. Almost never are they aimed at increasing

indigenous military production capacity."[22] In the study by Brauer, he has cited Molas-Gallart to argue that Spain had to abandon its dream of an "integrated, comprehensive, indigenous industry to be generated via arms trade offsets."[23] It was also argued that when offsets are bureaucratically mandated and applied to some vaguely specified national interests, net benefits may not exist.[24] Therefore, prescribing a generic list from which offset obligations are to be chosen for implementation may not be the best strategy to serve India's defence needs. This issue deserves further examination.[25]

India is a nation that has a reasonable defence industrial capability. It is more advanced in some areas than in others. For instance, in the field of naval shipbuilding, India has been able to achieve a fair degree of indigenisation and in some cases around 76 per cent. India today is designing stealth frigates and constructing them in Indian yards. But almost all the weapon systems are imported though India has developed and is using many indigenous sensors. Therefore, for instance, the navy should be able to identify areas of high priority such as the weapon systems that it will prefer to produce indigenously and incorporate them in the list. Through this process, the benefits of offset can be channelised into identified areas. For instance, given the plan of the navy for a 160-plus ship force[26] by 2022 from the 145 that it has at present, a prospective vendor will be inclined to invest in identified areas included in the list to: 1) fulfil its offset obligations; 2) accumulate offset credits knowing that orders for the weapons or other naval items will be assured for a known period, given the navy's maritime plan; and 3) be reasonably assured of future orders.

Assured of continuing orders, firms will also be inclined to provide value addition over time. To give further impetus to foreign vendors to endeavour towards this goal, a system of procurement through repeat orders, say for 10 years or so, from the same source that had produced indigenously such critical items should be seriously considered. Provision of value addition, etc., can also be made mandatory for such repeat orders. Similarly, critical items for the three services can be compiled and included in the list eligible for discharging offset obligations.

Use of Multipliers

Along with the critical areas/systems that may be included in the list eligible for the discharge of offset obligations, the concept of multipliers can be used. This can be a twin-pronged strategy to sharpen focus and channelise offset benefits. At present, the offset policy of India does not allow the use of multipliers, which are a

device to give additional credits for offsets in critical items or most critical technology.[27]

The use of multipliers will further help in directing the development of the indigenous defence industry. The danger in allowing the development of defence industry through a less-focused development strategy is that we may have the capability to produce small components of defence equipment, but not be able to produce complex systems. For instance, mortars are items that have been made eligible for the discharge of offset obligation. Therefore, a foreign firm may be able to discharge its obligations by setting up production units for the fins of mortars. But unless this is a technology that is lacking in India, little value is added to the Indian defence industry through the creation of such a facility.

Let us take another example how multipliers in conjunction with a carefully prepared list can reap rich dividends, both in monetary terms and improving the defence preparedness of the country. Multipliers, along with a priority list, can provide relief to some of the projects that have been bedevilled by time overruns. For instance, the MBT, Arjun tank project that was approved in 1974 and on which over Rs 306 crore[28] had been spent till 2005, is still struggling to gain approval of the army, which has complained among other things that it has had "four engine failures so far."[29] Will it, therefore, not be omniscient to include engines in the offset list and if necessary, provide multipliers for its co-production/license production, etc?

Another area where it will be advisable to apply multipliers is perhaps the indigenous development of special ammunitions. Though Indian ordnance factories produce a wide range of ammunitions, when it comes to special ammunitions, we are hopelessly dependant on imports. This affects India's operational capability, as was painfully seen during the Kargil conflict when emergency supplies had to be airlifted from Russia. Domestic production of such ammunition will also help in providing better training to our forces by giving them more opportunity to engage in live firing training, without having to unduly worry about war wastage reserves. Thus, application of multipliers for the indigenous production of ammunition along with the import of guns should deserve serious consideration.

Strengthening DOFA

It has been estimated that in the 11th Five Year Plan alone, India expects nearly US$10 billion (approx. Rs 47,000 crore)[30] to flow into the country through offsets. This means that on an average for every year of the plan, offsets worth Rs 9,400 crore will have to be processed by DOFA.

At present, DOFA is staffed mainly by part-time officials. It is headed by the Joint Secretary (Exports), Department of Defence Production, MoD, and has a supporting structure, which includes the Director of Planning and Coordination as its Member Secretary and members from the armed forces to assist in the functioning of the organisation.

DOFA, therefore, needs to be strengthened and made into a dedicated organisation with economists, financial and technical experts drawn from outside the government to steer the offset programme in the right direction.[31] Similarly, a more elaborate mechanism for offset monitoring should be put in place. It should also consist of dedicated staff, who are not assigned to any other task.

Conclusion

As has been argued, defence offsets come at a cost and defence economists are still confounded as to who benefits (seller or buyer) from these arrangements. There is no overwhelming evidence to support any definite conclusion. If empirical data from Belgium is any evidence, then implementation of offsets in defence contracts can add 20-30 per cent to the cost of imported equipment. Depending on the industrial and defence infrastructure of a country and its political relations with the seller nation, the cost to the purchasing nation can vary. But what is certain that offsets come at a price. At the same time, overwhelming evidence also suggests that offsets are gaining wide acceptance over time and in all regions. Evidently, importing nations are willing to compromise economic efficiency for the dividends that offsets promise in strengthening their defence industry. India has also now decided likewise.

Since offsets come at a price, implementation of the policy also implies that the armed forces do not get what they would have got in the absence of offset provisions. Therefore, there is a need to ensure that the policy is most carefully calibrated to focus development in identified areas as opposed to the aim of creating general defence capability, lest it should become a sterile investment of scarce resources.

GoI has taken some remarkable initiatives towards the achievement of these goals. These may, however, not be enough. Suitable changes should not only be made in the procedures of the MoD, but across the regulations and procedures of other ministries (commerce, for instance) that can impact the success of the policy. This should emanate from the acceptance of the harsh reality that no foreign vendor will invest in India for the long haul if it cannot get adequate returns on its investment. No policy to create a viable defence infrastructure in the country can succeed

unless this reality is accepted, however, unpalatable it may be. In other words, any offset policy to succeed should be able to create a stake for the foreign vendors to continue operating in the country, upgrading their systems along the way and in the process make it a win-win situation for both the parties.

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

Today, bold and innovative steps need to be taken. For instance, a system of assured orders for 10 years for a JV that invests in certain critical areas can reap rich dividends. Certainly, additional conditions like minimum indigenous content for such equipment, mandatory export obligations can be incorporated on a case-to-case basis. Special provisions like tax holidays for JVs and domestic entities engaged in critical defence areas can also be considered. Special concessions should also be extended to sub-contractors of JVs who are able to penetrate the defence supply networks of foreign vendors. It is important for the sub-contractors to flourish as they will eventually create the base for a viable defence base in the country. Alone, they will not be able to succeed as, "even potentially competitive domestic firms may not able to break into subcontracting networks of large foreign suppliers" unassisted.[32] Therefore, what is needed is a holistic approach to make a success of India's offset policy.

END NOTES:

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3. US Department of Commerce, Bureau of Industry and Security, *Offsets in Defence Trade: Tenth Study, December 2005,* p. 35, at http://www.bis.doc.gov/defenseindustrialbaseprograms/osies/offsets/offsetxfinalreport.pdf (accessed on October 20, 2008).

4. US Department of Commerce, Bureau of Industry and Security, *Offsets in Defence Trade: Twelfth Study*, December 2007, pp. 4-8, at http://www.bis.doc.gov/defenseindustrialbaseprograms/osies/offsets/final-12th-offset-report-2007.pdf (accessed October 19, 2008).

5. Stephen Martin and Keith Hartley (1995), quoted in Jurgen Brauer and J. Paul Dunne (eds), *Arms Trade and Economic Development: Theory, Policy, and Cases in Arms Trade Offsets*, Routledge, London and New York, 2004, p. 4.

6. Ashok Kapur, *India - From Regional to World Power*, Routledge, Abingdon, UK, 2006, p. 198.

7. This data is drawn from Table 5-A-3 of SIPRI Yearbook- Armaments, Disarmament and International Security, 2008, Oxford University Press, Sweden, pp. 219-225.

8. Hall and Markowski, n. 1, p. 175.

9. Stephen Martin, quoted in Lloyd J. Dumas, 'Do offsets mitigate or magnify the military burden?' in Brauer and Dunne (eds), n. 5, p. 21.

10. Wally Struys, quoted in Stephen Martin, quoted in Lloyd J. Dumas, 'Do offsets mitigate or magnify the military burden?' in Brauer and Dunne (eds), n. 5, p. 21.

11. Stefan Markowski and Peter Hall, 'The Defence Offsets Policy in Australia,' in Stephen Martin, *The Economics of Offsets: Defence Procurement and Countertrade*, Harwood Academic Publishers, The Netherlands, 1996, p. 50.

12. Ministry of Defence (2008), Government of India, Ministry of Defence, *Defence Procurement Procedure-2008*, p. 44.

13. The author had sent questionnaires to four large Indian entities to ascertain their views on this issue. Two opposed its expansion while the other two were in favour of the increase in FDI limit. Of the latter, one said that FDI should be increased to 50 per cent while the other said it would be desirable to increase it to 51 per cent. They also opined that higher FDI would encourage infusion of superior technology through the process.

14. US Department of Commerce (Fall 2001), *Offsets in Defense Trade,* Fifth Annual Report to Congress, p. 3.11, States Department of Commerce, at http://findarticles.com/p/articles/mi_m0IAJ/is_1_24/ai_80965656

(accessed on October 19, 2008).

15. Jurgen Brauer, 'Economic aspects of arms trade offset,' in Brauer and Dunne (eds), n. 5, p. 59.

16. In 10 years of its existence, the wholly owned subsidiary of Hyundai Motor Company of South Korea is the fastest growing car manufacturer in India exporting 42 per cent of the company's products.

17. Ron Matthew, 'Defense offsets: policy versus pragmatism,' in Brauer and Dunne (eds), n. 5, p. 97.

18. It was, however, later reported that the JV received the approval of the government after the foreign collaborator lowered their equity in the proposed entity.

19. Matthew, in Brauer and Dunne (eds), n. 5, p. 95.

20. Udis, quoted in Ron Matthew, 'Defense offsets: policy versus pragmatism,' in Brauer and Dunne (eds), n. 5, p. 95.

21. The author had sent questionnaires to four large Indian entities to ascertain their views on this issue. Two companies opposed offset trading. One favoured it saying that it would encourage exports of high technology items. The other firm stated that a decision could be taken on the basis of experience gained over the years.

22. Jurgen Brauer, 'Economic aspects of arms trade offsets,' in Brauer and Dunne (eds), n. 5, p. 58.

23. Ibid.

24. Stefan Markowski and Peter Hall, 'Mandatory defence offsets – conceptual foundations,' in Brauer and Dunne (eds), n. 5, p. 53.

25. The author had sent questionnaires to four large Indian entities to ascertain their views on this issue. All the four firms opposed limiting offsets to a shelf of projects. (In view of the overwhelming opposition to the limiting of offsets to a shelf of projects, the author recommends use of multipliers at least to attract offsets in critical areas. The list of items eligible for offset should have these identified areas).

26. The programme also envisages the indigenous construction of 38 of these vessels. ("Indian Naval Chief Admiral Sureesh Mehta spells out vision 2022". August 10, 2008, at http://www.indiadefence.com/print/3954 (accessed on October 22, 2008.) Such a programme would open up the prospects of obtaining through JV, licensed production, etc., of critical items.

27. The author had sent questionnaires to four large Indian entities to ascertain their views on this issue. Of the four, only one opposed the application of multipliers. Two supported it vigorously while the other accepting it as "useful" has recommended that it be considered after five years.

28. Jane's Armour and Artillery, "Arjun MBT (India)", March 20, 2008, at http://www.janes.com/extracts/extract/jaa/jaa_0027.html (accessed on October 21, 2008).

29. Lok Sabha Secretariat (April 2008), Twenty Ninth Report on *Demands for Grants (2008-09)*, p. 75, Standing Committee on Defence (2007-08), Fourteenth Lok Sabha.

30. Throughout the paper, the conversion of US$ has been taken at the rate of $1=Rs.47.

31. The author had sent questionnaires to four large Indian entities to ascertain their views on this issue. All the four firms were unanimous in their support of this aspect though their suggestions varied slightly. But all agreed on the need to give more representation to the domestic industry.

32. Hall and Markowski, n. 1, p. 186.