DEFENCE OFFSETS: BEYOND BORDERS

Reviving India's defence infrastructure is critical and so is discharging its offset obligations. More investments in infrastructure is the only way out

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Most believe, India's growth trajectory that has lost its steam due to the COVID-19 impact, is expected to return to its pre-covid growth trajectory in the next FY. There is also a universal acceptance that the best way for India to gain out of this global recession is to invest in its infrastructure. The infrastructure that goes beyond traditional infrastructure of transport and energy but also healthcare, agriculture, irrigation, water, etc. The challenge lies in being able to fund these in these times when revenue receipts have taken a historic hit.

Defence as a strategic sector still has a high ratio of imports vs exports. The defence infrastructure base in the country is being enhanced and is being made more competitive. However, the high capital investment and long gestation period required in the sector restricts the expectation of immediate returns. Hence, while as a nation we are focussing on indigenous design, development and production, imports may still continue for a while at least. The emergent purchases / imports being planned and / or already ordered are plugging a small section of the gap. If we consider the case of fighter aircraft, the additional 21 MiG-29s and 12 Su-30s along with upgradation of existing 59 MiG-29s coupled with the planned order for 83 LCA Tejas aircraft in the coming few years would enhance the IAF fleet.

OFFSET OBLIGATIONS

Till date, the defence sector has seen a lot of foreign purchases which have resulted in billions of dollars of offset obligations by the vendors. The numbers suggest that till March 2019, MoD has reportedly signed 52 offset contracts worth ~$11.8bn out of which as of 24 April 2020, only $1.6bn have been disposed while close to $1.2bn are either under examination or clarifications are being sought on claims. This leaves a huge gap of close of $9bn worth of offset obligations that are still pending to be discharged via the avenues as mentioned in the DPP. A delay in the discharge attracts penalties from the vendors.

> Lack of understanding of the defence ecosystem can be plugged via its detailed study. Policy angle where there are limited avenues for discharge of offset obligations needs urgent attention

As of date, close to $35mn in penalties has been reportedly charged to the foreign OEMs for violation of discharge of offset obligations. One of the reported cases is for a global leader which was fined ~$500,000 after the defence ministry was not satisfied with the discharge of obligations undertaken by the company in relation to the orders . Possible causes for such delays in meeting obligations and the subsequent fines possibly include among others (1) India's capacity to absorb offsets within the confines of the eligible list of goods and services in defence, civil aerospace, homeland security and services segments and (2) lack of a comprehensive understanding of the India defence landscape. The lack of a comprehensive understanding of the defence ecosystem can be plugged via a detailed exercise of studying the same. The more urgent requirement is the policy angle where there are limited avenues for discharge of offset obligations.

While there is merit in restricting the avenues to defence and allied segments, past experience has shown that it is not easy to discharge offset obligations just via this sector. Hence a case can be made that such obligations be allowed to be discharged in other infrastructure and / or social infrastructure based sectors via a banking set up maybe. These sectors including healthcare and education which provide for 100% FDI under the automatic route making it more convenient for all stakeholders. The foreign OEMs will get more avenues to discharge their offset obligations thereby probably completing it faster.

THE ROLE: Streamlining offset obligations

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The Indian ecosystem will get the desired equity FDI and / or investment in other relevant forms. A win-win for both. India needs investment in infrastructure right now and this is a readily available medium which can arguably be operationalised sooner than any other.

From a social infrastructure perspective, on one side there are many pressing requirements which need interventions from the Government and on the other there are many technology enabled solutions that can help build the ecosystem with a little investment support.

INDUSTRIAL COOPERATION

Referencing a case of Israel for example. Israel's offset policy requires a mandatory 50% offset discharge obligation for all contracts above $5mn. For India, the same is a minimum 30% offset liability for contracts above ~$300mn. However, in Israel the discharge of such obligations is through what is called as 'Industrial Co-operation' which is arguably more broad compared to the avenues as per the Indian DPP. Industrial Cooperation includes R&D, know-how transfer, vocational training, purchase of Israeli made goods and Work in Israel (work, services and assembly) . To each country its own. Hence given India's requirements, it is important to take the best practices of other countries and weave it into the best possible solution for self.

In healthcare for example, the Government is committed to increasing the spends from 1.4% of GDP to 2.5% of GDP . Investments are required in tier 1/2/3 in the healthcare sector along with focussing on removing bottlenecks or barriers as these would enable in building a supply side capacity. With the ongoing pandemic, manufacturing of APIs has been taken up on a mission mode by the Government of India as reportedly about 60% of its total imported APIs and intermediaries are from China alone. The Government has announced a $394mn scheme to promote the development of three bulk drug parks . FDI (both equity and / or in the form of science & technology) in such cases and areas will assist tremendously. India already has an established pharma and healthcare industry and the additional FDI will only add to it. In education sector for example, infrastructure requirements like laboratories, libraries, electricity requirements in schools and colleges also reportedly have critical gaps in terms of requisite budget allocations . Similarly in water related infrastructure, India reportedly needs to invest close to $270bn over the next 5-15 years to meet its water infrastructure ambitions . In a nutshell, the idea being pursued here is that while defence infrastructure is critical and also urgent, there are other sectors also where investments are required. Hence, expanding the avenues for discharging of defence obligations will just give the foreign OEMs more options to invest. If not for future contracts, an allowance to settle obligations via other avenues as a one-off case for all foreign vendors could also be considered.

UTILISING DEFENCE OFFSET FUNDS

In view of the current need for identifying non-tax revenues, it is important to utilise the defence offset funds on a relatively immediate basis. Options of putting the funds to use can be considered: a possible development banking set up, or Impact Investment Fund that discharges the obligation through FDI (equity) to further leverages the funds. The funding can also be used in cantonment infrastructure works. It is suggested that we target a part of the available offset pool, say 30%, which would amount to approximately $3billion (~INR 20,000 cr). This can target clear projects like Har Ghar Jal, Irrigation works, OFB modernization, national infrastructure pipeline projects, for example - with the priority being given to projects that are ready to disburse funding, or in an advanced state of the procurement process. Another option could be to open up specific infrastructure sectors in the eligible list, and allow the foreign vendors to find investment avenues with local partners. While this injects INR 20,000cr into the treasury as non-tax revenue, with the current leveraging ratio, this can inject INR 50,000cr into the economy, via critical infrastructure projects.

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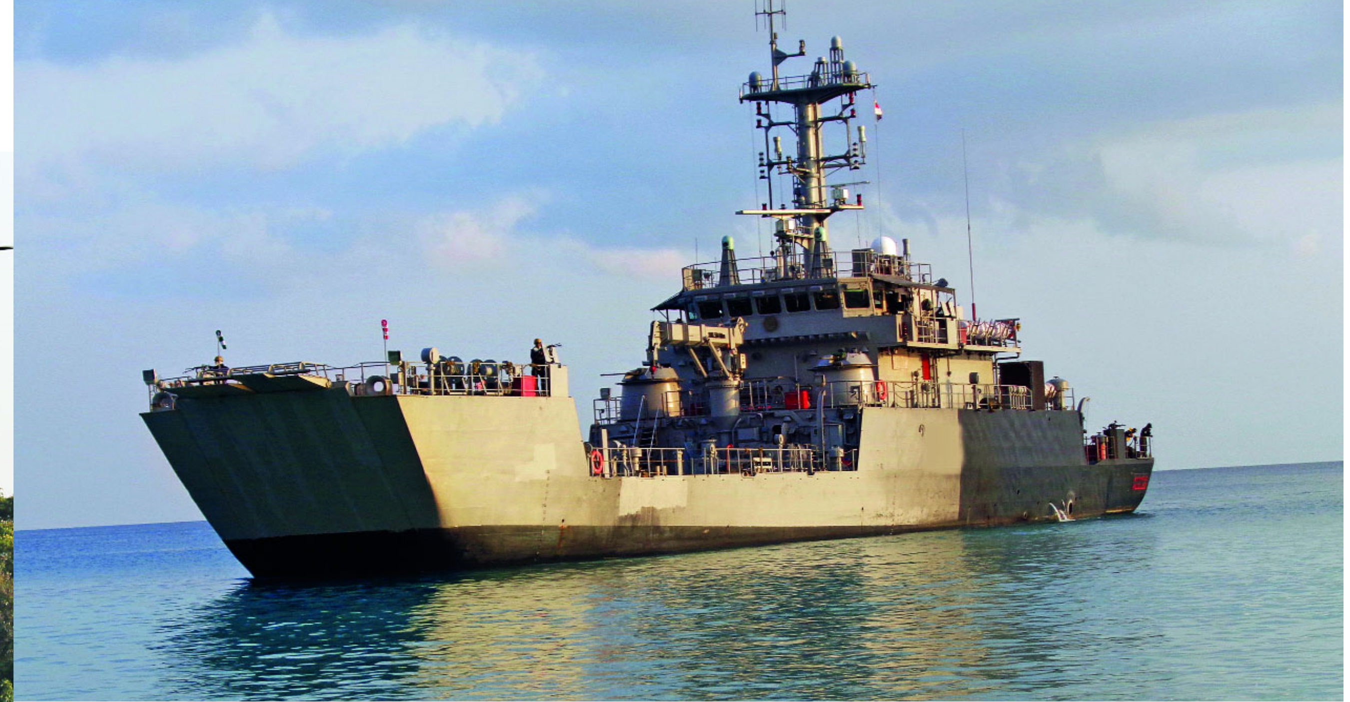

THE POTENTIAL: Utilising defence offset funds

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