
MEMORANDUM

TO: REP. M. SALMON (R-AZ); CHAIR—HOUSE FOREIGN AFFAIRS, ASIA-PACIFIC SUBCOMMITTEE
FROM: NICHOLAS NEUTEUFEL; POLITICAL AFFAIRS, US-ASIA INSTITUTE
SUBJECT: US-INDIA DEFENSE COOPERATION WITH A FOCUS ON INDIA'S OFFSETS REQUIREMENT
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Summary

While recent progress in the US-India defense procurement relationship marks improvement, India's offsets policies are still a major stumbling block towards a full defense procurement partnership. Offsets require that 30% of major defense acquisitions from a non-Indian firm be sourced within India (three ways to offset: a joint venture with an Indian firm, infrastructure or industrial investment, or manufacturing in India/with Indian parts). After examining three options: a "slow, but steady" approach, pressuring India to drop the requirement, and selective negotiation to relax offsets, I recommend that the US engage in selective negotiation with India to relax the requirement for critical technologies. This approach would help India build a defense-industrial base long-term while remedying its immediate lack of military readiness.

Introduction

President Obama's Republic Day visit to India in January 2015 marked a new resurgence in US-India relations. Prime Minister Modi and Pres. Obama were widely reported as having a great deal of personal chemistry, and they achieved a great deal during the visit. The trip saw two major breakthroughs in military/defense cooperation: finalizing the renewal of the 10-year Framework on Defense Cooperation and agreeing to the Defense Technology & Trade Initiative (DTTI). There are, however, still major obstacles on the road to a full partnership with India.

By far the most controversial aspect of the US-India strategic relationship is India's offsets requirement in military acquisitions. Offsets obligate any foreign firm winning an Indian procurement contract worth more than 3 billion rupees (~\$48 million USD) to invest 30 percent of the value in India's defense-industrial base. The offset investment could include engaging in a co-development or co-production joint venture with an Indian firm, financing Indian defense infrastructure, or working with Indian contractors or suppliers.

Issues

The intent of the offsets policy is to create a strong indigenous Indian defense sector with reliable technology so India can independently project its power and protect its interests. The Ministry of Defence's mission statements regarding offsets stress "self-reliance, indigenization, technology upgradation [*sic*]... [and] developing capabilities for exports in the defence sector." The two points of emphasis seem to be on domestic economic growth as well as the development of its burgeoning defense sector. Offsets offer starting point for realizing those goals while directly employing thousands—potentially millions—of Indian workers.

Offsets have downsides for India. One problem, discussed by Robert Metzger of the international law firm Rogers Joseph O'Donnell, is that they breed corruption. Offsets built into an Italian helicopter sale became kickbacks and bribes worth \$65 million (almost 10 percent of the total

sale) for Indian officials. Offsets can easily facilitate market failures and government capture, where bureaucrats play favorites for crony contractors. These problems can discourage smaller or less favored companies from participating, hurting those companies and the Indian military.

Offsets also have a demonstrable negative effect on job-creating US defense companies. The Indian military is the third largest in the world, and Modi has upped procurement spending by more than \$100 billion. There are a lot of jobs in play for defense corporations, some of which donated more than \$26,000 to your campaign (per Open Secrets). The Center for Strategic & International Studies (CSIS) reports major complaints from US companies and experts on a “lack of clarity” in offsets regulations. Senator Warner discusses Indian red tape as another impediment to US companies competing with Indian firms. Offsets operate as direct disincentive to US companies that sell defensive articles worth more than the threshold.

The major global impact of offsets, however, is the geopolitical implication of a weakly-armed India in the short-to-medium term. Offsets hamper Indian procurement by constraining sales from foreign firms that are much farther along the research and development process. As a result, India’s readiness is at a nadir, far behind the preparedness of its rivals in the Asia-Pacific like China. Its sole aircraft carrier is an outdated Russian model incompatible with new fighters, according to *India Today*. The replacement, the INS *Vikrant*, is three years behind schedule. Procuring jets for Air Force’s fleet (which is “in shambles,” according to WikiStrat’s Amit Saksena) has been a struggle. India is demanding that its fighter contractor, Dassault (a French firm), take responsibility for the production of 118 offset jets to be made in India at Hindustan Aeronautics Limited (HAL). Dassault has real concerns about HAL’s capacities, and the deal seems to be dead (or “in the doldrums,” in the words of *India Today*). Offsets have thus substantially limited India’s readiness.

An India weakened by suboptimal offsets policies and a rising, rapidly-arming China are bad news for US interests in Asia and for global security as a whole. India needs to balance China’s rising power in the region, lest an undemocratic and provocative China becomes the hegemon. A strong India would help prevent Chinese aggression in the South China Sea. An empowered India could provide security to smaller or democratic countries (i.e. Taiwan) that wish to resist Chinese provocation. This balancing effect from a prepared Indian military capability would enhance security by providing power competition and preventing China from taking advantage.

Options

(1) Continue with slow, but steady, engagement

The Obama approach to the offsets problem from the Modi visit to the US to Republic Day has been, in a word, tinkering. Progress has been made on a variety of US-India defense procurement issues, including an increase in the defense foreign direct investment (FDI) cap from 26% to 49% as well as an agreement on a few pathfinder projects in which American and Indian companies will co-produce small articles like the Raven drone or helicopter parts. These programs seem to be concessions to preserve offsets and political favor in New Delhi.

There is no guarantee, however, that the “slow, but steady” (some might say inconsistent or glacial) progress will achieve any meaningful offsets reform. So far, the only accomplishment

from months of negotiation, state visits, and extensive consultation is a promise by India to *consider* reviewing a *potential* case-by-case approach. Proponents of this “slow, but steady” approach only have a “wait and see” pledge about a very politically sensitive subject. There may not too much hope of immediate or meaningful reform in this arena.

(2) Pressure India to substantially reduce or eliminate offsets across the board

Another approach would be to pressure for a major cut in the offsets policy. This is the approach of the American Enterprise Institute’s Hemal Shah, who called the policy something that “betrays [India’s] protectionist defense industry and obsolete products” while criticizing its ambiguity and political motivations. Eliminating offsets would force true competition in Indian defense procurement and sharper focus on technology acquisition that improves the state of the Indian forces. Eliminating offsets may stop defense sector cronyism and protectionism.

In the current Indian political environment, however, offsets are very popular. Defense companies exert tremendous influence and employ thousands of workers—that number is growing with increased defense spending and offsets demand. Bending to eliminate offsets may break the greater progress the US has made on US-India defense cooperation. Pushing too hard against offsets might upset Modi and poison the well. The political backlash in India would be very real; the question is whether it is worth our entire relationship.

(3) Negotiate to selectively reduce or eliminate offsets for state-of-the-art technologies

A solid middle ground is a selective negotiation protocol focused on procurement that would enhance Indian readiness and military capabilities. A targeted relaxation protocol would shield the US and Modi from much of the potential political backlash as the policy would not affect most procurement contracts. A stronger India is worth the smaller backlash as Indian firms cannot produce the state-of-the-art defense technologies that US firms can. Reducing offsets or eliminating them for critical defense items would speed up India’s readiness improvements and help India be secure in the short-to-medium terms.

The problem with selective negotiation is that it does not solve the problem of Indian corruption in defense spending. By the nature of its targeted approach, it would not apply to the vast majority of contracts (and thus corruption opportunities). The benefits of an empowered India providing security for US allies and the people of Asia (and thus the world) outweigh the corruption problem, which should be solved through other avenues.

Recommendation

The selective negotiation option is a reasonable position that Modi can be flexible on, as it is just an extension of the case-by-case framework discussed in January. While it does not solve the corruption problem (other options should be explored), the selective relaxation approach would open the market for US defense companies that employ thousands of Americans while empowering India to have a stronger role in the Asian security space. Selective offsets would help bridge the gap from an unprepared India (the status quo) to a self-reliable and independently strong India (the offsets goal). A stronger India means a more secure Asia, a checked and balanced China, and a safer world.