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A Defense Partnership for the 21st century

Improving the U.S.-India defense relationship by solving the offsets problem

Nicholas Neuteufel
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Summary

While recent progress in the U.S.-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 percent of major defense acquisitions from a non-Indian firm be sourced within India. Offsets take one of three paths: a joint venture with an Indian firm, infrastructure or industrial investment, or manufacturing in India/with Indian parts. Offsets prevent India from modernizing its military, increase opportunities for corruption, and reduce export potential for U.S. firms. Reforming offsets is a vital first step in taking the U.S.-India defense partnership—and the whole of the bilateral relationship—to the next level.

The question is: How can the United States move against powerful interests protecting the status quo and endangering the security space of Asia? Choosing from three options: a "slow, but steady" approach, pressuring India to drop the requirement entirely, and negotiation to relax offsets for selected technology, the U.S. should engage in a negotiation protocol with India focusing on relaxing 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 so that India can properly balance against China.

Background

The post-independence India did not fit into the traditional American foreign policy mold. India was reluctant to make grand statements of foreign policy, and traditionally feared being perceived as too close to other countries (Gupta, 2015). India led the Non-Aligned Movement (NAM) during the Cold War, refusing to take either an explicitly pro-U.S. or pro-Soviet Union stance. Instead, the foreign policy of India reflected a position of "strategic

autonomy" and good (but not great) relations with all major powers (Gupta, 2015). In its economy, India sought self-reliance and discouraged foreign investment and trade. The U.S. became frustrated by India's refusal to integrate itself into trade liberalization as well as the U.S.-led global order in the post-Cold War time period (Gupta, 2015).

President Obama's Republic Day visit to India in January 2015 marked a resurgence in U.S.-India relations (Barry & Baker, 2015). The state trip followed a visit by Prime Minister Modi to Washington, D.C. in late 2014 (Barry & Baker, 2015). The Obama visit saw a great deal of progress in advancing the U.S. and India toward a strong bilateral relationship. Prime Minister Modi and President Obama were widely reported as having a great deal of personal chemistry, and they achieved a great deal during the visit (Barry & Baker, 2015). The trip saw two major breakthroughs in defense cooperation. The first was finalizing the renewal of a 10-year Framework on Defense Cooperation, and the second was agreement on the Defense Technology & Trade Initiative (DTTI). These covenants pave the way to greater defense cooperation between the two largest democracies in the world.

There are, however, still major obstacles on the road to a full partnership with India. One such challenge is the rise of China, which complicates the argument that India needs the U.S. in order to advance its interests. China's adventurism, bold approach to territorial disputes, and naval build-up have caused a great deal of uncertainty in the Asia-Pacific region (Huntsman & Gopalaswamy, 2015). China has, however, tried to position itself as a valuable resource—open to trade with other countries and to providing aid without conditions. This change in relations helped to prompt President Obama to declare a "rebalancing towards Asia" and a re-focus of U.S. grand strategy on the continent (Gupta, 2015). These actions by China have helped the

United States and India focus on mutual benefits between the two and have asked the U.S. how it can reach a full and beneficial partnership with India.

The Offsets Problem

Perhaps the most controversial aspect of the U.S.-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 U.S.D) 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/suppliers. Offsets lengthen the process for defense acquisition and add several complications to its procurement processes, but could have a strong payoff in the medium-to-long-term for India.

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 the goal of defense development while directly employing thousands—potentially millions after increased demand and investment—of Indian workers (Latif, 2012).

Offsets' benefits create, or at least strengthen, strong political constraints on potential reforms or cuts. India's state-owned defense companies, known as Defense Public Sector

Undertakings (DPSUs), exert tremendous influence on both the state/provincial and federal governments (Latif, 2012). Much of this comes from DPSUs employing thousands of workers and expanding infrastructure and investment as a result of directed offsets (Pubby, 2015). That employment number is growing with increased defense spending and demand for defense technologies. Also, many DSPUs' leaderships are deeply connected to elected officials or otherwise have a hold on contracting processes (Gupta, 2015). These influences form a strong constraint on reducing offsets, and the only beneficiaries of offsets reform are defense firms outside of India and those within India that value Asian security above a potential loss of jobs.

Offsets, however, have some downsides for India itself. One problem, discussed by Robert Metzger of the international law firm Rogers Joseph O'Donnell, is that they breed and propagate corruption (2013). Offsets built into an Italian helicopter sale became kickbacks and bribes worth $65 million—almost 10 percent of the total sale—for Indian officials (Metzger, 2013). Offsets can easily facilitate market failures and government capture, where bureaucrats play favorites for crony contractors—especially India's DPSUs (Gupta, 2015). These problems can discourage smaller or less favored companies from participating, hurting those companies and the Indian military. India's reluctance to confront its DPSUs also has a chilling effect on military contract competition (Gupta, 2015). These problems with the contracting/bidding processes have potential to reduce the level of innovation and price competition within the defense/military space, reducing India's readiness and military strength (Gupta, 2015).

Offsets also have a demonstrable negative effect on job-creating U.S. defense companies. The Indian military is the third largest in the world, and Modi has upped procurement spending by more than $100 billion (Wilkes, 2014). The Center for Strategic & International Studies (CSIS) reports major complaints from U.S. companies and experts on a "lack of clarity" in

offsets regulations (Latif, 2012). Senator Warner discussed offsets red tape as another impediment to U.S. companies competing with Indian firms (Warner, 2015). Offsets thus operate as direct disincentive to U.S. companies that sell defensive articles worth more than the threshold (Warner, 2015). Another effect is that the required infrastructure and manufacturing investment from offsets may replace manufacturing jobs and other parts of the defense/military supply chains for U.S. products (Latif, 2012).

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 (Latif, 2012). As a result, India's readiness is at a nadir, far behind the preparedness of its rivals in the Asia-Pacific like China (Gupta, 2015). The Indian military's sole aircraft carrier is an outdated Russian model incompatible with new fighters ("India's first", 2014). The replacement, the INS Vikrant, is three years behind schedule ("India's first", 2014). Procuring jets for Air Force's fleet (which is "in shambles," according to WikiStrat's Amit Saksena) has been a struggle (Saksena, 2014). 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. Offsets have thus substantially limited India's readiness in a time that India has an "urgent need for military modernization" (Saksena, 2014).

An India weakened by suboptimal offsets policies and a rising, rapidly-arming China has negative implications for U.S. interests in Asia and for global security as a whole. If one shares the values of stated U.S. goals (such as democracy, trade liberalization, etc.), India needs to balance China's rising power in the region—lest an undemocratic and provocative China

becomes the hegemon (Mohan, 2006). A strong India would help prevent Chinese aggression in the South China Sea, a site of major Asian territorial disputes. This cause is especially in mind, given a joint statement made by Modi and Obama targeting the issue of freedom of navigation in the Sea (U.S.-India Joint Statement, 2014).

Besides simply hedging against a rising China, a balancing, military-ready India would be a strong step towards preventing an arms race in Southeast Asia (Mohan, 2006). An empowered India could provide security to smaller or democratic countries, such as Taiwan, that wish to resist Chinese provocation (Huntsman & Gopalaswamy, 2015). These smaller countries would not have to engage in the "security dilemma"—whereby uncertainty about their military preparedness in the case of invasion causes them to acquire arms or develop their military, which causes other countries to view them as a growing threat (Jervis, 1978). Instead of engaging in the security dilemma, smaller countries could simply "bandwagon" onto India and share the burden of security (Jervis, 1978). This balancing effect from a prepared Indian military capability would enhance security by preventing arms races and providing security against Chinese aggression.

Options for U.S. Policymakers on Offset Reform

(1) Continue with slow, but steady, engagement.

The Obama approach to the offsets problem from the Modi visit to the U.S. to Republic Day has been, in a word, tinkering. Progress has been made on a variety of U.S.-India defense procurement issues, including an increase in the defense foreign direct investment (FDI) cap from 26 percent to 49 percent as well as an agreement on a few pathfinder projects in which American and Indian companies will co-produce small articles such as the Raven drone and helicopter parts (Barry & Baker, 2015). Another good step was for India to raise its defense

expenditures by 12 percent after the Obama visit (Shah, 2014). These programs seem to be concessions to preserve—or in the case of the expenditure increase, create—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 with stakeholders (Barry & Baker, 2015). Proponents of this "slow, but steady" approach only have a "wait and see" pledge about a very politically sensitive subject (Shah, 2014). There may not too much hope of immediate reform in this arena because the current Obama bargaining position does not have a meaningful strategy to change the political constraints or fundamentals of offsets policy.

(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 as a whole. This is the approach of the American Enterprise Institute's Hemal Shah. Ms. Shah has called the policy a position that "betrays [India's] protectionist defense industry and obsolete products" while criticizing its ambiguity and political motivations (2014). Eliminating offsets would force true competition in Indian defense procurement and sharper focus on technology acquisition that improves the state of Indian forces. Eliminating offsets would be a crucial and probably extremely effective act to end (or at least majorly decrease) defense sector cronyism and protectionism (Shah, 2014).

In the current Indian political environment, however, offsets curry a great deal of political currency. Pushing to eliminate offsets means an American imposition on Prime Minister Modi that requires a great deal of political courage. It would force Modi to campaign against Indian

jobs and investment while promoting foreign influence, of which many in his party, the Bharatiya Janata (BJP), are skeptical (Gupta, 2015). Bending to eliminate offsets may break the greater progress the U.S. has made on U.S.-India defense cooperation and the Obama-Modi personal relationship. Pushing too hard against offsets has a strong chance of upsetting PM Modi and poisoning the well on the whole of the U.S.-India partnership. The political backlash in India would be very real—the question is whether it is worth the entire procurement relationship. If one is concerned about China, it almost certainly is not.

(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, in other words, critical or emerging technologies. Examples of such articles include drones, stealth bombers, or ballistic missile improvements. A targeted relaxation protocol would shield the U.S. and Modi from much of the potential political backlash as the policy would not affect most procurement contracts as Indian DSPUs cannot produce items competitive with U.S. emerging technologies. Modi's BJP would probably push back on the initiative, but the benefits of a stronger India outweigh the reactions. A stronger India is worth the smaller backlash as Indian firms cannot produce the state-of-the-art defense technologies that U.S. 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 selective negotiation option is not issue-free. One 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). This is a double-edged sword as the political savings compared to the across-the-

board cuts come from protecting offsets in the vast majority of cases, but it also shields much of the corruption inherent in the DSPUs-contractor-Ministry of Defence ecosystem of Indian defense procurement (Gupta, 2015).

The benefits of an empowered India providing security for U.S. allies and the people of Asia (and thus the world), however, outweigh the corruption problem, which should be solved through other avenues. Offsets are a large part of the governmental corruption picture, but the root causes and symptoms of the problem are throughout the industrial picture in India (Metzger, 2013). Even selective offset reform could serve as a "'model' for new structures and procedures… [to] reduce both the incentive and opportunity for corruption" (Metzger, 2013).

The related political problem, however, is not as simple. If there is a political sacrifice to be made or political capital to be expended, however, this option would probably be the most worth the expense. Emerging and mission-critical weapons, arms, and defense technologies would bring the best value to the defense partnership as they would be most equipped to expand India's defense reach for the smallest political backlash or retribution possible within Modi's political sphere. Drones, advanced stealth technologies, and missile technologies would be out-of-reach for India's DSPUs in the short-term, and the offsets requirement could even be reinstated gradually as India became better at development and production. These are feasible political risks and policy that simply acts as a moratorium to prepare India for its greater goals of security and economic development.

Conclusion

The U.S.-India partnership will guide trajectory of the twenty-first century in the regions of South and Southeast Asia. China will play a gigantic role, but the combined soft power

(cultural, social, and diplomatic influence), economic might, and security management of India and the U.S. in the region will be pivotal. The Association of Southeast Asian Nations (ASEAN) already looks to the partnership as a security check against China's aggression in territorial and maritime disputes (Gupta, 2015). India—with the assurances of the U.S.—balancing China could help prevent security miscalculation and arms races in Southeast Asia by calming smaller nations. Countries like Malaysia and Singapore would not need feel the need to build up their arms and militaries against China as they would have an ally with military assets in the region to help prevent invasion by another country.

A quick modernization of the Indian military does not come without costs. The offsets policy focused on improving India's defense-industrial base and its economic development has good intentions, but creates a severe delay in India's procurement process and a lack of state-of-the-art technology. U.S. firms, however, have the technology and the expertise to help a military that is "in shambles" (Saksena, 2014). Given the political constraints of Modi's BJP, offsets repeal seems to be off-the-board, and the status quo may not equip India well-enough in the short-term.

Pressuring India to relax offsets in a selective negotiation is a reasonable position with which Modi can be flexible. Selective relaxation for critical and emerging technologies is just an extension of a case-by-case framework discussed during Obama's visit but gives more certainty to U.S. firms. While selective negotiation does not solve the corruption problem (other options should be explored to solve this pervasive issue), the selective relaxation approach would open the market for U.S. 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 India suffering from an obsolete military—the status quo—to a self-reliable and

independently strong India, which is the offsets goal. A stronger India means a more secure Asia, a checked and balanced China, and a safer world. These goals are worth the risk of limited backlash, and selective negotiation should be explored and discussed in consultation with the Indian government.

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