

Federation of Indian Micro and Small Medium Enterprises (FISME)

&

Koan Advisory

Consultation Paper

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Challenges of Indian MSME participation in the Defence Sector*

India has historically been a defence importer. To boost domestic participation, in 2005, the Government announced an offset policy for the first time. Offsets refer to direct and indirect collaborations between the supplier and recipient. In defence procurement, this is often achieved through activities such as joint or licensed production, through joint ventures (JVs) and transfer of technology (ToT). The current 30 per cent offset policy for procurement of defence equipment in excess of INR 300 crores provides a significant opportunity for Micro Small and Medium Enterprises (MSMEs) to become part of the defence ecosystem. Annual defence offset obligations are projected to cross INR 25000 crore by 2022, providing MSMEs a historic opportunity to participate in India's defence sector and its growth ambitions.

The Government of India's Defence Procurement Policy (DPP) 2013, outlines the scope for 'greater involvement' of Indian industry in the defence sector. The DPP outlines the order of priorities as:

1. 'Buy' (Indian) : outright purchase of equipment from Indian vendor with minimum local content of 30%
2. 'Buy and Make' (Indian) : purchase from an Indian company or Indian JV with minimum local content of 50%
3. 'Make' (Indian) : indigenous design ,development and production of equipment
4. 'Buy and Make' (with Transfer of Technology) : purchase from a foreign vendor followed by licensed domestic manufacture through transfer of technology
5. 'Buy' (Global) : outright purchase of equipment from a foreign vendor

Despite such directional provisions in the current policy framework, Indian MSMEs continue to face a range of challenges, some of which will be listed here. These concerns were first highlighted in a meeting conducted by the Federation of Small and Medium Enterprises (FISME) on 06 May 2015.

Offset Policy

Between the years 2006 and 2013, over USD 4 billion of offset contracts were signed, 60 per cent of the value of which was discharged through the private sector.ⁱ The DPP 2013 specifies offset conditions that are applicable for all procurement proposals (exceeding INR 300 crores) for *Buy* (Global) and *Buy and Make with Transfer of Technology* (TOT). As per the policy, the Defence Research and Development Organisation (DRDO) can “assist industry by having back to back arrangements for conducting research, design or development”.ⁱⁱ According to the DPP, the DRDO’s mandate is to work on “strategic, complex and security sensitive systems”, which by definition can be assumed to be outside the scope of MSMEs that may not have requisite capacities to design and build systems.

Among the tasks of the Department of Defence Production as specified in the DPP is to identify and map “prospective agencies for undertaking development and/or manufacture”.ⁱⁱⁱ However, the backward links in the supply chain that are created by DRDO are tenuous at best and the mapping of MSMEs is inadequate from the point of view of approaching defence manufacturing from a ‘systems design’ perspective. Disjointed industry mapping is compounded by the lack of a robust IPR policy, particularly with regard to TOT^{iv}.

The Defence Offsets Management Wing (DOMW) under the Department of Defence Production should take the lead in building links with industry, especially as the DPP specifically mandates the DOMW to “assist vendors in interfacing with Indian industry” and is empowered to “avail the assistance of any appropriate entity to discharge its functions”. However the DOMW’s capacity to do this is limited.

In recognition of capacity constraints, the Department of Defence Production should aim to remove information asymmetries that persist in research and development policy and procurement procedures by following international best practices.

For example, a ready template for backward integration exists in the form of the United States Government’s Department of Defence Office of Small Business. A Similar agency could be set up in India. Another template can be found in Singapore’s Defence Science and Technology Agency’s (DSTA) processes for integrating private businesses in government procurement. In the United Kingdom, the Ministry of Defence has released an action plan to improve MSME participation in defence production. Such initiatives give small firms a clear idea of what is expected from them.

The following table gives outlines industry best practices that are followed to stimulate MSME participation

	India	UK	Singapore	USA
Procurement micro-site	X	✓	✓	✓
SME micro-site	X	X	X	✓
Step by step guide	X	✓	✓	✓
Procurement forecast	X	X	X	✓

Online registration	✓	✓	✓	✓
Procurement Technical Assistance Centres	X	X	✓	✓
Dedicated Ombudsman	X	X	X	✓
Business development programmes	'Make in India' initiative	MoD SME focused action plan (updated 17 Oct2014)	X	Various plans put into place

The offset policy in the Government of India DPP is directional as mentioned earlier, and in the absence of a National Offset Policy, it is incumbent upon the Government to provide specifics on how the Indian MSME supply chain can be developed through 'investment in kind' as part of TOT and 'provision of equipment' towards meeting offset targets.

Industry Standards

Every component of Defence Stores from clothing and field equipment to satellite communications and missiles are to be manufactured under complex service quality requirements. Preliminary requirements are set by the Service HQ or the Lead Service for Procurement under the 'Make' scheme. Thereafter, the Integrated Project Management Team (IPMT) consisting of at least eight different interests subject the requirements to review.

MSMEs can only be made competitive in defence manufacturing if this process is made transparent and industry is assisted by government agencies for upgrading its production processes in consonance with changing requirements.

A unified industry understanding of the drivers of decision making that are followed by the IPMT and the Service HQ is necessary. An analogous example of a government-industry interface is the now ubiquitous 'Investor Facilitation Cells' under Department of Industries across various Indian states. These cells are mandated to facilitate interaction between government officials and industry. Such regular interface is required given the inequitable access by MSMEs to government process and long-term thinking. Coherent national standards (with legal consistency on TOT and IPR provisions) would also ease the defence industry's engagement with foreign firms, particularly in the case of MSMEs wishing to participate in the supply chain.

Limitations of Sub Contractors

A major limitation to the participation of MSMEs in defence manufacturing in the past was that many defence-store lines were regulated by industrial licensing norms. As a result it was administratively very hard for small manufacturers to avail the necessary clearances to contribute to the production of complex platforms. A compounded limitation was that for defence stores under industrial licensing, foreign vendors / manufacturers had to be minority shareholders, which severely restricted the attractiveness of entering into joint-ventures with local firms. This regime has been liberalised. For instance most components, raw materials, testing equipment, production machinery, castings, forgings etc. have been removed from the purview of industrial licensing (Press Note No. 3, 2014 series, Department of Industrial Policy and Promotion).

Furthermore FDI restrictions have also been done away with for these products. It is still early days to gauge the impact of reform.

To encourage transfer of technology to MSMEs, foreign vendors could be allowed to establish manufacturing facilities in India with full ownership. Clarity would be needed with respect to how this arrangement should be structured (as a joint venture, under a Memorandum of Understanding which evolves into a subsidiary or partnership structure, or something else) and how suitable vendors would be identified.^v

One approach could be to follow the example of the Indonesian mining industry, in which India could invite foreign firms to establish manufacturing facilities with full ownership and, while building an MSME supplier ecosystem, dilute ownership to 51 per cent in structured manner over a timeframe of seven to 10 years (with a limitation on the transfer of shares to domestic investors only). This model could be considered in parallel with implementation of a strategy to promote defence exports.^{vi}

In addition the DPP incorporates a multiplier clause for offsets discharged through MSMEs. While this is a good initiative on paper, there remain several on-the-ground challenges to encouraging participation of MSMEs in defence offsets. For instance offset obligations are to be discharged within two years of completion of a procurement contract. The experience of Original Equipment Manufacturers (OEMs) and Prime Contractors has been that handholding MSMEs to meet supply requirements takes a lot of time to ensure quality compliance, often breaching the allowed time-period for discharging offset obligations. One of the suggested means of encouraging discharge of offset obligations being channelled to MSMEs is to have variable multipliers for different sized firms.

Conclusions

The Indian defence landscape is evolving rapidly. The prioritisation of indigenous manufacturing in the current DPP has helped set the tone for expanded domestic capacities and larger investments in production capabilities. The MSME ecosystem however remains underdeveloped for a variety of reasons. The offsets regime has tried to correct this imbalance by imposing certain conditions for regulating procurement from foreign vendors. Even as the offsets regime matures, and methodologies to discharge offsets become well defined, the following areas require immediate attention:

a. Capacity constraints of Government bodies

Global best practice standards in terms of government–private sector interface are far ahead of Indian standards. Bodies such as the DOMW and institutions such as the DRDO have not been able to build the requisite industry linkages for integrating MSMEs in government procurement and very little by way of offsets has reached this sector. Given the thrust on Make in India, it is the right time to review the successes and failures of government entities while simultaneously mapping global best practices so as to create the requisite capacities to facilitate the diffusion of technological know-how.

b. Transparency in standard setting

Both Central and State Governments have begun to lay emphasis on ‘facilitation’ of private sector investments by creating specialised bodies to interact with industries. A substantive effort is also required as far as the military and government interactions with defence MSMEs is concerned, particularly for bringing transparency in terms of evolving service requirements and projected need assessments for various systems.

c. Process innovation in discharge of offset obligations

Process innovation in the discharge of offsets through MSMEs can catalyse domestic production. For instance, in place of a blanket multiplier of 1.5 for all MSMEs, variable multipliers (for example 1.5 for Medium Enterprises, 2.0 for Small Enterprises and 2.5 for Micro Enterprises) could reward an OEM/Prime Contractor to engage and build capacities with the smallest of enterprises, instead of favouring relatively larger firms. There should be no impediment to include this enabling clause, especially as the DPP allows a multiplier of 3.0 for technology acquisition by DRDO.

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Endnotes

ⁱ http://www.claws.in/images/publication_pdf/1393477856IB%20%2032%20%20%20%2025-02-14.pdf

ⁱⁱ DPP 2013

ⁱⁱⁱ *ibid*

^{iv} Verma, S. (2014), ‘India’s Defence Procurement Procedure: Assessing the Case for Review and Reforms’, IDSA Issue Brief, 17 October 2014

^v Cowshish, A. (2013), ‘Defence Procurement Procedure 2013 - A ringside view’, IDSA Issue Brief 11 June 2013

^{vi} Grevatt, J. (2014), ‘India contemplates developing defence export strategy’, IHS Jane’s Defence Weekly [<http://www.janes.com/article/42966/india-contemplates-developing-defence-export-strategy>]