



OPPORTUNITIES FOR MSMEs IN DEFENCE

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ABSTRACT

Micro, Small and Medium Enterprises (MSMEs) play a pivotal role in defence manufacturing sector and act as incubation sector for defence technology. The defence sector is among those niche breed of industrial and Research and Development (R&D) activities where net gain in terms of value addition as well as employee rewards are much higher compared to MSME units in other sectors. The logistic units and establishments of the defence forces are spread over the entire nation and although the maintenance supplies and services are in general centrally catered by them, shortfall in central supply is frequent and is replenished locally by various local unit commanders in a decentralized manner. The indigenization efforts of the defence forces, in the wake of Government of India's (Gol's) 'Make in India' initiative have provided a golden opportunity for the MSMEs of the nation, to participate competitively and transparently with the traditional defence suppliers, Defence Public Sector Undertakings (DPSUs) and other Original Equipment Manufacturers (OEMs) who are inherently integrators of components manufactured by MSMEs. Hence, it is pertinent that the existing challenges be mitigated and concerted efforts are made for and by the MSMEs to exploit the impending environment.

KEYWORDS : MSME, Defence, Manufacturing, Make in India, Challenges, Recommendations

1. Introduction

India has been into defence production ever since it attained Independence in 1947. British had established several Ordnance Factories in the country to support its operations against Burma and Japan during the WWII. These factories received efficient ancillary support from Micro, Small and Medium Enterprises (MSMEs) which were located in close proximity to them. Ever since then, MSMEs have been playing a pivotal role in defence manufacturing sector while also acting as incubation sector for defence technology. However, the defence industry in India itself has been in Reserved List post independence and it was only in 2001 that it was placed under the Licensed Category with the opening of floodgates for the Foreign Direct Investment (FDI) coming as late as 2014. Subsequently, MSMED Act 2006, Offset Guidelines 2012, the promising 'Make in India' initiative and DPP-2016 have paved a way for a larger role for MSMEs in defence manufacturing which needs to be harnessed in correct perspective.

2. Potential of MSMEs in Defence

Strategically, the defence sector has always been among those niche breed of industrial and research and Development (R&D) activities where net gain in terms of value addition as well as employee rewards are much higher compared to MSME units in other sectors. As on date the defence industry is primarily dominated by OEMs (Original Equipment Manufacturers) who are basically integrators of components manufactured by MSMEs. As per Dharendra Singh Committee Report of 2015, more than 80% of components, aggregates and assemblies of even complex weapon system and Aircrafts are being manufactured by MSMEs. Also, there are more than 6,000 MSMEs across the country employing over 11 lakh population and supply components and sub assemblies to Defence Public Sector Undertaking (DPSUs), ordnance factories, Defence Research and Development Organization (DRDO) and private industry engaged with defence. Also, MSMEs generate employment for more than 1.3 million population annually and manufacture approximately 8,000 different types of quality products for the market.

3. Government Efforts

The Government of India (Gol) has instituted key provisions for fostering manufacturing by MSMEs. In the wake of 'Make in India' initiative, DPP-2016 has introduced a new procurement category, Buy (Indian-Indigenously Designed, Developed and Manufactured), or 'Buy (Indian - IDDM)' which has not only been given a higher priority but is also aimed at ensuring that indigenously designed equipment with 40% indigenous content (IC), or equipment not necessarily designed in-house but having a 60% IC, is intended for procurement from the local industry, thereby harboring MSMEs and in-house designing and manufacturing.

Subsequently, the revised DPP has enhanced the IC requirement under the existing 'Buy (Indian)' category from the earlier 30% to 40%, which invariably shall help MSMEs. Also, the 'Make' projects have been sub-divided into 'Make-I' (Government funded) and 'Make-II' (Industry funded) clearly favoring MSMEs. The new procedure gives MSMEs the first right to undertake prototype development upto Rs 10 Crore under 'Make-I' and upto Rs 3 Crore under 'Make-II' category. The eligibility criteria for MSMEs under 'Make' category has been relaxed to three years operational efficiency as against five years for bigger stakeholders, with a provision of B++ credit ratings by reputed credit rating agencies. As regards the offsets, the Offsets Guidelines 2012 clearly institutes a multiplier of 150% to the Original Equipment Manufacturer (OEM) if the Indian Offset Partner (IOP) is MSME. The Micro, Small and Medium Enterprises Development Act (MSMED), 2006 has also made it mandatory for all Government departments to source 20% of their annual procurement to MSMEs. In order to promote R&D, the DPP-2016 advocates formulation of a separate R&D funds exclusively for MSMEs.

It can be visualized that Gol has indeed taken proactive steps reach out to MSMEs and encourage them to flourish. However, in spite of Gol's bold initiatives, the MSME segment is still in dire need of a level playing field, the reasons for which need to be assessed.

4. Challenges for MSMEs

While the opportunities are galore, the MSMEs are mired by numerous challenges and issues which are enumerated as below:-

- **Reprehensive Procedures.** Defence is the only industry wherein the sole buyer i.e. the Gol is also the regulatory authority. However, in absence of clear cut defined policies and inherent lapses, most of the defence related projects are marred by inadvertent delays, flawed procedures and bureaucratic fetters leading to delayed payments. Hence, MSMEs with meager funding support may find the investments challenging. Subsequently, major buyers of defence products, namely various DPSUs may find it difficult to source the projects to MSMEs on lending.
- **Funding/Financing.** Though DPP-2016 has laid down welcoming procedures for funding MSMEs under the 'Make' categories, far reaching dividends may only be reaped if concrete efforts are undertaken to boost up R&D for MSMEs.
- **Permanence of Orders/Supply.** Though, MSMEs since long have been involved in assisting DPSUs in defence production and manufacturing, their sustenance has been highly affected by absence of substantial repeat/permanent orders/supply of

spares/products. Subsequently, no OEM/DPSU has ventured in concluding long term contracts with potential MSMEs. This only discourages MSMEs to establish units solely dependent on catering defence related products.

- **Trust Deficit.** There exists a general perception that the quality of products supplied/manufactured by the MSMEs is mediocre, hence major buyers shy away from placing demand of even retail/off the shelf products. While it is noteworthy that, finished products may lack quality, there is no denying the fact that MSMEs have always been excelling in providing an efficient ancillary support.
- **Heavy Dependence on DPSUs.** The defence production in India is traditionally tilted towards DPSUs. Though DPSUs suffer from insufficient R&D and low productivity, ideological and strategic constraints have left little for private participants to compete in defence industry. With little funding and technological limitations, MSMEs may find it difficult to vie for a substantial market access.
- **Technology Constraint.** Modern military systems, besides being complex and based on 'State of the Art' technology, have long gestation periods. Also, the OEMs normally do not part with the complete know-how making it difficult for the petite MSMEs to gain access to the contemporary technologies and consequently bridge own capability gaps.
- **Quality Certification (QC).** Owing to low financial backing, MSMEs find it hard to muster QC from Government authorized sources, an essential element of sourcing to OEMs and DPSUs. Obtaining certifications such as Environmental Testing, Information Security, Quality Management, Functional Safety of Electrical/Electronic Systems and EMI/EMC Standards are mandatory as per Bureau of Indian Standards (BIS), however the same demands heavy investments and overcoming innate bureaucratic hurdles which MSMEs find difficult to resolve.
- **Procurement Delays.** Defence procurements in India undergo long and delayed cycle times consisting of numerous processes and procedures right from Request for Information (RFI) to final delivery of finished product with frequent mid-stage inspections, trials and testing. At times even the orders get cancelled in between due to unavoidable and unseen circumstances resulting in enormous loss to the potential vendors.
- **No Cost No Commitment (NC/NC) Trials.** Most defence procurements in India have to undergo a mandatory requirement wherein the vendors are required to manufacture a prototype on No Cost No Commitment. This clause invariably favors bigger industrial houses/foreign vendors and MSMEs shy away from the bidding process.
- **Tax Structure.** Though substantial tax benefits have been provisioned for the MSMEs, payment of Value Added Tax (VAT) still needs to be resolved. Also, the state taxes and customs duty varies, thereby putting additional burden on the MSMEs. The tax structure perpetually affects the working capital management of the MSMEs.
- **Testing of Products.** Not too many laboratories exist in India which exclusively cater for testing defence related products manufactured by the MSMEs. Also, the cost of testing is too high and the procedures complicated and long drawn. In absence of certified testing MSMEs' products are not encouraged by the OEMs/DPSUs.
- **Human Resource.** Lack of skilled and trained manpower is the most intimidating challenge MSMEs face in the defence sector. Poor education during initial phases of life and lack of adequate

vocational training and formal education of the largely unorganized labour force that the MSMEs mostly employ only hampers their growth prospects in the highly competitive defence sector, wherein powerful players vie for available trained manpower.

- **Lack of Information.** As per Report of Prime Minister's Task Force on MSME Sector, Gol (2010) more than 94% of the MSMEs of the nation remain unregistered, thus amounting to challenges like lack of adequate exposure towards the world market, limited access to equity capital, ignorance of Government policies, initiatives and schemes, taxation and labour laws. Lack of timely information poorly affects the business opportunities, particularly in defence sector, which is close-knit.

5. Recommendations

- **Revitalization of Procurement Procedures/Government Policies.** In order to encourage MSMEs to play a bigger role in the defence industry, there is a pressing need to streamline the existing procurement procedures particularly adherence to specific timelines for procurement. MSMEs interested in defence startups may be provided adequate advance for manufacturing. Also, reduction in cost of capital and significant increase in lending shall help increase the number of defence startups. The Offset clause may be redefined to enhance the participation of MSMEs for ancillary related products. Subsequently, tax benefits in the form of tax holidays shall be a welcome gesture for the MSMEs.
- **Technology Growth.** The Gol has launched the Technology Acquisition and Development Fund (TADF) under National Manufacturing Policy. TADF aims at facilitating acquisition of Clean, Green & Energy Efficient Technologies, in form of Technology / Customized Products / Specialized Services / Patents / Industrial Design available in the market available in India or globally, by the MSMEs. However, its scope should be enlarged specifically for the complex defence technology under the Offsets. Also, Department of Industrial Policy and Promotion (DIPP) may exclusively focus on skill based education to include intrinsic factors such as understanding of market, contemporary defence technologies, encourage access to new age defence product design complexities and existing modern-day infrastructure, Tax systems, labour laws, export policies, promotional strategies, Offset policies etc.
- **Impetus by DPSU.** It may be made mandatory for the DPSUs to outsource approximately 40-50% of their contracts to potential MSMEs engaged in defence manufacturing. Subsequently, the payment terms involving 85% advance payment followed with the DPSUs should be made applicable for the MSMEs too. Also, the contracts with MSMEs should be concluded with Corporate Guarantee without Bank Guarantee.
- **Foreign Exchange Rate Variation (FERV) Relief.** Though the Gol has allowed the FERV protection on foreign exchange component to all Indian companies including private companies in all categories of capital acquisitions, inclusion of MSMEs in the same needs to be categorically mitigated. Owing to anticipated long delays in defence contracts, procurement of items of foreign origin by MSMEs can only be eased by according FERV relief to the MSMEs
- **Identification of Key Focus Areas.** There is a need to identify explicit areas in defence products and manufacturing wherein impetus may be imparted to MSMEs. Ancillary support in repair and overhaul of vehicles, weapons and equipment, development of softwares for non-combat equipments, training aids and simulators, electronics and communication related spare parts, forgings, castings and other unfinished

product are some of the areas where Gol should focus in terms of building competency through exclusive training, technology transfer and increased business avenues. Subsequently, OEMs should accordingly be incentivized to outsource identified obligatory requirements to the MSMEs.

- **Increasing Collaboration.** An increased collaboration of MSMEs with Department of Defence Production (DPP), Directorate General of Quality Assurance (DGQA), Ordnance Factory Boards (OFBs), Directorate of Standardization (DOS), Directorate of Planning & Coordination (Dte. of P&C) and Directorate of Indigenisation (DOI) at service HQs should be facilitated by Ministry of Micro, Small & Medium Enterprises, Gol to increase participation of MSMEs in defence products and manufacturing. Timely and regular flow of information to the potential MSMEs through a centralized agency is a must to foster Indegenization efforts of Indian Army through MSMEs. Also, MSMEs may be encouraged to tie up with a prospective overseas MSME for modern technology and marketing support. Regular interaction with Academia shall also help in boosting technological base of the MSMEs.

6. Conclusion

With an aim to transform the nation's economy into a major manufacturing hub, the 'Make in India' mission was launched by the Gol with special provisions for upliftment of MSMEs. To achieve success in the initiative, an eco-system has been set in place to include simplified licensing procedures and lesser bureaucratic hurdles, hence the immense potential of the MSMEs needs to be identified and harnessed. The existing environment presents immense opportunities for the largely unorganized and informal sector, wherein MSMEs need to plan wisely and take proficient steps to exploit the enduring prospects. The resurgence towards achieving self-reliance has offered immense scope for greater involvement of MSMEs particularly in defence indigenization. Augmentation of requisite skills and infrastructure is a must for undertaking 'Production', 'Manufacturing' and specific R&D. Hence, MSMEs must concentrate on specific spheres which best fit their existing technical work force, capabilities and establish capacity to take up the imminent challenges.

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