PAHLE INDIA FOUNDATION
FACILITATING POLICY CHANGE

Policy Brief

PRE-BUDGET RECOMMENDATIONS

By
PIF Research Team

December 2017

PIF/2017/BUD/PB/02

PRE-BUDGET RECOMMENDATIONS

PIF Research Team
nirupama.soundararajan@pahleindia.org

PIF/2017/BUD/PB/02

December 2017

Contents

BACKGROUND

The Indian economy is currently growing at a rate of around 6 per cent. India's young working population, robust private consumption and public investment, healthy savings, skilled labour and ongoing structural reforms will lead to the growth of Indian economy in coming years. According to the United Nation's current report, World Economic Situation Prospects (WESP 2018), India is projected to grow at the rate of 7.2 per cent in 2018 and 7.4 per cent in 2019.

India is also a preferred investment destination. According to the Department of Industrial Policy and Promotion (DIPP), the total FDI inflows into India during April-September 2017 stood at US$ 33.75 billion. The cumulative FDI inflows (from April, 2000 to June, 2017) were valued at $342.4 billion. Countries such as the United States of America (USA), United Kingdom (UK), Japan, Germany and France are the countries that account for the maximum FDI inflows into India.

However, the global economic order is fast changing towards one of protectionism. Brexit, and the withdrawal of USA from the Paris Agreement on climate are just a couple of indications of this trend. Protectionist measures, specifically from developed countries have posed the risk of lower capital inflows and increased outflows from emerging economies.

Development, transformation and reinvigoration have been the cornerstones of the government's agenda since May 2014. The defining features of the first couple of budgets were a focus on farmers' welfare, creation of economic opportunities for underprivileged classes and the makeover of institutions like the Planning Commission, including structural reform of the budget itself. This was done with the objective of making the system more efficient and reinvigorating it, all while being fiscally prudent and cautious. The 2018-19 Union Budget will be the last full budget before the 2019 general elections. This is therefore a good time to take stock of achievements thus far and determine what course corrections are required to ensure policy continuity.

It is in context of this economic situation that Pahle India Foundation held its first annual Pre-Budget Seminar on 19th December 2017. The event covered macroeconomic considerations and the government's 'Development Agenda', budget expectations for banking, financial services, infrastructure and investment in 2018-19. This document details some of the policy issues and recommendations that were highlighted during panel discussions along with PIF's recommendations for the 2018-19 Union Budget. The budget recommendations are focused on a few sectors such as MSMEs, entrepreneurship, banking and financial services, infrastructure, investments and defence industry.

RECOMMENDATIONS FOR UNION BUDGET 2018-19

1. *FOCUS ON MSMEs*

MSMEs remain the hub of not only manufacturing but also innovation across India. Whether it is high value, research intensive manufacturing for defence or low value, labour intensive manufacturing of handicrafts, MSMEs are the centres of activity both up and down the supply chain. MSMEs in manufacturing employ as many as 110 million people. Budgets since 2014-15 have announced credit support, the Fund of Funds with a corpus of INR 10,000 crores, a Technology Centre Network and increased turnover limit to INR 2 crores under presumptive taxation scheme to bring relief to several MSMEs. However greater focus must be awarded to cluster development of MSME. The quality of clusters and cooperative associations of enterprises in India is much weaker than in other countries where small enterprises have provided the backbone of their faster industrial growth. Digital technology platforms and communication networks are becoming further accelerators for the empowerment of small and micro enterprises. In addition to 'easing conditions for doing business', government policies must promote the formation of strong clusters and networks and link these in a more direct manner to the Make in India campaign. Only if this link is explicitly defined, MSMEs can take root and grow, simultaneously contributing to employment generation and GDP growth.

2. *FOCUS ON SECTORS WITH STRONG INTERLINKAGES*

This budget must focus on sectors that have strong interlinkages with other sectors. These sectors, such as tourism, construction, and logistics, will generate not only direct employment but also indirect employment in other related sectors. The tourism sector is a labour intensive sector with extensive forward and backward economic linkages to inter-related sectors such as hotels, restaurants and airlines that build overall income and employment. The sector contributed 9.3 per cent in total employment in 2016 (compared to 11.5 per cent in 2011-12, 10.8 per cent in 2010-11 and 10.2 per cent in 2009-10). Similarly, the construction sector is the second largest employer in India, next only to agriculture. Today, the sector generates around 31 million jobs. The sector has backward and forward linkages to approximately 265 ancillary industries. The logistics sector currently employs 16.74 million people and potential to generate more than 28.4 million employment by 2022. With India aiming to develop into a logistics hub, this sector has the potential to generate both skilled and unskilled employment.

3. *REDUCTION IN CORPORATE TAX RATES*

India has one of the highest rates of corporate tax in the world. In India, the corporate tax rate is around 30 per cent compared to 25 per cent in China; 17 per cent in Singapore; 20 per cent in Thailand and Russia; 25 per cent in Indonesia; and 28 per cent in South Africa. In the 2015-16 budget speech, the Finance Minister alluded to the *"higher than the rates prevalent in the other major Asian economies, making our domestic industry uncompetitive."* In this context, the Finance Minister proposed to reduce corporate tax rate from 30 per cent to 25 per cent by 2019. In the coming Union Budget 2018-19, the government should therefore reduce corporate tax for all companies to 25 per cent.

4. GREATER PUSH FOR 'STARTUP INDIA' SCHEME

India does have the third largest startup base in the world but what India lacks is an ecosystem that can help in growing and sustaining these startups. The NASSCOM report, 2017 pegged the overall mortality rate for Indian startups at 20-25 per cent. It has been noted that a major reason for shutting down of a large number of startups is lack of appropriate mentoring, business consulting and strategic alliances. Under Startup India, the government has only been able to create around 125 incubators which are responsible for providing guidance to around 5000-5200 tech startups. This means each incubator must mentor, guide and support around 42 startups. In China, on the other hand, each incubator supports around 2 startups. India's incubator to startup ratio must improve drastically for mortality rate to come down.

4.1 Include industry stakeholders in Inter Ministerial Board (IMB) for improving the turnaround time in granting tax exemptions

> The government should consider increasing the duration of income tax exemption from the current three years to five years. The panel of the IMB consists of Joint Secretary of DIPP, Representative of Department of Science and Technology and Representative of Department of Bio-technology. What it lacks are industry stakeholders, such as, entrepreneurs and investors. Sectoral experts, as part of the IMB, along with the bureaucrats can help expedite approval processes.

4.2 Need for higher contribution from SIDBI

> The government's initiative to create a domestic source of funds for startups is laudable. However, these funds have not been utilised efficiently because of the cap of 15 per cent set by SIDBI for funding each startup. This means that no startup can access these funds unless they have recourse to the remaining 85 per cent of funds by other means. Currently, startups obtain a major amount of funding from either venture capitalists or angel investors. There is a need to make Fund of Funds (FFS) a major source of finance for startups to reduce their dependence on foreign sources. This can be done if SIDBI contributes a major share of the corpus of FFS for financing startups and, thus, making VC and angel investments a supplement source of funding.

4.3 Establishing more Incubation centres

> Financial institutions like banks, Provident Fund offices and IT departments have unclaimed investments of around INR 33, 000 crores lying with them. Currently, such amounts are transferred to Investor Education Fund and

Protection (IEPF). The government could earmark a certain percentage of these unclaimed funds for setting up more incubators centres for startups in both metro as well as non-metro cities, which will provide both tangible and intangible benefits to startups and will also help them in improving their graduation rates.

4.4 Establishment of Alliance Networks for the resource-constrained startups

Stinchcombe (1965) proposed that the propensity to fail among startups exist because young firms do not have clearly defined work roles and relationship. The establishment of an alliance network at the time of founding will significantly reduce the hazards faced by a startups which are frequently characterized by lack of resources, funding and technological knowledge. Baum, Calabrese and Silverman (2000) empirically show that the bio-technology startups in Canada that had alliances with the industry, government and academia experienced higher rates of patenting and R&D spending, thereby, conforming to the spirit of innovation. It was also found that strategic alliances with potential rivals increases opportunity for learning as individuals share with their rivals their internal knowledge and technology. In India, while the Government has recognised the need of the former and has also taken some steps for a successful collaboration of industry with the research institutes under the Startup India Action Plan, a formal mechanism that encourages alliance networks for startups to work together instead of competing with each other may generate greater success stories.

4.5 Encouraging alternative sources of funding

VC as a source of funding is not a dependable source for most of the startups. A large number of venture capitalists invest in companies that are selected based on prevalent investment trends and not valued based on their long-term value additions. Thus, there is a need to tap into alternative sources of funding such as consumer crowdfunding, investor crowdfunding and startup accelerators. "Crowdfunding" for startups is gaining popularity in India where a “crowd” is asked to pay for the development of a product. Once the product is ready, the “crowd investors” have access to the product at discounted market price. The advantage of this kind of funding is that only those who understand the product and are likely end users of the product will fund the startup’s campaign. Furthermore, in this digital era, the startup has access to global market that is not constricted by investor regulations, since each person’s contribution in crowdfunding is at par with individual contributions. Similarly, the trend of accelerators is only now catching up in India. While China and USA have more than 2400 and 1500 accelerators respectively, India has around 140 accelerators. Accelerators such as Freemont Partners (Mumbai) focus on the growth stage of startups and offer financing for shorter durations such as

3-12 months to kick-start the startups[1]. Thus, the entrepreneurs instead of focussing on one or two funding sources should keep all sources open. Much like incubators, policy measures for encouraging the setting up of accelerators is equally important for the success of Startup India.

4.6 Need for SEBI to dilute the rules for startups

Despite the relaxation of rules by SEBI for startup stock exchanges, not many startups are listed on this exchange. Minimum requirement on trading lot set by SEBI is INR 10 lakhs. Consequently, only sophisticated and large investors are able to buy stocks of these companies. In order attract larger number of investors to fund these cash-strapped startups, the minimum trading lot size should be reduced; for example, initially at INR 1 lakh in the initial years, which may then be gradually increased.

4.7 Linking Startup Policy to job creation

A major objective of the government under Startup India Action Plan is to encourage the youth to become job creators rather than job seekers. In order to concentrate on the objective of job creation, DIPP has also mandated startups to declare upfront the number of jobs they can create, making it an important basis for recognition of a startup. Among States, Uttar Pradesh is the only one to have explicitly included an employment target through startup India. This is an important aspect. As part of the Ease of Doing Business rankings of DIPP, the creation of a startup policy must be made compulsory. Furthermore, it must be stressed that the aforementioned policy is mandatorily connected to employment generation targets.

5. GREATER FOCUS ON AFFORDABLE HOUSING

Pradhan Mantri Awas Yojana (Housing for all 2022 – Urban) scheme was launched in June 2015, in order to give 20 million affordable houses to all sections of society including homeless and slum dwellers by 2022. Now, there are less than five years to achieve this target. Based on the targets, the government should ideally construct around 3 million houses each year, however only 16 per cent of houses have been completed. The progress has been very slow and not very encouraging. Focus on housing leads to positive externalities. In our case, the successful implementation of PMAY (U), apart from giving the households access to their own houses, will also lead to an increase in the standard of living of the beneficiaries as they will have a *pucca* house replete with the facilities of clean water supply, sanitation and solid waste management. With such positive externalities to be realised, the private sector alone cannot be entrusted with such an ambitious housing program. It is not enough for the government to declare subsidies and expect market forces and the private sector to deliver on the targets as has been observed in India on multiple occasions. In the case

[1] https://economictimes.indiatimes.com/small-biz/startups/.cms

of "in-situ redevelopment" component the reliance on private builders to rehabilitate slum dwellers has led to very sluggish progress. The public sector should, therefore, take the primary role and involve the private sector as and when necessary. There is a dire need for government activism for successful achievement of the defined targets.

5.1 Reviewing Estimation of Demand for Housing

The initial target for housing based on a 2012 survey of demand for affordable housing was 1.87 crore houses. As per recent reports, this target has been cut by 67 lakh houses and the government also reduced its demand estimates to 1.2 crore houses. While Punjab needs 3.94 lakh houses to meet slum rehabilitation targets, the housing shortage for the state has been pegged at only 3.90 lakh. Similarly for Andhra Pradesh, which will have an estimated 18.47 lakh slum households in 2017 has only been estimated to have a housing shortage of 12.70 lakh housing units. These are only a couple of examples highlighting the disconnect between official estimates and ground realities. Another aspect not taken into consideration is the increase in rural to urban migration which will further exacerbate the housing shortage problem. This discrepancy in numbers necessitates a review and recalibration of demand and demand estimation methodology.

5.2 Review of Government Land Banks

In the coming budget, the government should find a way of utilising government land that is lying vacant and unused which, if used efficiently, can reduce the problem of land shortage for urban housing and for setting up industrial clusters and parks to a great extent. Data shows that the quantum of land with Railways, not under any operational use, is around 1.14 lakh acres. Similarly, 2.35 lakh acres of non-productive land lies with public sector undertakings (PSUs). Also, the Ministry of Defence and Airport Authority of India (AAI) have vast tracts of unused land lying in some of the most populous states. In addition, a significant portion of the government's land has been encroached upon. For instance, Railways has slums on 1198 acres of its land.

5.3 Improving quality along with affordability

Providing houses at subsidised or affordable prices to slum dwellers or the urban poor is by no means a sufficient condition to fulfil the mandate of HFA. It is important to ensure that the beneficiary moves into a house of decent quality. Basic Services to Urban Poor (BSUP) was one of the components of JNNURM which focussed on the provision of, "…Basic Services to Urban Poor including security of tenure at affordable prices, improved housing, water supply, sanitation and ensuring delivery through convergence of other already existing universal services of the Government for education, health and social security." Although the government bore a substantial proportion of the housing unit costs, poor monitoring of the construction process resulted in houses that were unsuitable for beneficiaries to move in. Hindman et al in 'Addressing Slum Redevelopment Issues in India (2015)' found that, "In the case of Bhopal, the housing was so poorly constructed, with dark alleys and leaking pipes that slum residents refused to move in, and in this case overall take-up rates by original inhabitants was less than 30 per cent." Thus, the builder as well as the government while constructing the houses under PMAY (U) must ensure that the urban poor want to move into the new houses and for this the houses must be of decent quality and size.

5.4 Increasing Flow of Credit to Housing

Credit to the construction sector has not shown any significant increase. This should have been otherwise given the steep targets set out by the Scheme, suggesting that either construction activity has stalled and therefore credit flow has stalled or vice versa. In truth this a vicious circle caused by the twin balance sheet problem in the economy. Many construction companies have become non-performing assets in the banking system. As a result, banks are now hesitant to lend to any builder. Without the flow of credit, builders are unable to complete grounded projects. This problem is supported by data that has been discussed earlier. The government has before it two options for consideration:

a. The government must take over all such projects that have stalled and complete them so that they may be sold to beneficiaries.
b. The government must ensure limited flow of credit to the builders that is sufficient for the completion of the stalled projects. These payments must be made under strict scrutiny and in phased manner.

5.5 Accessing Capital Markets for Finance

Infrastructure, construction and housing have all long been dependent on the banking sector for finances. It is time that we look towards the capital markets for meeting atleast part of our financing requirements. Finances through the capital markets can be made available in the following manner:

a. The housing finance institutions like HUDCO and NHB should float long-term bonds that attract domestic and foreign investors.
b. Municipal bonds have always been a means of raising funds for infrastructure investments. Recently the Pune Municipal Corporation raised INR 200 crores by issuing a 10-year bond. The demand for this bond was strong as it was oversubscribed by six times. The proceeds of this bond are to be used for a water project. The proceeds of such bonds can also be used to fund affordable housing projects.
c. We must attract foreign pension funds to invest into the housing market. Currently, developed nations are struggling as the interest rates there have remained depressed for quite some time. Moreover, the trend of negative interest rates that has been observed lately in Japan, Denmark,

Switzerland and much of the Europe has led to a persistent decline in investment rates in these economies. As a result, global pension funds are looking for new markets to invest in to meet their payment obligations. The government must project India as a faouarble investment destination from where they can obtain higher returns from the assets they manage.

d. India must allow our own insurance and pension funds to invest in affordable housing. With the recently acquired infra status it would seem a prudent time to allow for long term domestic institutional funds to flow into the housing sector. Zambia here serves as an interesting example. Like India, Zambia also had an acute shortage of urban housing and a majority of the urban population resided in squatter settlements. Since a majority of the houses constructed were for rental purposes, there was an acute shortage of funds with the government. Among other sources of finance, it was the funding provided by Zambia National Provident Fund (ZNPF) that helped majorly in funding this housing development program.
e. Developers must issue green bonds that can be used to build or convert existing buildings into eco-friendly dwellings. Green bonds will also attract many foreign investors who are required to invest part of their monies in green investments. By raising green bonds, builders will achieve the duel objective of not only constructing houses, but constructing environmentally friendly green houses.

5.6 Improving Affordability

The three factors that adversely affect the affordability of housing are the cost of construction per square foot, high interest rates on personal loans and low tenure for repayment of personal loans. All of these contribute to making the EMI payable on affordable housing an untenable 55 per cent of monthly income. Therefore;

a. The cost of construction must be brought down to INR 2000 by leveraging land
b. Personal loans for lump sum payments towards affordable housing must be provided at zero per cent interest for longer tenures. This has been done to encourage the purchase of consumer durables, especially electronics.
c. Stamp duties are a state subject and tend to vary across states. In the interest of driving affordable housing, all states must reach a consensus by which, stamp duty for affordable homes is exempted, and registration costs are kept at a bare minimum.

6. BANKING AND FINANCIAL SERVICES

6.1 Deposit Insurance

Deposit insurance currently offers only INR 1 lakh insurance. The bill proposes to base the deposit insurance on risk. But no particular amount of deposit insurance is enough and no one number can become sacrosanct. So, individual depositors should be allowed to finance their own deposit insurance, through private third-party entities.

6.2 Bond Market

The Indian bond market can be strengthened by making bonds acceptable for repo by the RBI.

6.3 Raising Loan Amount Limits

The limits for home loan amounts that fall under priority sector lending are INR 28 lacs in top cities and INR 20 lacs in other cities. Seeing the rise in prices of houses the government should raise these limits.

6.4 Raising Limits on Investment in Corporate Bonds

The percentage of limit utilised for investment into corporate bonds hovers around 95 per cent and often touches 99 per cent. RBI could raise the limit to direct more flow of funds in corporate bonds.

6.5 Loan Demand

The banking sector, in present day, needs demand for loans that come with security of repayment. The government could provide the banks with this demand and fund infrastructure projects with it.

6.6 Bank Recapitalisation

Out of the INR 2.11 trillion infusion of capital, which the government has recently announced, INR 0.58 trillion has to be raised by the banks through equity. However, the past performance of the banks hasn’t been good at raising capital through equity markets. The banks had to raise a capital of INR 1.1 trillion from the equity market under Mission Indradhanush. But since the launch of this mission in August 2015, banks have been able to raise only INR 0.07 trillion which is 6.3% of the total amount (CAG report No. 28, 2017). The government should take this into account while announcing the details of recapitalisation. The component of amount to be raised through equity markets should be reduced and that which is to be infused through recapitalisation bonds should be increased.

7. *INVESTMENTS AND INFRASTRUCTURE*

7.1 National Infrastructure Investment Fund (NIIF)

NIIF has, gotten off to a slow start, even after two years since its inception, it has garnered merely USD 1 billion (INR 65 billion) in a single deal from private investors and is yet to make a single investment commitment. The NIIF team is yet not complete and had twelve members as of July 2017. This calls for an overview of the NIIF functioning. The fund should drop its over cautious approach and explore some of the available funding opportunities more persistently.

7.2 Disinvestment

Poor corporate governance has had a negative impact on balance sheets, valuation of many CPSEs, consequently the performance of CPSEs has been declining over the years as alluded to in the CAG reports of 2015 and 2016. This has affected the ability of a CPSE to be listed in the foreseeable future. Even strategic sales and private placements appear difficult. Under such circumstances, the government should aim at improving the performances of such CPSEs rather than selling them for quick cash.

7.3 Housing for All

Given the growth and employment generation potential of 'Housing for All' scheme, government should look at expanding the scheme by developing a flagship programme for housing all public sector employees by 2022. Further, to counter the shortage of housing spaces for the scheme, the government can utilise its vacant and unused land for vertical growth.

7.4 Using Utility Payment Records to Establish Credit Worthiness

A lot of the applicants for affordable housing have difficulties in securing loans because they lack records, which allow lenders to track their credit worthiness. To resolve this issue, utility payments records (gas, electricity, water, etc.) with the government agencies could be used, as a proxy measure and hence should be made available to the financial institutions for the same.

7.5 Capital Market

The government should look at introducing tax deductible infra bonds, in order to increase retail participation in infrastructure investment.

7.6 Insurance and Pension

The regulations and thinking guiding investment by insurance and pension funds is an extremely conservative one. Such an approach not only limits the returns to investors, but also restricts the flow of credit into the broader economy. In view of this the investment regulations for them should be relaxed sequentially.

7.7 Real Estate

As per Securities and Exchange Board of India's (SEBI) rules, atleast 90% of funds collected by, Real Estate Investment Trust (REIT) and Infrastructure Investment Trust (InvIT), after paying for expenses, taxes and repayment of external debt, should be passed on to investors every six months. Such a regulation may affect liquidity for managing the underlying asset and hence should be looked into in order to jumpstart the investment procedure via these funds.

8. EASE OF DOING BUSINESS

8.1 Increasing the focus on specific reform areas

World Bank's Ease of Doing Business (EODB) rankings are based on the regulatory reforms undertaken by the countries in order to improve their business environment. India has recently created history by making a 30-notch jump from 130th rank in 2016-17 to 100th in 2017-18. The parameters included in the study are – Starting a Business, Dealing with Construction Permits, Getting Electricity, Registering Property, Getting Credit, Protecting Minority Investors, Paying Taxes, Trading across Borders, Enforcing Contracts and Resolving Insolvency. India has shown significant improvement in the areas of Paying Taxes and Protecting Minority Investors in the last few years. However, it severely lags behind other countries in parameters like – Starting a Business (rank 156), Dealing with Construction Permits (rank 181), Registering Property (rank 154) and Enforcing Contracts (rank 164).

In the last few years, there has been an increased focus on Ease of Doing Business, both by the governments and as a topic of research. Recently, significant research has been undertaken to determine whether all the above parameters are equally important for "doing business" or some factors matter more than the others do. Trading across borders, availability of land, obtaining permits and enforcing contracts stand out as more crucial for attracting FDI inflows as well as encouraging domestic private investment. The Government needs to stress more on the areas that have a direct and larger impact on the business activity. We need to prioritize providing the necessary regulatory infrastructure to the businesses in order to minimize and ease out the procedures in these areas.

8.2 Change in the methodology for assessment

One major criticism of the World Bank's EODB Rankings is that they capture reforms in de jure and not in de facto. In addition, in case of India, the rankings only take into account the two metro cities – Delhi and Mumbai. In order to provide a pan-India picture of the "doing business" environment, since 2014, the Department of Industrial Policy and Promotion (DIPP) has started ranking all the States and Union Territories based on their implementation of the Business Reforms Action Plan, which focuses on improving the regulatory and legal environment that the businesses operate in.

The methodology for assessment of the implementation of reforms conducted in 2015 and 2016 was based only on the evidence submitted by the states. For 2017, DIPP had planned to carry out a comprehensive business-to-government (B2G) feedback exercise, whereby the States / UTs would take feedback from businesses on the quality of implementation of the reforms claimed. The Total Score of the states will include, the Feedback Score as well as the Implementation Score. The B2G feedback exercise is likely to convey a better perspective of the quality of implementation. However, there continues to be ambiguity, as the DIPP website still displays the rankings based on the Implementation Scores and does not account for the feedback received from the businesses and other stakeholders. Thus, information on the feedback results needs to be made publicly available as well.

9. DEFENCE INDUSTRY

9.1 FDI Limits in Strategic Partnership

The provisions of the Strategic Partnership (SP) Policy need to be aligned with those of the FDI Policy in recognising the possibility and avenues of greater than 49 per cent FDI in the sector.

A clarification in the upcoming budget on whether the cap on FDI in defence is 49 per cent or 100 per cent would be an assurance to both the domestic and foreign defence manufacturers. This would lay the foundation from which the SP Policy would truly take off. A detailed description of 'modern' and 'cutting edge technology' would help set out the circumstances that could merit greater than 49 per cent FDI for specific SP projects.

9.2 Transfer of Technology

Laws governing IPR and sharing of technologies in other countries make unilateral confirmations from foreign original equipment manufacturers (OEMs) insufficient. To ensure a fool proof ToT regime for the SP Policy and requests for proposals (RFPs) issued thereunder, a budget announcement assuring government to government negotiations would be helpful. This would help provide assurance to defence manufacturers as well as non-disclosure/IPR security to OEMs. The government should pursue dialogue with the OEMs in order to determine the cost and quality of product platforms and available technologies, prior to issuing final requirements.

9.3 Skilling and Training Programs for Defence Technology and Manufacturing

The delivery timelines under contracts should be re-assessed, recognising the fact that even with the availability of technology, the process of absorption would take longer as the learning curve would be steeper. Specific focus needs to be put on skilling and training programs by the government, potential SPs as well as the OEMs to facilitate quicker absorption of technology.

9.4 Future Procurements and Export prospects for SPs

The initial strategic partnership contract provides order security for the SP, however, vendor management and supply chain innovation could become a burden given the lack of guarantee of future orders. In this light, government may also have to consider relaxing the extant export norms on defence products to permit an additional revenue opportunity for the SPs.

9.5 Minimum Qualification and Financial Criteria for Selection

When it comes to consolidated turnover and net worth, government should consider giving greater weightage to healthy balance sheets and investments in India over the company's investments abroad.

Government could consider allowing potential SPs to rely on their parent/group companies as long as the parent/group companies furnish a support letter/affidavit of comfort. Reliance on parent/group companies may be allowed subject to the condition that such entity will infuse equity in the SP in a phased manner.

9.6 Financing Strategic Partnership

The high value investments that defence manufacturing require and the relative shortage of capital in financial markets make for a difficult environment for financing SP projects.

There are two probable ways of easing the burden of financing. One, all stakeholders involved in the project pitch in and share financial responsibilities. Two, relevant/concerned companies can issue bonds (similar to green bonds or infrastructure bonds) in order to raise capital for funding production. The latter option will require some help from the government. An announcement of the government's intent to draft a framework which can facilitate such capital raises through defence bonds (not to fund war, but to raise capital for defence production) would help provide a fillip to domestic defence manufacturing.

9.7 Need for an Independent Regulator for Strategic Partnership

The V. K. Aatre Taskforce Report clearly states in section 7.3 the need for an independent regulator for *"regulation and development of the Strategic Partnership model"*[2]. The Taskforce Report also states that such a body is needed because the Strategic Partnership (SP) model will require continuous modification and improvement, as opposed to an annual or multi-year review. The only mention in Chapter VII (as approved by Cabinet in May 2017), of any new organisational structure for managing SP is that an *"institutional and administrative mechanism for effective implementation of the Strategic Partnerships will be set up within the MoD, with adequate expertise in relevant fields like procurement, contract law and ToT arrangements"*[3]. This does not seem adequate and does not address the purpose for which the recommendation for an independent regulator had been made by the Taskforce Report.

It is important that an independent regulator be set up to oversee implementation of SP Policy. The functions of this body as envisaged in the Taskforce Report range from dealing with development and regulation of the SP model, reviewing pricing mechanisms and adjustments, publishing binding rules or regulations, recording and monitoring contracts to investigating allegations of fraud or breach of contract by SP.[4]
Given the trust deficit and procedural delays that have been elaborated on in earlier sections, having a regulatory body independent of the bureaucratic hierarchy of the MoD and armed forces will be crucial to efficient implementation and evolution of the SP Policy. The details of this have already been provided in the Taskforce Report. The Government need only act upon the recommendations made in this regard.

---

[2] Report of the Taskforce on Selection of Strategic Partners, Ministry of Defence, Government of India: pg. 51.

[3] 'Chapter VII – Revitalising Defence Industrial Ecosystem Through Strategic Partnerships', May 2016: pg. 6. https://mod.gov.in/sites/default/files/Chapterdppn.pdf

[4] *Ibid*: pg. 52.

PAHLE INDIA FOUNDATION
FACILITATING POLICY CHANGE

C4/54 First Floor, Safdarjung Development Area,
New Delhi - 110016
(+) 91 11 41551498