Creating Reliable Manufacturing Ecosystem

It's estimated that as of 2019, India has crossed a mind boggling 500 Million smartphone users. In other words, every third person in India, owns a smartphone which is probably replaced every three years. The number of users has only been increasing exponentially and will continue to do so for the foreseeable future. How big a piece of this enormous pie is enjoyed by Indian companies though, one might ask. The answer is, "crumbs". Can something be done? Answer is 'yes'. Read on…

CA Hari Subramanian

The author is a member of the Institute. He can be reached at harisubramanian@outlook.com and eboard@icai.in

The market share of Indian companies in this fast-paced growing multi-trillion-dollar Industry, is almost negligible. And why is that? Is it due to lack of accessible technologies? Surely, it can't be due to a lack of skilled labour - given the number of professionals including technological experts our country churns out each year? Or is it because India is a cost-sensitive market and we simply prefer to import cheaper phones – perhaps. I believe it is due to the lack of a reliable manufacturing ecosystem for Indian Manufacturers. In this article, I hypothesize and simulate a concept I'd like to call "most favoured manufacturer" and explore how a few key fiscal changes can create a thriving ecosystem for localized manufacturing which will eventually lead to a leveled playing field for Indian manufacturers, or perhaps even result in leading the market? Government is already trying to facilitate manufacturing in a big way. As professionals we Chartered Accountants can also encourage industry, wherever feasible, to adopt diversification and growth strategies in the area to save critical foreign currency, boost Indian business and generate employment.

Earlier this year, there have been many discussions lauding India for becoming the second largest mobile phone manufacturing

hub in the world. While it certainly sounds positive, is there more to this than meets the eye?

Let's quickly take a few steps down the history lane, right back to 2014, when India's smartphone manufacturing sector was more or less limited to mobiles phone devices in a Semi Knocked-Down state, where almost all parts of a phone were assembled in countries such as China, Taiwan, South Korea or Vietnam and thereafter, imported to India. The "manufacturing" was limited to the insertion of battery and perhaps, adding locally sourced headphones along with a charger to the handset box. Fast forward to 2017, India had advanced to Completely Knocked-Down manufacturing, where parts such as screens, PCBs, semi-conductors, camera modules came in from different suppliers and were put together in assembly-oriented factories in India. They were then sold as "Made in India", which begs the rhetoric were they really "made in India" though?

Things have improved ever since and there are brands, which claim that 99% of the phones sold in India are locally built, with as much as 65% parts sourced locally. India has also started exporting devices to Bangladesh and Nepal. However, that's not the case for all manufacturers. Most manufacturers still rely on importing many parts (>50%), and why wouldn't they? Some of the most important components in manufacturing a phone, namely, the chipset, memory and display, require advanced technologies, uninterrupted supply of water and electricity, and highly skilled & trained employees to run high end automated machines. India's infrastructure needs a major upgrade to meet the required standards.

The government for one, has taken cognizance of this issue. Earlier this year Hon'ble Finance Minister Smt. Nirmala Sitharaman unveiled an INR 50,000 crore package targeting large smartphone makers operating in India, with performance-linked incentives (PLI) that involve cash benefits subject to meeting local sourcing, manufacturing and sales targets. While the local manufacturing of parts would require huge upfront investments by smartphone manufacturers/part suppliers, the benefits would be enormous in terms of savings in import duty cost which usually varies from 15-30 percent depending on the part imported, country of origin and a few other parameters.

That being said, the question remains - **"What more can we do to incentivize local sourcing of parts?"**

I believe the usage of our current multi – level tax rate structure (GST), as a carrot and stick approach towards the manufacturer would really help address this issue. Currently, 18% GST is levied on smartphones, but what if a manufacturer sourced 60% of its components locally?

On this premise, we progress with our vision which then, leads us to the question, ***could we perhaps grant them the status of "Most Favoured Manufacturer (MFM)"*** and levy only 12% GST on their phones – thereby making it a better value for money product compared to its counterparts, who continue to import more than 40% of the parts required? I've simulated a scenario to understand this better:

Manufacturer	% of parts sourced locally	MFM level	Tax Rate applicable	Explanation
Company A	Up to 59	-	18	No benefits under 60%
Company B	60 – 69	1	12	Some benefits
Company C	70 – 79	2	9	More benefits
Company D	80 – 100	3	5	Maximum benefits

While the staggered rate benefits would certainly allow competitive pricing, that alone wouldn't be necessarily enough. The MFM program should also have a vocational training centre where technical training for manufacturing and assembly of parts and electronics can be imparted onto semi-skilled workers. The training would

not only upskill the semi-skilled labour available in our country but also generate employment opportunities, possibly in millions. The same can also funded partly by the manufacturer and subsidized by the government. Perhaps some technical and management institutes can also be encouraged to start focussed courses to impart special skills.

Government could allocate SEZ like zones specially for manufacturers enrolled under this program. Infrastructure in such SEZ should be built by the government and leased out to manufacturers for a pre-determined period upon promise of fulfilling mutually accepted production quantities. Along with infrastructure, decade long direct tax holidays too could incentivize and attract more manufacturers to join the program.

> While the local manufacturing of parts would require huge upfront investments by smartphone manufacturers/part suppliers, the benefits would be enormous in terms of savings in import duty cost which usually varies from 15-30 percent depending on the part imported, country of origin and a few other parameters.

The idea is to have a multipronged approach which is required and now inevitable to make India Aatmanirbhar in manufacturing mobile phones.

How to arrive at the percentage of goods sourced locally?

The ideal solution would be, to have a value-oriented approach. That is to say, if the value of materials sourced locally is more than sixty per cent of total material cost, the manufacturer gets a MFM status. In other words, the total landed cost of materials imported should be more than forty per cent of the total cost of materials.

For example, let's say Mobile Manufacturer "X" procures the following:

1. Chipset from South Korea supplier (SKS) for paying the equivalent of INR 2,000 per piece (CIF + Customs)
2. Memory and Screen from China paying a total of INR 3,000 per set (CIF + Customs)
3. The rest of the parts are sourced locally at a total of INR 8,000 per handset.

This brings the total cost of materials (pre-assembly) to INR 13,000. The total landed cost of imported materials is INR 5,000, or 38.47%. This also means, the value of materials sourced locally, amounts to 61.53%, thereby granting manufacturer X - the status of MFM level 1.

This would not just allow him to sell his finished product by levying a lower GST rate of 12%, but would also motivate him to

> The training would not only upskill the semi-skilled labour available in our country but also generate employment opportunities, possibly in millions. The same can also funded partly by the manufacturer and subsidized by the government.

procure more locally – thereby moving up in the MFM level scale. He may request his SKS to move some production capacity to India. Also, it would be safe to assume that manufacturer X isn't the only Indian customer of the SKS, and hence would wish to tap a potentially bigger market. Sure, the establishment costs would be considerably high – but so would the continuous savings in shipping & insurance.

In a realistic scenario, a manufacturer will have a number of phones in his portfolio – the percentage of locally sourced materials for his portfolio collectively will be considered for MFM status.

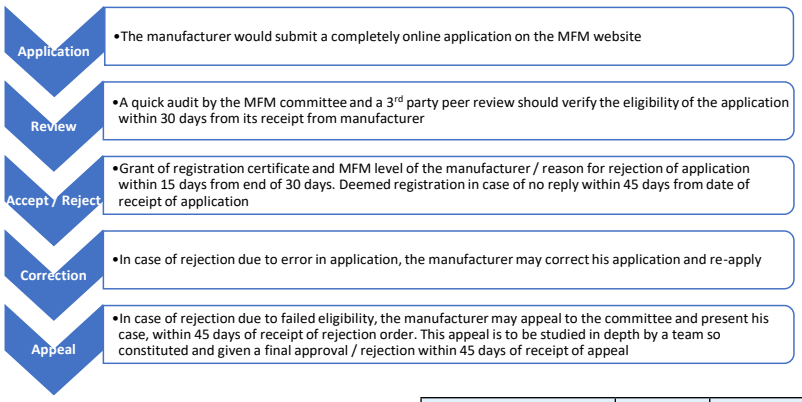
How would the government grant MFM status?

A seamless and efficient process, with minimal manual intervention, is what we should strive for. This would ensure that the dreadful era of License Raj is left behind once and for all.

This would involve the formation of a dedicated committee spearheaded by a high ranking official with several Industries and legal experts as the ideal

> Government could allocate SEZ like zones specially for manufacturers enrolled under this program. Infrastructure in such SEZ should be built by the government and leased out to manufacturers for a pre-determined period upon promise of fulfilling mutually accepted production quantities.

team to manage the show. The following could be the steps on a macro-level:



MFM Status once given, will be valid for the financial year. For the next year, the manufacturer would have to file a self-declaration to renew the MFM status. There can be an audit by the MFM committee into the declaration within 30 days of the filing of it to confirm/reject the status.

If the manufacturer believes there's a change in MFM level, he would have to submit an application a fresh application for said new level and the procedure will follow. Until such time, old MFM level and rates will be applicable.

How do we integrate it with our existing tax laws?

This program can be and should be, consciously merged into existing GST laws with adequate caution, while leveraging the existing framework of the "Make in India" campaign. An inclusion to the existing HSN rate charts is probably one of the few changes required in terms of integrating it with our existing laws.

How does it impact the end consumer?

For the sake of simplicity, let's simulate , presuming the phones manufactured by all these companies are of comparable quality/features and are currently priced at 11,800/-

Manufacturer	MFM level	Old GST Rates	MFM GST Rates	Phone Rates under MFM
Company A	-	18	18	11,800
Company B	1		12	11,200
Company C	2		9	10,900
Company D	3		5	10,500

As evident from the above, Company D's phones will be flying off the shelves faster than they can be produced, while company A would eventually have to change their modus operandi to level the playing field.

The companies that source most parts locally under the MFM program, would also avoid import duties ranging from 15-30%, & pay GST at lower rates to their local governments instead reducing their cost further.

Endnote

Our existent Foreign Direct Investment (FDI) policy permits 100% FDI under the automatic route for electronics manufacturing. This, for the uninitiated, is the equivalent of a red carpet invitation into electronics manufacturing companies. This also leads us to the question, "Why to stop at smartphones - why not all electronic devices?" In my opinion, manufacturing has already begun its transformation as a "robot intensive automated process" and not a labour intensive process of the yesteryears. We need to catch the train before it leaves the station forever. If we are able to carefully weave this program into the "Make in India" campaign, we could see several possible tangible and immediate benefits:

- Multiple new MSMEs and countless employment opportunities
- Real Manufacturing in India, not just assembly
- Big boost to the "Make in India" campaign and Transform India into an export hub
- Reduced reliance on other countries
- Reduced cost to end users

"The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails." - William Arthur Ward ■■■