Tax Breaks for the Small Scale Sector: An Appraisal

Amaresh Bagchi
R. Kavita Rao
Bulbul Sen

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Introduction

Exemptions and/or concessions for the small scale sector have been an integral feature of India's tax system for over five decades. In order to undo the setback suffered during the British colonial rule by craftsmen and rural artisans who constituted the backbone of India's traditional industry, one of the first tasks for policymakers of independent India was to help village and small industries (SSI) to stand on their own feet once again. The rationale for protection to the small scale sector, first articulated in the *Industrial Policy Statement, 1948* got embedded in the industrial policy framework of the government in the fifties, with an explicit statement in the *Industrial Policy Resolution, 1956* saying "….the aim of state policy will be to ensure that the decentralised sectors acquire sufficient vitality to be self-supporting". Considerations that drove this policy primarily were promotion of employment and wide dispersal of industrial growth avoiding urban congestion as also the

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* Professor Emeritus, National Institute of Public Finance and Policy, New Delhi
E-mail: bagchi@nipfp.org.in.
** Senior Fellow, National Institute of Public Finance and Policy, New Delhi
E-mail: kavita@nipfp.org.in
*** On deputation from the Indian Revenue Service as Principal Consultant, National Institute of Public Finance and Policy, New Delhi
E-mail : bulbulsen@nipfp.org.in.

Gandhian ideology of self supporting village economy. The policy was implemented through various measures of support to small scale industries during the Second Plan period and onward. Concessional tax treatment played a prominent role in this endeavour.

In addition to tax concessions, the SSIs were protected with a policy of reservation over a wide range of products to the exclusion of large scale producers. SSIs, it was felt, needed support from government to neutralise their handicap in facing competition from the large scale producers, such as, lack of easy access to credit and high cost of borrowing, constraints in marketing, lack of access to information, and so on. Support was given also in various other forms such as concessional credit, capital subsidy, rebate on sale of products, purchase preference in government procurement, and so on. In view of their potential for generating employment and developing rural economy, there was consensus in favour of such support.

Even so, the policy of protection to SSIs through reservation and tax concession has come in for criticism from time to time from observers of India's economic performance and progress. Studies carried out by several eminent economists have concluded that the policy of protecting small scale sector with 'reservation' over a wide range of industrial products (running to over 800 items at one stage), and fiscal support like tax concessions have not been beneficial either for the economy or even for the small scale sector. Many are of the opinion that the policy of protection to SSIs at the cost of large units has been a major factor responsible for the poor growth of Indian economy during the 60s and 70s.[1] While the policy may have helped to generate or sustain employment in the unorganised sector, such employment was provided at low levels of income and thus contributed to the persistence of poverty across the country. The design of protection provided through preferential treatment in taxation has also been a subject of criticism as a factor inhibiting the growth of SSI units as they serve as a disincentive to grow beyond the level upto which the concessions are available. Several official committees have also reviewed the schemes of exemption/concession and some of them have been highly critical of the regime of tax concessions and/or their design.[2] The schemes have undergone changes almost continuously ever since they have been in operation. Yet, critics have remained skeptical as to whether their benefits have been worth the cost to the society.

Persistent criticism and more importantly, economic liberalisation initiated in the early nineties led to rethinking on the policy of small scale protection. With the opening up of the Indian economy, reservation of certain products for the small scale sector to the exclusion of domestic large producers became untenable.[3] Hence, the ambit of reservation for SSIs has been progressively reduced. Some, however, still remain[4] as also many of the other benefits extended by the government. As just mentioned, the tax concessions also have undergone many changes. For instance, the tax holiday for SSIs in income tax has been phased out, while the concessions in excise duty continue, though in a different form than in the past. Given their deleterious effect on revenues, it is time the concessions were subjected to a more rigorous cost-benefit analysis than has been undertaken so far.

Reforms in the structure of central excise, which transformed a cascading type tax on manufacturing into a manufacturers value added tax (VAT), too call for a review of the policy for SSI exemptions. The provision for credit for input taxes, both in the form of excise and service tax, reduces the gains from exemption, especially for units manufacturing intermediate goods. This, however, does not find reflection in assessments of cost-benefit of excise concessions in the economic environment that small scale units now function in.

Though it may sound surprising, the revenue cost of the concessions remains unknown. Going by the share of the small scale sector in the economy, it would be fair to say that *prima facie*, these concessions cost the exchequer dearly. As mentioned above, except for some sectoral studies, no rigorous cost benefit analysis of fiscal concessions to the small scale sector as a whole seems to have been carried out.[5] This note attempts a tentative estimate of revenue cost of the concessions to the small scale sector as they are in operation at present and seeks to evaluate the arguments for and against their continuation. We begin with a brief account of the tax concessions as they have evolved over the years and then proceed to present an estimate of their current revenue cost. This is followed by a review of the case for and against tax concessions for SSIs.

The finding, briefly, is that the revenue forgone by the exchequer in providing concession in excise duties to the small scale sector (excluding textiles) is of the order of Rs. 14,000 crore a year.[6] The rationale for this 'tax expenditure' is however extremely weak. While there is every reason to assist small scale producers particularly in rural areas through access to institutional credit and assistance in technological upgradation and marketing, protection through tax concession is harmful in many ways and needs to be withdrawn forthwith. The exemptions for only tiny and household units may, however, continue. Promotional measures like supply of institutional credit should be reinforced.

II. Tax Concessions for the Small Scale Sector: Brief History and Revenue Cost

History

Concessions were provided to the small scale sector in India for many years in income tax as well as excise duties. New industrial undertakings coming under the category of small scale defined in terms of investment in plant and machinery were allowed tax holiday for a specified number of years subject to certain conditions, such as location in rural areas, and so on. Whereas the income tax holiday was granted to new undertakings only if they were engaged in producing goods in what was called the “priority list”, in the case of new small scale enterprises no such restriction applied. Such preferential treatment for small scale units occured in many of the tax benefits extended in income tax to promote new industries, technological advancement, and development of backward regions. However, as mentioned above, these have largely been withdrawn or are on their way out.

Concessions in excise duties, too, were provided to the small scale right from the inception of support policy for the small and tiny sector as a strategy of development and employment promotion. Excise concessions provided a potent instrument for influencing the pattern of production and technological choices in favour of employment intensive techniques because of the wide coverage of union excises and their impact on the relative prices of outputs as also inputs. In order to promote employment, products of several industries were exempted from excise if produced without the aid of power. Items so exempted included confectionery, food products, vegetable and ‘non-essential’ oils, paper and paper board, man-made fiber and yarn, footwear, steel furniture, bolts, nuts etc. In the case of a few tariff items like cotton fabrics, woollen fabrics, and man-made fabrics, exemption was available in respect of a few sub-items only. In the case of goods brought under taxation in 1975 through tariff item 68 ("goods not elsewhere specified"), full exemption was allowed if certified by the *Khadi and Village Industries Commission* (KVIC) as products of a village unit. Similar concession was extended to producers of handmade paper and paperboard. Handicrafts falling under item 68 were also fully exempted from duty.

Differential excise taxation was used also to discourage the use of machines in certain cases e.g., in the manufacture of *biris*. Glassware produced by manually operated press was treated favourably for taxation as compared to those made with the help of automatic or semi-automatic press. The handloom sector of textile industry too enjoyed several concessions in excise duty. In addition to these, exemption and/or concession was granted to the small scale producers of a number of commodities, using varying criteria (or a combination thereof) based on scale of clearances, i.e., production for sale and/or size of investment in plant and machinery and the number of workers. Under a scheme introduced in 1978, full exemption was granted in excise duty on a specified level of clearances of SSIs and thereafter slab-wise concessions were given in respect of specified items. For full exemption from duty the limit fixed was clearances upto Rs. 5 lakh in a given year if the total clearances in the preceding year did not exceed Rs. 15 lakh. In order not to discourage employment of labour beyond a level, under a scheme introduced in 1977, for manufacturers of tariff item 68 products (i.e., goods not specified elsewhere) using power, full exemption was based on twofold criteria in terms of both investment and turnover. A general scheme of small scale exemption was introduced in respect of certain specified items in 1985. This was replaced in 1986 and subsequently amended through notifications.[7]

In order not to discourage the growth of an SS producer beyond the limit laid down for entitlement of concession, the ceilings in terms of clearances were raised from time to time and the scheme of exemption made simpler. Under the scheme currently in operation[8], a producer of specified goods with a clearance of not more than Rs. 4 crore in a given year, does not have to pay any duty on the first Rs. 1 crore of clearances in the following year. 'Specified goods' now cover a wide range of products; only a few are left out. This concession is however not available in respect of specified goods bearing a 'brand name' of another producer, except where the brand is one of KVIC, a state *Khadi* and Village Industry Board, National Small Industries Corporation etc. Until the year 2005, producers availing exemption could opt for paying duty at a concessional rate and claim credit for CenVAT paid on inputs. The option has since been withdrawn. However, exemption for specified goods like 'essential oils', perfumes, ceramic goods, locks, if produced without the aid of power which was granted in 1986[9] continues. Similarly goods produced in rural areas continue to be exempt if certified by KVIC or produced by a registered cooperative society. Such goods include preparations of vegetables and fruits, pickles, sauces and ketchups, and footwear.[10]

Recent years have witnessed a number of measures to simplify the procedure to be followed by small scale producers in the matter of compliance with excise laws. For instance, no registration with the Directorate of Industry or DCSSI is necessary for availing the SSI excise exemption. No declaration is now needed to be filed either with the central excise authorities so long as the sales of goods (including completed exempted goods) do not exceed Rs. 50 lakh. No monthly return need be filed by a small scale producer unless he is required to pay duty. Only the 2005 Union Budget has provided that SSI units with clearances exceeding Rs.40 lakh will file a simple declaration. This position remains unchanged this year (2006-07).

Revenue Cost of Excise Concessions: An Estimate

Even though largely simplified, the exemption granted to small scale producers is still substantial and the revenue cost thereof is not so negligible. However, an evaluation of the costs and benefits of these exemptions presents formidable difficulties owing to (i) the acute paucity of requisite data; and (ii) simultaneous operation of other benefits for the small scale sector, making it problematic to isolate the influence of one to the exclusion of others.

The revenue cost of tax concessions is not easy to figure out, primarily for the reason that the data required for such an exercise is not available.[11] The number of small scale units availing the benefit of exemption and the total value of their tax exemption clearance is not known. As just mentioned, units having less than 1 crore clearance – the tiny ones – do not have to register with the Central Excise department. Nor are they required to file any declaration about their production or clearance. It appears that the excise authorities do carry out some survey from time to time but the figures of tax concessions availed or worked out therefrom seem to be grossly unrealistic. The reasons for such skepticism are set out below along with an alternative measure of the revenue cost of SSI excise exemption.

According to official estimates[12] the SSI sector accounts for about 40 percent of GDP from manufacturing in the Indian economy. 'Industry' in turn accounts for 29 percent of GDP. Thus, in terms of contribution to GDP, the share of SSI works out to 40 percent of 29 percent or 11.6 percent. It would however not be correct to take this proportion of GDP in full as constituting the base for excise taxation. It is necessary to exclude the value added of tiny or village units which are out of the tax net in any case and also the value of products which necessarily have to be left out of taxation, like, exports. Allowance has also to be made for the credit for tax on inputs produced by small scale units which are used by large scale producers and get taxed in the hands of the latter.

In deriving the taxable base in the SS sector, it is necessary to derive the value added in the tiny sector comprising *khadi* and village industry units and the tiny units of SSI (with fixed investment less than Rs 25 lakh[13]). This is because these units cannot and should not be brought under the tax net. No data on the production of these units are however, available. Using the figures available for production of *khadi* and village industries[14] and the share of tiny units derived from the *Third Census of Small Scale Industries* for the year 2001-02, we arrive at a figure for output of these units – Rs. 7,685 crore in a total production of Rs. 52,504 crore by SSI units as a whole. While the former is assumed to represent fully the value added of the SSIs, since tax paid purchases by KVIC is minimal, the value added by other small scale units may be arrived at by looking at the ratio of value added to output of the small scale sector. This turns out to be 35 percent.[15] With GDP of Rs. 2,082 thousand crore in 2001-02, these work out to 2.9 percent of GDP. The revised base for excise duty for SSI production thus comes to 8.7 percent of GDP.

The base so derived has to be adjusted further for the following components to arrive at the potential base for excise revenue from value added by small scale producers:

- value added in exempt goods
- value added in goods that are exported
- value added in products that are used mainly as intermediate goods. These need to be excluded as they get taxed at the subsequent stages.

These three categories tend to overlap. Corrections are needed to ensure that double counting does not occur. For this purpose the following identities are kept in view:

Total value added = value added in exempt goods
+ value added in non-exempt intermediate goods
+ value added in non-exempt final use goods, and … (1)

Value of exports = exports of exempt goods
+ exports of non-exempt intermediate goods
+ exports of non-exempt final use goods …….(2)

Information in this regard is not available individually for any of these categories. The only source of information for the shares of each of these categories is the *Third All India Census of Small Scale Industries 2001-2002* (final results).[16] The actual figures from this census are however not used here since the totals presented from this census do not match even in dimensions the figures reported earlier for this sector. Exports for instance are recorded at Rs. 14,199 crore in the census. On the other hand, figures from other sources suggest that SSI sector contributes about 35 percent of total exports of the country, constituting 4 percent of GDP. This translates into about Rs. 75,000 crore for the year 2000-01.[17] According to sample survey for 1999-00, exports were of the order of Rs. 29,900 crore. These differences are attributed to the relatively smaller coverage of the SSI census conducted by the Small Industries Development Organisation (SIDO).[18] Therefore, for the aggregates, the figures provided in the *Handbook of Industrial Policy and Statistics, 2002* and further updates from the SIDO website are used.[19]

It needs to be noted here that the definition of SSI in these surveys covers units which have investment in plant and machinery of less than Rs. 1 crore. (Going by the second SSI census, output capital ratio on the average is 2, suggesting that the turnover of these units would be in the range of Rs. 2 crore at the most). The ratios for the other categories in the identity 1 above are derived from the tables provided in the report. These are reproduced in the table presented below.

Table 1: Computed Shares

	Share in value Added	Share in exports
Exempt goods	38%	53.93%
Non-exempt intermediate goods	28.15%	15.04%
Non-exempt final use goods	33.85%	31.04%

Source: Constructed from tables for top 200 products/activities from the *Third Census for Small Scale Industries*

Out of the information available from official sources, exports from SSI, may be taken to be 35 percent of the total exports of India. Given that India's exports are about 12 percent of GDP, the SSI contribution would thus be about 4 percent of GDP. The SSI census indicates that the exports by the tiny sector contribute 26.6 percent of the total SSI exports. The exports by the non-tiny sector therefore can be taken to be 2.94 percent of GDP. Since non-exempt final use goods have a share of a little over 31 percent in SSI exports, the exports of such goods by the non-tiny sector may be put at 0.91 percent of GDP. Further, applying the ratio of gross value added to value of output of 0.35, value added in exports would be 0.32 percent of GDP. This is to be excluded from the potential excise tax base.

On the other hand, the contribution of the non-exempt final use goods to GDP is 2.94 percent. Correcting this figure for exports, the net taxable component of SSI production comes to about 2.62 percent of GDP. Applying the average rate of CENVAT of 16 percent to this base, the loss of revenue may be assessed at 0.42 percent of GDP. Taking the estimated GDP figure for 2005-06 at Rs. 3,200.6 thousand crore, the estimated loss of revenue from excise exemption to SSIs works out to Rs. 13,442 crore for the last financial year and assuming the same growth as excise revenue, Rs. 14,282 crore for the current financial year, 2006-07.[20] As already stated, this leaves out the revenue forgone by the excise concessions in a major segment of Indian industry, *viz.,* textiles. Besides, the estimate is based on fairly conservative assumptions and so may be taken as the lower limit of the revenue loss caused by concessions for the SSI sector. In any case, it leaves out the revenue loss suffered by the state governments because of preferential treatment of the SSI sector in state sales tax (now VAT). Whether this revenue cost is justified by the benefits to the society, is examined briefly in the section that follows.

III. The Case for and Against Tax Concessions for the Small Scale Sector

The Case for

The case for providing tax concession to SSIs rests essentially on the following arguments:

- Small scale production is inherently employment intensive. Available information (ASI and SSI census) shows that as against an investment requirement of Rs. 4 lakh per unit of labour in the large scale sector, the investment requirement for one unit of labour in the small scale is only Rs. 2 lakh.

- Small scale units suffer from a number of handicaps particularly in the matter of credit, access to input and output markets which stands in the way of their competing with large producers. Institutional credit is not usually available to small scale units as banks and other lenders find it difficult and costly to handle numerous small loans. Banks usually prefer a small number of large borrowers over a large number of small ones. Hence the need for state support to provide a level playing field for the SSIs.

- Large scale producers have the advantage of economies of scale and thus enjoy an advantage in the cost of production. Hence small scale producers cannot survive without tax protection. Even where the manufacturing process is scale-neutral, large producers enjoy economies in bulk purchases of materials due to discounts allowed by suppliers, economies in selling costs, and so on, which are not open to the small scale units. Small scale producers also cannot take advantage of superior market strategy available to large producers owing to their size. Nor can they operate distribution channels of their own on account of resource constraints. Limited access to market information leaves them with little access to the product markets. This limits their access to technical information as well, and thereby impedes upgradation of technology.

- The only advantage the small scale units enjoy is in the matter of hiring wage labour. They can hire labour at a cheaper rate and they do not need to always observe the restrictions on hiring and firing of labour. Small scale units set up in rural areas also have the advantage of lower cost of factory space, and so on. Often village industries operate in households. However, these advantages are outweighed by the disadvantages enumerated above. Hence the need for concessional tax treatment and support in other forms.

- The case for maintaining state support to SSI units including excise exemption is reinforced by citing the dynamism of the SSI sector in recent years. The Mid-Term Appraisal of the Tenth Five Year Plan, while reviewing sectoral progress and prospects observes: "The unregistered manufacturing or the small and medium enterprise (SME) sector has been a dynamic segment of Indian industry and has proved its competitive ability in recent years" (para 1.29). The Indian automobile components sector – an ancillary industry for automobile manufacturing – has come in for special attention for its fast growth in the recently published Human Development Report 2005 of the UNDP (p134). Besides, the contribution of SSI in terms of employment and exports is cited all the time to advance the case for support to SSIs.

The Case Against

Despite the arguments advanced above, pleas for tax concession and reservation are questionable on several counts. Briefly, these are:

- Prior to the reform of excise into a levy based on input tax credit, there was a cascading levy and therefore exemptions implied significant differences in terms of prices. Subsequent to the introduction of MODVAT in 1987 and its reform through the early nineties transforming central excise into a manufacturer's VAT, cascading within the tax structure has been reduced considerably. The tax due from any manufacturer now was limited to the difference between the tax due on the value of clearances net of input taxes paid. Exemption in this scenario meant that the manufacturer could not get credit for input taxes and which therefore become embedded in the price of the good. This would have two consequences:

1. Regular registered units who potentially can purchase their inputs from small scale units, may be reluctant to do so, since there would be no possibility of input tax credit.
2. Exporters, too, may be unwilling to source their goods from exempt SS units, since the scope for zero-rating gets considerably curtailed.

These concerns find reflection in the composition of dealers in the survey of small scale units undertaken by the excise department. When the law permitted a regime of concessional rates of tax as an alternative to exemption, where the former allowed for tax credit, there was a revealed preference for the former. Only 12 percent of the total clearances of small scale units availed of the exemption option. But this option has now been made compulsory to the detriment of the SSIs. In other words, they would stand to gain if there was no exemption.

- While there is a strong case for "promotional" measures to support the small scale sector, protective measures like concessions extended over a long time turn out to be props for inefficiency in production and lead to a proliferation of spurious small units to get the advantage of the protective umbrella. "Protection to small units in combination with various statutory regulations on large scale organised industry, provide perverse incentives to remain small. Continuous protection thus gives positive disincentive to improve competitive strength".[21] A critical evaluation of the small scale industry policy in India by Rakesh Mohan, published by NCAER in 2001 brings out succinctly the damage caused by the policy of protection to SSIs even in the matter of employment. The points that emerge from Mohan's study, based on a careful analysis of available evidence, merit attention. Basically these are:

- Preference to SSIs has discouraged large scale industry (LSI) from specialising in labour intensive products in which India has a comparative advantage. This has gone against employment generation, which is the professed aim of protecting SSIs.

- Encouragement to SSIs has limited the choice of techniques and plant size available to Indian producers and thus stunted the growth and technological advancement of Indian industry.

- Employment growth in manufacturing sector in India in the 80s and 90s has been lower than in the countries of south east Asia.

- Value addition by SSI has been low compared to the LSI. As a result, low level manufacturing activities have prolonged low income employment activities. "Workers in the non-SSI sector are on average 2.5 to 3 times as productive as the SSI sectors, 5 to 10 times as DMEs and 5 to 25 times in the NDMEs and OAEs[22]. These productivity differences between different schemes of the manufacturing sectors are much higher than that typically found in other countries".[23]

- The story of growth of small scale industry put out by SIDO is not reliable as their data are open to question. This has been highlighted in the Abid Hussain Committee Report too.

- The objective of dispersion of production also has not been achieved.

- Impact on exports also has been deleterious, contrary to what is widely believed. India has not graduated from low technology/low capital categories of exports to high technology categories at the same pace as other Asian economies.

- How the policy of protection to the small scale sector created problems for India's industrial development was analysed in a rigorous framework in the paper by Dipak Mazumdar cited earlier with the specific example of the textile sector. The aim of protecting the household sector (handlooms) the paper observes, "led inadvertently to the rapid growth of an intermediate technology — the sector making use of low-grade semi-automatic looms in small units" (the powerlooms). Static cost-benefit analysis showed that private profitability was highest in the powerloom sector and it would have developed even without any restrictions on the mills. Much of this sector's profitability came from the differential in wage between mills and the power looms. In the absence of this differential, social profitability of the mills, Mazumdar points out, would be much larger even in a static framework. When dynamic considerations are brought in, "the problems boil down to favouring a policy of increasing employment per unit of output at the cost of doing damage to the possibility of achieving an increase in output large enough to outweigh the smaller use of labour per unit of output". These observations would apply equally to other products as well.

- While the SSI sector has shown remarkable dynamism in recent years, this is attributable largely to the withdrawal of reservations and exposure to competition. In the automobile ancillaries, the growth has been attributed in the UNDP report cited earlier to the support provided through regulation of foreign investors, including local content obligations (UNDP, ibid, p.134).

- Data thrown up by the Third SSI Census bring out facts that go against the claims about higher employment potential of the small scale sector. When these figures are compared with the figures for the factory sector, it is increasingly evident that the distinct identity of the SSI sector on this count is gradually getting blurred. From the comparison presented below, for improved efficiency in production as well as employment with reasonable incomes, expanded production in formal manufacturing sector emerges as a more appropriate option. It may be pointed out that all these comparisons refer to the registered SSI sector alone. For instance:

    - The average number of employees per unit has declined from 6.29 to 4.48.

    - Ratio of output to fixed investment has declined from 4.61 to 2.21 signifying a higher capital output ratio in the small scale sector. The ratio of output to fixed investment for total industry from the Annual Survey of Industries, 2002-03 is 18.53.

    - Capital intensities have also increased. Employment per 1 lakh of investment has declined from 3.93 to 0.67. Even adjusted for inflation, capital intensity in SSI seems to have increased. Capital labour ratio has gone up by more than 115 percent. While there were sharp differences in the capital intensity in 1987-88, 0.6 per lakh of investment for the factory sector against 3.93 for the SSI sector, this difference has reduced over time, the figures for 2000-01 being 0.2 for the factory sector versus 0.67 for the SSI sector. Adjusted for inflation, the ratio for the factory sector has increased only by 73 percent during the corresponding period. This reflects the fact that the SSI sector is sharply losing out its employment edge.

- Ratio of production to employment has increased from 1.1733 lakh per one unit of labour to 3.299 lakh. Corrected for inflation (WPI for manufactured goods) this works out to less than 10 percent increase for the entire period. If deflated by WPI for all commodities, virtually no increase in output per employee seems to have taken place. To be precise, the increase has been only 0.95 percent over the entire period. In contrast, the corresponding figure for the ASI sector has increased by 63 percent between 1990-91 and 2000-01 and stands as 11.6 lakh per employee in 2000-01.

- The claim of large employment generation by SSIs needs to be taken with a lot of caution, especially given the periodic expansion in threshold in the coverage of SSI sector. First, to quote the Mid-Term Appraisal again: "The Office of Development Commissioner of Small Scale Industries under the Ministry of SSI has recently completed the Third SSI Census (reference year 2001-02). Employment per SSI unit has reduced from 6.29 per unit to 4.6 per unit between 1988 (the reference year for the previous Census) and 2001-02" (para 8.13). It is not clear how such a change continues to support the argument for high and unchanging employment potential in this sector. Second, if one examines the profile of SSI units as per the Third SSI Census, there is a concentration of employment in the lowest output firms – 38.7 percent of employment is sustained in units with output less that Rs. 1 lakh for registered SSI units and 88 percent in the case of unregistered SSI units. In contrast, the outputs are concentrated in units with turnover above Rs. 5 crore – 49 percent for registered SSI sector. Treating this entire sector as one homogenous unit is therefore not justified either on grounds of employment generation or on grounds of efficiency.

- Protection of SSIs through tax concessions and reservations, coupled with purchase preference by the public sector has had a negative fallout on economy and social welfare, the cost of which remains unknown. Protected units did not have the motivation to ensure quality in their products. Thus with reservation, many electrical items and auto parts produced by SSIs turned out to be substandard. Their use posed hazards for safety. It is only with dereservation, that is, when faced with competitors, that the automobile ancillary industry has emerged competitive in the world market. Protection through excise concession like reservation goes against efficiency. So far as we could gather, the automobile ancillary industry now consists of relatively large producers supported by large automobile manufacturers.

- Viewed in the light of the facts and arguments put forward above, the recent recommendations of the Task Force on Drugs[24] for raising the ceiling on clearances entitled to excise exemptions in the case of SSI drug manufacturers from Rs. 1 crore to Rs 5 crore cannot but be regarded as ill-advised. The contention in favour of the recommendation seems to be that it is only the small manufacturers who produce drugs at prices affordable by the common man. If that is the case, one may ask, is excise concession called for? If on the other hand, small scale manufacturers cannot survive without tax concessions, then such concessions clearly turn out to be a prop for inefficiency. Among the considerations which seem to have prevailed with the committee to recommend a higher scale of excise concession for drug manufacturers, especially small scale manufacturers, are:

(i) Excise is levied on the basis of MRP[25], with rather inadequate abatement for trade margins.
(ii) They are facing competition from new units located in zero-tax areas, like Himachal Pradesh, Uttaranchal, Jammu & Kashmir.

The right remedy for these problems is an appropriate level of abatement for trade margins, as recommended by the committee for drugs in general, irrespective of whether they are manufactured by large or small producers. As for unfair competition from units operating from zero-tax territories, there is a clear case for withdrawal of tax holidays by region, as they distort location choices of the producers. Neither of the considerations mentioned by the committee therefore provide a valid ground for expanding the excise concessions for small units.

An additional argument against excise concession to small scale drug manufacturers is that the really small or tiny units may not find it possible to institute any rigorous quality control measures, or observe the requirements of Good Manufacturing Practices (GMP) as prescribed for drug manufacturers. Observance of GMP requires minimum scale of operation. To enable small scale units to achieve this scale, the requirements are, easy access to institutional credit, dissemination of information regarding technology and a more efficient regulator for the sector.[26] The focus should be for assistance in these directions, rather than on tax concessions, which blunt the incentives for efficiency.

- Another consideration that goes against exemption to any sector in excise is the break in the VAT chain that results from such concessions. It provides an opportunity for SSI units to use the CenVAT paid by them on their purchase by selling them to units who can make use of the invoice, thereby creating a market for invoices.

- Whatever be the ceiling for eligibility for exemption, the SSIs would always have an incentive not to exceed the ceiling at least on paper. Thus given a ceiling at any level, there will always be strong incentive for under-reporting by units that grow fast, leading to evasion of other taxes as well.

The plea for expanding the ambit of excise exemption by raising the level of clearances for qualifying for the benefit, as often put forward to enable the SSIs to grow, ignores the fact that 'small scale' is not a homogenous sector. A high ceiling puts the tiny village and cottage industries at a disadvantage whereas it is the latter that are most labour-intensive. There can therefore be a case for assisting the tiny and cottage units only. However, what these units need most is institutional credit on reasonable terms, raw material at reasonable prices, and market access. In the absence of help in this regard, tax concessions go more to the benefit of those who supply capital to village producers and in many industries with products which are sold at high prices, a sizeable chunk of the benefits may be appropriated by traders/middlemen. It is worth recalling what the Dandekar Committee said in the context. To quote: "These (village and cottage) industries being unorganised are at present in the clutches of merchant capital. Unless this is replaced by a non exploitative institutional infrastructure, the policy to protect and promote employment in the industries, while it may promote low productivity and low paid employment, also helps perpetuate exploitation by merchant capital through the trader-money-lender nexus it creates." Sad to say, the situation does not seem to have changed materially even after twenty-five years since these observations were made. Nothing brings this home more poignantly than the suicides by farmers because of their debt burden to village money lenders.

IV. Conclusion and Recommendations

The negative consequences of protection and exemption based on specified levels of production clearly outweigh the points advanced in their favour. Clearly, the policy of protection has outlived its utility. It is worth noting that the case for protection through tax concession put forward in policy documents in the past invariably mentioned that such protection should be given only for a limited period. Mahalanobis, the intellectual father of the Second Five Year Plan that assigned a special role for the small scale sector, had advocated a 'transition phase' in which preference would be given to the so called 'small-scale and household industries' and visualised the need for such preference to decrease over time. It was envisaged that eventually "a gradual and steady change-over would be made to move to efficient forms of production by the increasing use of machinery driven by power."[27] It is a pity that the 'transition' has not ended even after fifty years.

The arguments for extension of small scale exemption and expansion of their ambit periodically emanate mostly from the lobby of what may be called the "modern small scale industry". These are the industries that are most dynamic. The main advantage in this case is the low wages they pay and gains from operating in the unorganised sector. The dynamism now displayed by them owes more to dereservation than to tax concessions. Hence, as the Mid Term Appraisal of the Tenth Plan emphasises, dereservation should be accelerated and this seems to be happening. Excise concessions under these circumstances are redundant.

Indeed it is time the policy for protection to SSIs through reservation and tax concessions was ended. For administrative reasons alone, tiny and village units may be kept out of the purview of excise taxation. This can be secured by granting exemption to units with clearances of no more than Rs. 50 lakh. To elaborate, units with clearances of upto Rs. 50 lakh in the previous year would continue to be exempt in the current year. In the eventuality of exceeding Rs. 50 lakh in clearances in the current year, tax would become payable on all clearances beyond Rs. 50 lakh. In subsequent years, such a dealer would become a regular tax-paying dealer.[28] All other units should be fully taxed with the benefit of credit for tax paid on inputs. It may be pointed out that as per the Third SSI census, the proportion of units with turnover more than Rs. 50 lakh is a mere 3.6 percent of registered SSI units and only 0.08 percent of unregistered SSI units. They account for over 78 percent of output and only 22 percent of employment in the registered SSI sector. In unregistered SSI sector, this segment accounts for 0.4 percent of total employment and 22 percent of gross output. Clearly, the bulk of the small and tiny units within this sector would be left completely unaffected by the proposed threshold, thereby also protecting the employment generation in the sector.

The limit of Rs. 50 lakh should be applied with no exemptions or exclusions from the base. This would be in sharp contrast to the provisions at present, whereby, in computing Rs. 1 crore for exemption in the current year or Rs. 4 crore in the previous year for eligibility, a number of exclusions are allowed.[29] Lowering the threshold to Rs. 50 lakh is being proposed to keep the focus firmly on the size of the unit and not on the nature of transactions undertaken/goods produced.

It may be pointed out that this recommendation accords also with that of the *Kelkar Task Force on Indirect Taxation (2002)* on reducing the level of excise exemption. It is also pertinent to note that all dealers (including village producers) having turnover of more than Rs. 10 lakh a year are liable to pay VAT in their respective states.[30] With a turnover of Rs. 50 lakh, any given unit is expected to generate value added to the tune of Rs. 17 lakh,[31] of which net income should easily cross Rs. 1 lakh. Since the income tax threshold for exemption is currently Rs. 1 lakh, there is a consonance with the proposed threshold in excise.

Two further arguments for such a radical departure from the existing provisions are:

(i.) The present regime creates a complicated set of provisions, with exemptions within exclusions, providing scope and incentive for considerable efforts on tax planning alone, besides complexity in tax administration.

(ii.) The CenVAT tax credit mechanism allows credit for input taxes and thereby eliminates the need for providing specific exemptions, more so in the case of units producing intermediate goods. With provisions for availing credit not only for CenVAT but also for service tax, we now have a timely window of opportunity to clean up the jungle of elaborate provisions to ease the tax burden on specific sets of producers. All such initiatives were undertaken during the pre-CenVAT regime with cascading taxes.

Measures to help the SSI sector should focus on promotional measures, particularly making institutional credit available on reasonable terms. The recent initiative to have credit rating for SMEs, to enable them to have access to formal sector credit is thus to be welcomed. 'Micro-finance' seems to have transformed the rural development scene in Bangladesh dramatically. There is need to explore the scope of micro-finance in India, too. Further, rather than emphasising the dichotomy between the small and large scale sectors, it would be worthwhile to promote the synergies and interdependence between the two sectors, through, *inter alia*, higher downstream integration. Our policy should strengthen such initiatives to facilitate the small scale sector rather than continue with the irrational and harmful practice of providing tax breaks.

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Endnotes

[1] An incisive critique of the policy is provided in a working paper of the Centre for Development Economics, Delhi School of Economics, published in 1997 ("Policy on Modern Small Scale Industries: A Case of Government Failure") by Suresh Tendulkar and T.A. Bhavani. A paper written for a conference in Helsinki, by Dipak Mazumdar in 1988 articulated a scathing criticism of India's small scale policy. ("Import Substituting Industrialisation: The Indian Experience in the Textile Industry", EDI Word Bank). A more recent critique is contained in an NCAER publication of 2001 (*Small Scale Industry Policy in India: A Critical Evaluation)* by Rakesh Mohan.

[2] *The Committee on Tax Measures to Promote Employment* (or Dandekar Committee) of 1980 was particularly critical about several aspects of the protection policy for the small scale sector. Other committees that took a look at their tax treatment of SSIs are the *Committee on Indirect Taxation of 1976* headed by L.K. Jha, the Nayak Committee (1992), Abid Hussain Committee (1997) and the S.P. Gupta Committee (2001), to name the notable ones. Only the S.P. Gupta Committee seemed to be in favour of continuing and even widening the scope of tax concessions.

[3] The removal of QRs implied that goods reserved for SSI could be imported into the country but not produced by domestic large scale units.

[4] As of March 2005, 506 items continue to be on the reserved list. The Union Budget for 2006-07 announced some further pruning of this list – 180 items have been identified for dereservation.

[5] The Dandekar Committee had attempted to quantify the revenue cost of concessions to the small scale sector in textiles, and a few other products *viz*., matches, leather, soap and agricultural machinery. These estimates are now dated. Besides, no global or overall estimate of the revenue cost was attempted.

[6] 'Textiles' are left out of the purview of this paper as they fall under a separate excise regime and are not incorporated under SSI exemption scheme.

[7] The history recounted here is based partly on the *Report of the Dandekar Committee* and also information available on SIDO online.

[8] Formulated in notification nos. 8 /2003 & 9/2003 – CE as amended in 2004 and 2005.

[9] Under notification no. 167/86-CenVAT.

[10] These exemptions are provided under notification no. 88/88 as amended from time to time.

[11] Paucity of data on SSIs has been a subject of persistent complaint by analysts and almost all official panels. To quote the *Dandekar Committee Report* of 1980, "The costs and benefits of prevailing differential excise duties and direct assistance through sale rebates and interest subsidies given to the labour-intensive sector have not been systematically examined. Unfortunately, relevant data are also wanting. We would like to underscore the paucity of even basic information relevant for decision-making in the first instance and its evaluation

subsequently. How serious this lacuna is can be judged by reading our studies of a few selected industries." (para 8.28) Data availability does not seem to have improved much since then, as may be seen from the Report of the *Abid Hussain Committee* and the *Study by Rakesh Mohan (op. cit.)*.

[12] *Vide* Report of the *Study Group on Development of Small Scale Industries*, Planning Commission, 2001.

[13] This is the definition used in the SSI policy documents.

[14] ref.: table 57, *Handbook of Industrial Policy and Statistics*, 2002, Ministry of Commerce and Industry, Government of India.

[15] This is derived from the 1999-2000 sample survey for small scale industries. Similar figures are not available for the third census. (ref.: table 42, *Handbook of Industrial Policy and Statistics*, 2002, Ministry of Commerce and Industry, Government of India.)

[16] The report provides information on production as well as exports for the top 200 commodities/ activities. These cover 54 percent of total production of the sampled firms and 88 percent of total exports. This data is used to derive the decomposition discussed above. It is assumed that the decomposition within the top 200 commodities/activities would apply to the entire sector as well. http://www.smallindustryindia.com/publications/books/fcensus.htm

[17] A similar figure is reported in table 54 in *Handbook of Industrial Policy and Statistics, 2002*.

[18] *Abid Hussain Committee Report* (1997) identifies the problems with the various data sources on SSI units. In particular, it is highlighted that the SIDO census has an incomplete coverage.

[19] http://www.smallindustryindia.com/ssiindia/statistics/economic.htm

[20] The statement of "Tax Expenditures under the Central Tax System" presented by the Finance Minister, as a part of the Union Budget 2006-07, provides an estimate of Rs. 12,560 crore based on an earlier version of this paper. The figures presented here are revised numbers taking into account more recent GDP numbers.

[21] Tendulkar and Bhavani, ibid.

[22] 'DME' stands for Directory Manufacturing Establishments which had six employees of whom at least one was hired. 'NDME' stands for Non-Directory Manufacturing Establishments which had five or less employees of whom at least one was hired. 'OAE' stands for Own-Account Enterprises.

[23] Rakesh Mohan ibid., p.95

[24] Report of the *Task Force to Explore Options other than Price Control for Achieving the Objective of Making Available Life-saving Drugs at Reasonable Prices*, September 20, 2005.

[25] The change from excise based on ex-factory price to that based on 60 percent of MRP was effected through a notification of January 7, 2005.

[26] In the absence of such a regulator or auditor — and it would be unrealistic to except such monitoring to be effective over small units across the country — encouraging small scale units to come up in drugs is likely to lead to proliferation

of substandard drugs which many a time results from procurement by state agencies from local small scale units. This apprehension is articulated in an editorial in the Business Standard of September 23, 2005 in following words: "The Indian public machinery simply does not have the competence to manage a price control-cum-procurement system which will bring down drug prices even further, particularly when there is a need to stay away from substandard drugs."

[27] Quoted in Tendulkar and Bhavani, *op cit.* Dandekar Committee also had said, "It is generally recognised that enhancing employment by adoption of labour intensive technology can only be a temporary and transitional solution to the problem of unemployment ." (para 8.22)

[28] Reverting from tax paying to an exempt status can be allowed if clearances in two consecutive years fall short of Rs. 50 lakh.

[29] Exemptions so allowed include value of exports, ineligible branded output, and exempt items.

[30] Since state VAT allows for some deductions in computing the limit of Rs. 10 lakh, a higher threshold without such deductions should be acceptable. It may be noted that some states require manufacturers to register and pay VAT irrespective of turnover.

[31] As mentioned earlier, the second small scale census and the survey in 1999-2000 estimate the average ratio of value addition to value of output at 35 percent for this sector.