

**Memorandum
For
Union Budget 2008-09**

**To
Hon'ble Minister of Finance
Government of India**

**From
Federation of Indian Micro and Small & Medium Enterprises
(FISME)**

B-4/161, Safdarjung Enclave, New Delhi-110029

info@fisme.org.in

<http://www.fisme.org.in>

FISME's Memorandum for Union Budget 2008-09

1. Background on Indian SMEs: How is the sector doing

1.1 In the Memorandum submitted to you last year, we highlighted the high growth the SME sector was undergoing. The major drivers of growth for the sector have been the boom in housing sector, infrastructure and exports. A very large number of SMEs in sectors such as Engineering, Electricals, Plastics, Building hardware, Home Furnishing, Paints, Furniture, Industrial consumables among others grew rapidly. Exports of Auto components and Textile and garments did very well too.

1.2 The tide has turned in current fiscal year though. Rise in interest rates, appreciation of rupee and sobering of consumer demand have the combined pairing impact on SME growth. Rise in interest rates have retarded the housing sector; rupee rise has blunted exports and high inflation has reduced consumer demand. Though it will take at least 12-18 months for the combined impact of these factors on industrial production to become fully apparent, some early disturbing signs are already on horizon. **Industrial output is down to 9.7 percent between April and October compared with 10.1 percent in the same period.** Though Exports during April-October rose by 20.9 per cent in dollar terms to \$85.58 billion (Rs. 3,47,793.90 crore), **export performance of most of SME intensive sectors have been disappointing.** During the period **Textile exports fell by 22 per cent, handicrafts by 66 per cent, leather by 9 per cent and marine products almost by 20 per cent.**

1.3 Though there is no denying the fact that large number of exporting SMEs have been hit by rising rupee. FISME's analysis is that the impact has not been same across sectors. Further, we also feel that amidst the high decibel pitch for quick fix measures for export support, larger question of impact of the twin factors of rupee and interest rise on competitiveness of domestic industry serving the local market has attracted little attention.

2. Expectation from Union Budget 2008-09

2.1 The emerging challenge for the domestic industry, especially SMEs, is sustaining competitiveness against the new odds of rise of Rupee, impact of which has been like reduction in import duty, and higher interest rates which has further increased the cost of production. Addition of these two new factors define the tipping-point for SMEs who have been reeling under pressure from rising cost of production because of skewed supply and demand of skilled labour and access to competitively priced public services- infrastructure, finance, electricity among others.

2.2 FISME does not believe that sustainable competitiveness could be achieved only by provisioning of artificial measures. New age financial instruments like currency hedging and SWAPs are also short term measures. In medium and long term, competitiveness could only be ensured by increasing productivity and reducing transaction costs in economy. Based on feedback and FISME's analysis, the following comments form the core of our expectations and suggestions.

3. Suggestions:

3.1 Credit linked capital subsidy scheme (CLCSS)

Since the process of liberalization started in 1991, leading to complete removal the QRs and de-reservation of bulk of sector, CLCSS has been the ONLY scheme that aimed to address SMEs' need of technological up gradation, however marginally. It has been a targeted subsidy. It took some time for the delivery norms to be formalized and scheme popularized but has since been lapped up by the sector. There are two issues:

- a. The scheme has come to an abrupt end on 31st March 2007. Due to reasons best known to the Planning Commission, it has not found the favour in absence of large scale lobbying as in case of TUF scheme.

- b. The fate of hundreds of units is in lurch whose cases have been cleared under CLCSS by SIDBI/ DCMSME, loans disbursed and investments made based on promise of subsidy support. When the Finance Minister of the country announces a scheme, many SMEs do believe him and based on his promise make investment decisions. How would you react to more than 1000 cases where SIDBI signed agreement with SMEs under CLCSC, appraised projects and sanctioned loans also. Now the SIDBI/ MoMSME says that they do not have any money left under the scheme! The implementation of the scheme has been seriously botched up and undermined credibility of policy makers.

Suggestion: FISME strongly recommends continuance of CLCS scheme and clearing of the backlog of cases already approved by ensuring adequate re-allocation of funds. It would be hugely disappointing for the sector if the scheme is allowed to be lapsed.

3.2 Access to Finance

It is not amusing to raise the issue of SMEs' access to finance again and again. The issue has become staple food for budget agenda of SME associations. FISME always stood for market based solution to the problems, which are not only efficient but also sustainable. It has always looked at initiative of directed lending with skepticism and suspicion. The priority sector lending (PSL) to small scale is no exception.

- a. **Need for newer and better instruments for augmenting flow of funds to SMEs than Priority Sector lending**

With 85% of SME sector not having access to any form of institutional funds and percentage of SME lending, as the total percentage of lending banks, falling consistently for over the decade in spite of all kinds of public pressure, PSL has proved to be a policy which has achieved neither outreach nor impact.

Suggestions:

- i. **There is an urgent need to revisit the whole premise of Priority Sector Lending.**
- ii. **We feel the way forward is through intensifying competition among banks buttressed by suitable fiscal incentives, effecting financial sector reforms to reduce entry barriers and inducing better 'code of conduct' in banks for service.**
- iii. **New financial instruments need to be encouraged for SMEs to reduce their sole reliance of debt finance particularly factoring (with/ without recourse) and private equity. Both are hindered at the moment due to want of necessary legislative and policy changes and institutional gaps. A high level working group including States and RBI, needs to be constituted to thrash out details of legislative and policy hurdles in way of Factoring. States should be made part of the group as in many states, it is the high stamp duty that makes factoring unviable or risky.**

b. BASEL-II and Third Party Rating

Recent RBI guidelines on capital adequacy issued on 27th April' 07, call for third party rating through seven accredited agencies for exposure above Rs. 5 Cr. Firstly, mandatory third party rating may crowd out many smaller units acting yet another barrier which they will have to overcome to access bank credit. Secondly, there is the question of rating agencies themselves. Currently, there is no regulation on the rating companies, their methodology of rating, fee structure etc. Our early feed back from ground is that none of them have contextualized their rating systems for SMEs. Their rating methodology is largely 'cut & paste' of models they employ for large

corporate. Then there is question of transaction cost. They quote fee on 'case to case' basis. With millions of units as their captive clients thanks to RBI guidance, their services smack of typical monopolies. For an SME having loans of Rs. 5 Cr, the fee could be well in range of Rs. 3 lac per annum!

Suggestions:

- i. Regulate the Rating Companies, their methodologies and fee structure**
- ii. Get the risk of different SME segment studied and assign risk weightage only after through investigation.**
- iii. Encourage more Rating Companies including those promoted by SMEs collectively to reduce cost and increase outreach within the RBI / SEBI guidelines.**

3.3 Delisting norms for SMEs

Because of very high cost of compliance not commensurate with SME size, a significant number SMEs are struggling to get themselves de-listed from bourses. These companies are essentially closely held ones and seldom do their shares trade. The problem is well appreciated and is in public domain for quite some time. However, in absence of clear guidelines, the situation has only gotten worse. On one hand the bourses keep pressurizing the companies for compliance and keep threatening them of black listing and of imposing penalties, on the other hand, on one pretext or another, they refuse to de-list the companies who are willing to get themselves de-listed.

While the smaller companies are suffering, neither the SEBI nor Ministry of Company Affairs, is ready to take a call. The stock exchanges are obviously not very interested in allowing companies to get de-listed as it will affect their bottom-line.

Suggestion:

As Ministry of Corporate Affairs and SEBI have communicated to us that the matter is in the domain of Department of Economic Affairs, Ministry of Finance. Therefore, a committee may kindly be constituted with stakeholder participation and a set of guidelines may be prepared for delisting of the companies while ensuring interests of investors.

3.4 Direct Taxes

It is heartening that government is considering revisiting the income tax code. From the perspective of SMEs, we have the following suggestions:

a. Incentivising informal to become formal:

In spite of an option of becoming 'Company'- a superior form of legal entity, more than 93% of SMEs chose to remain proprietorship or partnerships primarily because of two reasons: complexities and high cost of compliance of Companies Act. Secondly, because of prospect of higher slab of Income Tax once they change from prop/partnership to company. Now that a number of steps to minimize compliance cost for SMEs under Companies Act are already underway, addressing the impediment of taxation would be very helpful.

Suggestion:

Graded Taxation for companies may also be introduced on the basis of slabs of Income. It would facilitate transition of informal SMEs to become companies and improve their ability to access capital.

b. TDS

Suggestion:

For SMEs deductions may be allowed to be carried forward from year to year. Secondly, as the quantum of taxation is very low in

case of SMEs a provision could be made for submitting annual return in lieu of monthly return.

c. Fringe Benefit Tax (FBT)

FBT continues to be a major irritant for SMEs and is proving too much of a burden.

Suggestion:

Micro and Small Enterprises may considered to be exempted from FBT.

3.5 Indirect taxes

i. Due diligence in effecting changes in import duty structure during budget or RTAs

Every time there is an initiation of trade negotiation, SMEs have sleepless nights. The reason is that, in contrast to multilateral agreements, bilateral or regional trade agreements invariably leave a trail of inverted tariff in large number of items. While products of large corporates, even of they are raw materials, find way to 'Sensitive Lists' on the other hand, owing to weak advocacy capabilities, SMEs suffer as their final produce attract lower duties and their raw materials higher duties, producing '**Reverse Tariff Escalation**'. Similar problems arise while the ad-hoc changes in import duty regime are effected during budget. The experience bears out that this scenario is particularly true for four major raw material categories- building blocks of down stream SMEs i.e. Iron and Steel; Copper; Aluminium and Plastic resins.

Suggestion:

FISME under UNCTAD India project (DFID sponsored) has created a unique software tool to detect inverted duties with changes in duty structure of inputs. Fully functional, the tool is accessible free of cost on line. (details appended).

The due diligence exercise, prior checking of possibility of inverted duties for other products with changes in import duty structure, should be made mandatory. The free software FISME developed could be effectively used saving SMEs and other down-stream industries of unnecessary hardships.

b. CST, VAT and GST

- i. The continuance of CST at 3% remains a big deterrent in making India a single market.

Suggestion:

- i. **We urge once again that its reduction is hastened towards '0'% against Form C or may be 0.5% (with adequate compensation to states).**
- ii. **However, a solution needs to be found of an anomaly Urgently that such a change is giving rise to when a supplier in a state sells to entities which cannot charge VAT (e.g. Utilities of Electricity, Water; Municipalities, State Corporations etc).**
- ii. **Deviation of rates in VAT among different states is further disintegrating the country economically. It is increasingly becoming a mess as incumbent governments in states are using VAT as a tool to extract political gains. Through carrot or stick, the Central government needs to put an end to the mess.**
- **Similarly, a unified decision is necessary to be taken on issue of Entry Tax and states should be asked to subsume it with VAT.**

- **Implementation of GST** will be the mother of all reforms undertaken in independent India. The D-day for GST needs to be preponed.

c. Excise and Service Tax

i. Urgent Need to Revisit Excise Exemptions

FISME has consistently raised the issue that the grant of direct and indirect tax exemptions by the Union Ministry of Finance to Himachal and Uttarakhand have created an unfair cost advantage for the new and existing manufacturing units in the two states and has adversely affected the competitiveness of industries-particularly SMEs of other states. Unlike large industries, which are closing/ scaling down their plants in other states and relocating (e.g. Bajaj Auto) to take advantage of incentives thus lowering their cost of production, SMEs are embedded in local socio-economic milieu and cannot relocate. Many existing industrial units in the neighbouring states, particularly in Uttar Pradesh, Haryana and Punjab are compelled either to shift their manufacturing bases in these two states or face slow down and eventual closure.

What pains us is that Union Govt did not get the matter examined through independent agencies as to what would be the likely impact of concessions on those not entitled and did not invite objections if any of those likely to be adversely affected by any such measure of the Government. All the three most important high-powered groups set-up by government of India to study and to suggest reforms in direct and indirect taxes namely- Dr. Challiah's, Dr. Kelkar's and Mr. Patrthasarthy's, have unanimously upheld that location based tax concessions produce

distortionary impact on the economy as a whole and are unsustainable in long run and therefore be avoided.

Suggestion:

Revisit the scheme of exemption and suspend it forthwith in view of distortions it has already created and the revenue losses because of the scheme are bound to exceed of earlier projections due to misuses. (One such case is quoted below)

ii. Misuse of Excise Exemptions by Corporates Drive SMEs to Closure in Aluminum Conductors

The instant case is potent example how the excise exemptions can play havoc with industries. A new opportunity for undue enrichment has been unearthed by some large aluminum conductor manufacturing companies by combining the loopholes in the area exemption schemes for Himachal and Uttaranchal and duty free import provisions in Foreign Trade Policy. These companies- with large turnovers ranging from Rs 500 cr. to Rs 800 cr, have multi-location plants in exempted areas of Himachal/ Uttaranchal as well as in other parts of India.

The modus operandi is simple. First their units in non-exempted areas acquire duty free advance licences for import of inputs against physical/deemed exports made/to be made using domestic raw material. Then the duty free raw material is passed on to their units located in exempted areas. Finally the units in exempted areas produce goods for domestic sales and clear them without paying any duty under exemption scheme.

In the normal course the duty amount was payable at least once, i.e. while purchasing the inputs and thus formed part of the cost to the unit and revenue gain to the Government. However in the

present case neither the duty free imported inputs suffered any ad valorem duty payment nor the Excise Duty levied on finished goods.

Thus the companies corner an undue advantage of around 16.5% (equivalent to duty saved). In an industry where there are 500 number of SME producers and where working margins range from 2~5%, the unfair advantage of 16.5% is sufficient for these companies to destroy competition as part of the ill-gotten largesse is passed on to buyers in domestic markets winning large contracts. The incidents came to light when large number of SMEs discovered that some companies are quoting prices well below even the landed cost of raw material and cornering contracts in India.

The Government of India is also a big loser in this game. When the Central Excise concession was granted in Uttaranchal and Himachal Pradesh, it was assumed that the loss to the exchequer would be to the extent of Excise Duty foregone on the Value Added component only. In the above cases the actual loss would be equal to the entire Excise Duty component which is many times more than the envisaged amounts

The loophole has the potential to snowball into a major leak for the revenue when manufacturers of automobiles and other products having multiple units including in the Excise exempt areas, also start utilizing the current provisions

Suggestion:

The loophole needs to be plugged immediately- by restricting the provision 4.5 of Chapter IV in the Foreign Trade Policy by excluding transfers of such duty free advance licences or goods imported against the said licences, to any unit of the company situated in the Excise Duty exempted area.

- iii. **In run up to GST, the Government should seriously consider reducing the excise duty from 16% to the level of services @ 12% to bring about a parity between goods and services.**
- iv. The role of standards is rising enormously in trade. Latest OECD figures state that more than 80% world trade is affected by International Standards. Compliance to standards for increased market access is critical for Small enterprises. To bring the entry cost at affordable level Government can at least decide **'not to tax' fee for acquiring standards i.e. exemption from service tax.**

4. Other Important issues: Pending Reforms for Development and Growth of SMEs

Over the years, the Union Budget has evolved into opportunity for the Government to convey the reform intent for the following year. To take advantage of the opportunity, FISME would like to flag key pending issues relevant to SMEs:

4.1 Labour Laws:

a. Threshold of Exemption from Labour laws

There is a ground swell for exemption from labour laws (except Minimum Wages) to SMEs employing up to 100 employees. The threshold limit would assist the smaller segment of SMEs greatly allowing them to concentrate on their core functions.

b. Adoption of Rational Criteria for Minimum Wages

Many states follow a **flawed mechanism of determining Minimum Wages based on sectors in which a worker is employed**. Therefore, a worker in Engineering sector is entitled to a different rate than the one in food processing sector. Nationally let there be a consensus on the issue that the minimum wages will be based on rational economic criteria.

c. Market based alternative to hugely inefficient ESI and EPF

The government should provide an **option to SMEs for using market based schemes for ESI and PF**. After contribution to the scheme, the employer should be free of keeping records and unnecessary bureaucratic formalities. ESI in particular is one of the most useless scheme where huge contribution goes wasted in dilapidated ESI infrastructure that nobody uses. A beginning could be made by allowing SMEs to exercise that choice.

4.2 Accordance of Supreme Priority to Seamless Movement of Goods Across the Country

Movement of goods in India is marred with obstacles of all kind: multiplicity of laws, taxation and competing jurisdictions. The Regulatory regime applicable on the movement of goods has become a complex maze. There are restrictions that are specific to commodities (Essential, Hazardous, Adulterated, Licensed, Forest, Endangered Species, Others); Fiscal Related (Customs, Excise, Sales Tax, Octroi, Entry Tax, Toll) and Location Specific (National Borders, State Borders, District Borders, Municipal Limits, Law & Order, Bridges, Others)

National Highways are meaningless when they could be held to ransom by local and regional authorities of all hues under petty pretexts. Movement of goods ought to be accorded supreme priority. **There is an**

urgency to form a high level committee, to ensure seamless movement of goods across states.

4.3 Modern Insolvency and Bankruptcy Codes

SMEs are exposed to unlimited risk even in corporate type of entity (Companies) due to personal guarantees. Not only there is no option of honourable exit after failure for them but there is a sword of jail hanging over them under host of antiquated regulations. There is an urgent need for putting in place the modern bankruptcy and insolvency codes reflecting the needs of ruthless competitive markets and uncertainties in globalization.

Enclosure: Online Tool for detection of Inverted Tariff

Web based tool to calculate Effective Rate of Protection and instances of inverted tariff

It is obvious that due care is needed in preparing the Sensitive lists and selective tinkering with external tariff regime. However, production mechanisms are increasingly becoming complex. The number of inputs required to produce a final product could be many, each having different rates of tariff and different weightings. Further, consumption of different inputs in the production process may also vary, depends on the efficiency of the producer. In spite of adequate these ex ante studies, there are many products competitiveness of which could be affected because of changes in tariff structure of their inputs. Given the complexities involved, it becomes difficult for SMEs to argue on a scientific basis that their outputs are facing negative rates of effective protection. Also, trade negotiators and policy makers may not have the analytical tools to identify specific products, which might face negative protection as a result of changes in customs tariff.

To address the issue, under a development project³², Indian tariff lines on harmonized systems were matched with Standard Input-Output Norms (SION) database and current customs duty rates were fed. Upon selecting a product (HS database), the web-based tool asks for selection of best match from a drop down menu (SION database). Upon selection, the tool enlists the final product, related inputs, duties on each on MFN and asks for percentage of inputs from the user. Once the tool captures the percentages, it provides the answers to two questions:

- Whether the final product at the given rate of duties (of output and inputs) suffers from negative rate of protection
- How much is the Effective Rate of Protection

Theoretically, it employs simple economic calculation but in the hands of users (SMEs) and the trade negotiators it has been found to be a very helpful tool. The value lies in its in built flexibility. Firstly, the users could change the percentages of inputs for the same output (as use of inputs differs on the management and employment of inputs). Secondly, while the users test their different combination of input use, the backend of the software builds the database of average use of inputs for product categories. Thirdly, the users can change the duties and look at various scenarios: what if the duty becomes zero on my input 'x' or 'y'.

Further value is added by integrating the tariff schedule of different RTAs India has signed so far. It also provides a facility to compare rates of effective protection in partner countries of those RTAs. This can be used as a tool for assessing the impact on domestic producers of different scenarios of tariff reduction in RTA negotiations.

The tool can be accessed from
<http://www.smenetwork.net/tariff/home.aspx>
or
<http://www.smeindia.net>

How to use the Web-based Mechanism

You will need to input or confirm the following information:

1. The description of product or relevant ITC-HS code
2. New duty rates applicable on this product (optional)
3. The description of your inputs (or relevant ITC-HS code)
4. The percentage of value of each input in value of total inputs

Steps:

Step 1: Browse <http://www.smenetwork.net/tariff/home.aspx> and enter finished product.

Step 2: Click on the button 'Search' and identify precise product name as per either ITC (HS) or SION Code.

Step 3: If exact ITC (HS)/ SION Code is not found then select nearest ITC (HS)/SION Code from the drop down box.

Step 4: If you know the ITC (HS) code you can directly search your product description by clicking on the button 'Search/Change ITC (HS) Code'. A new window opens up where you can select your product. Then select the corresponding SION code. If exact SION Code is not found then select nearest SION Code from the drop down box.

Step 5: Click on the button 'Get Input Details' for identifying the input norms (SION).

Step 6: Follow instructions on the Input grid that shows up.

Step 7: Click on the button 'Submit'

