Financial Express

Budget Expectations

Focus on distortions

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As another Budget day draws close amidst rising concerns of a slowdown in economic growth, the prospects for MSMEs look challenging in the short term. High inflation, particularly food inflation, pressures MSME bottomlines, as labour costs have to be adjusted immediately. Further, rising interest rates impact demand in price-sensitive sectors such as housing, construction, auto components and white goods. The top line of a very large segment of MSMEs that cater to these sectoral supply chains would also be affected.

The expectations of MSMEs from the Union Budget, therefore, constitute a mix of initiatives that would address both the short- and medium-term challenges. For the short term, initiatives could focus on helping SMEs access a greater pie of the domestic market, leaving a little more cash in their hands and reducing some irritants in taxation; and the medium-term measures could address the perpetual problem of access to funds, by looking beyond the existing banking structure.

Conceptually, we should agree on the principle that the regime of indirect taxes should be devoid of distortions/exemptions---particularly location-based ones--for their economy-wide cascading effects. Wherever necessary, the regime of direct taxes could be leveraged for achieving policy objectives.

On this count, from the MSME perspective, tax breaks could be based on the ratio of employment generation rather than on the capital invested. This will help MSMEs in capital formation. Currently MSMEs are unable to claim depreciation benefits in the absence of large investments in capital assets.

Further, to encourage capital accumulation among MSMEs, profits ploughed back by them into the business may be exempted from income tax. The move will greatly help improve the quality of their balance sheets and help raise funds from banks. Also, the income tax structure for MSMEs could be graded to encourage them to adopt limited liability partnership (LLP) or company formats.

As for LLP, there is an urgent need to remove the restrictions and preconditions for conversion. The Union Budget 2009-10 exempted conversion of an enterprise into LLP from capital gains tax. However, the exemption was based on certain ‘conditions’, namely a turnover cap of Rs 60 lakh; restrictions on shareholding patterns and the like.

The conditions have proved too restrictive for MSMEs to consider a conversion to LLP. Conversion of proprietorship/ partnership firms into LLPs should be considerably liberalised and be encouraged through positive incentives.

A very important intervention is needed in central sales tax. Introduction of GST is facing resistance from the states mainly on perceived dilution of their fiscal autonomy. Pending consensus on uniform tax-rates and constitutional amendments, a ‘modified GST’ may be adopted through the following measures, which will aid transition to a GST regime.

In the case of inter-state sales, the rate of CST is to be fixed at zero and inter state GST (IGST) levied at CGST rates + state GST rates applicable in the destination state. The SGST revenue will obviously belong to the destination state. The net effect will be that a purchaser of goods can claim input tax credit (ITC) even if he buys the goods from another state. A way also needs to be found for the introduction of GST even if a few states stay away initially.

If these cannot be implemented immediately for any reason, an important amendment in the CST Act may be brought in alongside the next Union Budget to withdraw the status of “registered dealer” from utilities and all such service providers who do not have to collect sales tax on their produce. Consequently the facility of “C” form and the concessional rate of CST will stand withdrawn from such firms.

Such an amendment will remove a serious anomaly in the system, due to which these service providers prefer to buy goods from suppliers situated outside their own state, by paying a 2% CST as against state VAT that varies from 4 to 12.5%.

For enabling access to funds, the need for large SME-dedicated banks, NBFCs, institutional mechanism for raising risk capital and SME exchanges has been debated for decades. But MSME associations are increasingly getting wary of the Reserve Bank of India. And in tandem with the opinion of several past RBI governors who raised similar concerns, a separate regulator for banks to induce customer-orientation is required.

It is strongly being felt that RBI is too occupied with the macro management of the economy. It is said that decision-making processes at banks with regard to pricing continues to be non-transparent, services discretionary and the grievance redressal mechanism largely defunct.

A separate dedicated banking regulator can bring in more transparency and reduce discretion in granting facilities and favourable terms/prices.The authority will also provide an effective redressal mechanism that MSME borrowers—not having the benefit of relationship at the top level in banks—need desperately.

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