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Manufacturing Centric Fiscal Policy

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Manufacturing sector has significant fiscal policy implications. Most of indirect taxes, such as customs and excise duties and corporate income tax originate from manufacturing sector. While the expenditure implications are not that significant but both tax and transfers (including tax expenditure) proposed in Budget are manufacturing centric and aim at either accelerating investment or making the products more affordable and competitive.

2. Sustained higher growth of GDP critically depends on manufacturing and many of services are also manufacturing dependant. It is in view of this the New Manufacturing Policy (NMP) proposed to raise the share of manufacturing in GDP to 25 per cent and create 100 million additional jobs in this sector by 2022.

3. Manufacturing sector has, however, been under stress in last few years and has witnessed a moderate growth. There has also been lesser investment and incremental job creation compared to what was envisaged in NMP. The Index of Industrial Production, which proxies the manufacturing growth as a lead indicator clearly shows subdued performance for 13 quarters (Table 1). This subdued performance could largely be attributed to low/negative growth of consumer durables, industrial intermediates and capital goods, suggesting sluggishness in both investment and domestic demand.

Table 1: Quarterly Growth of Index of Industrial Production (IIP) for Broad Groups (per cent)

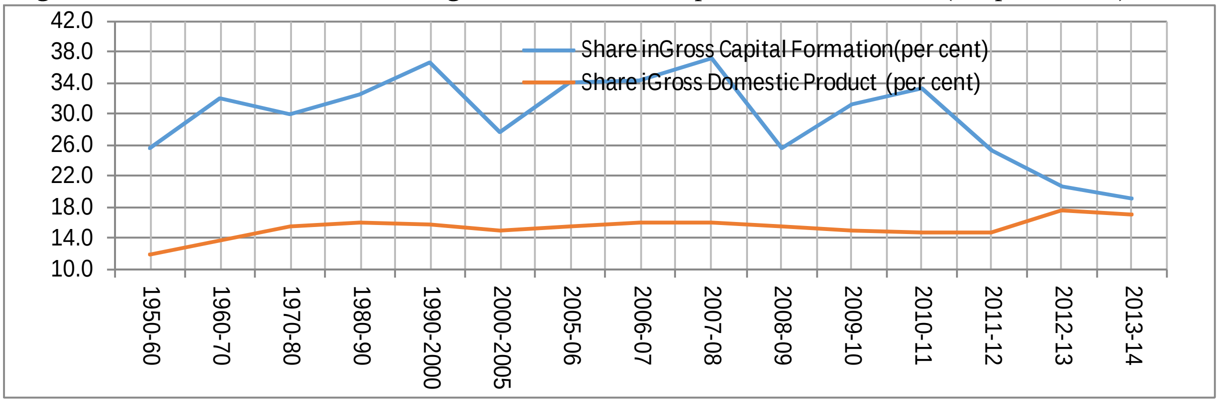
Year		Basic Goods	Capital Goods	Inter-mediate Goods	Consumer Durables	Consumer Non-Durable	Over All IIP	Manufacturing
2011-12	Q1	7.47	17.19	1.85	2.74	5.97	6.98	7.72
	Q2	7.00	-5.41	-0.84	7.82	2.03	3.18	3.36
	Q3	4.39	-15.71	-2.86	5.04	9.75	1.24	1.16
	Q4	3.55	-4.11	-0.50	-4.19	5.30	0.80	0.54
2012-13	Q1	3.30	-19.26	0.84	8.06	0.58	-0.26	-0.80
	Q2	2.23	-7.85	1.48	0.10	2.68	0.42	0.27
	Q3	2.55	-0.87	2.68	3.24	3.06	2.28	2.79
	Q4	1.73	5.39	1.62	-2.73	5.06	2.19	3.04
2013-14	Q1	-0.23	-3.53	1.62	-12.66	7.08	-0.97	-1.04
	Q2	2.87	2.46	3.80	-9.50	8.26	1.90	1.40
	Q3	1.76	0.05	3.87	-16.69	2.28	-0.79	-1.66
	Q4	3.95	-10.99	3.17	-10.00	2.50	-0.45	-1.64
2014-15	Q1	8.74	13.61	3.07	-9.12	1.49	4.54	3.94
	Q2	7.03	-0.23	1.62	-15.50	2.30	1.33	0.43
	Q3	5.16	2.52	0.35	-19.54	2.87	0.48	-0.74

Source- Ministry of Statistics & Programme Implementation

4. Moderate growth of manufacturing has in fact persisted for a longer period. The share of manufacturing in GDP has nearly stagnated has remained in 14-18 per cent range for nearly 40 years now indicating that at best over a longer period, the rate of growth of manufacturing has remained aligned to the overall GDP growth. Its share in gross domestic capital formation, which at one point has reached over 35 per cent has declined sharply in last four years, which perhaps

could be impinging on its long term growth potential (Fig 1), making fiscal interventions all that more urgent.

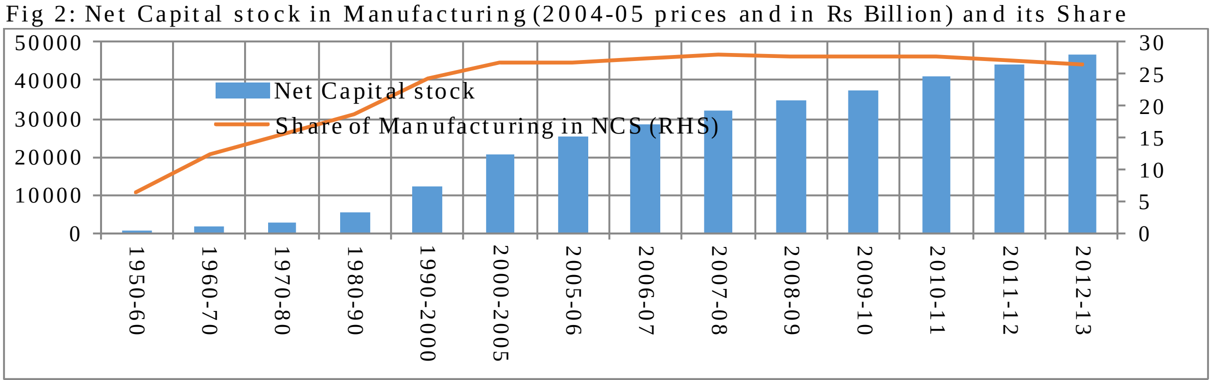
Fig 1: Share of Manufacturing in GDP and Capital Formation (in per cent)



Source- Ministry of Statistics & Programme Implementation

5. Not only the share of manufacturing in gross capital formation (as a flow) has witnessed some squeeze, even its share in net capital stock has remained nearly static for over 10 years now (Fig 2).

Fig 2: Net Capital stock in Manufacturing (2004-05 prices and in Rs Billion) and its Share



Source- Ministry of Statistics & Programme Implementation

6. *License permit Raj* was initially considered as an inhibiting factor, but India ushered in product market reform in 1991 and reforms in the commodity taxes thereafter. The economy was also opened for foreign direct investment in a big way and today almost entire manufacturing sector has free access to foreign investment and technology. Three factors may have contributed to keep manufacturing growth almost aligned to overall GDP growth. First factor is that the manufacturing in India has continued to remain resource intensive. The share of value added in output in organised manufacturing sector nearly stagnated indicating little infusion of modern technology at an aggregated level (Table 2). The low value addition or high input component in the manufacturing reduced the elbow room for the industry for either adoption of modern technology or equip its manpower to improve up on the acquired technology. India's share in patents filed by residents of the country in the world remains under one per cent as against the share of China, which now exceed 30 per cent[1]. Only in three broad industry groups of beverages & tobacco; non-metallic minerals (cement as the dominant product) and chemicals including pharmaceuticals the ratio of value added to output exceeded 25 per cent. In the unorganised sector the matter may have been even worse.

[1] Share of China in patents filed by the residents has increased from 1 per cent in 1990 to 37.4 per cent in 2012. While share of India has continued to remain under one per cent during this period.

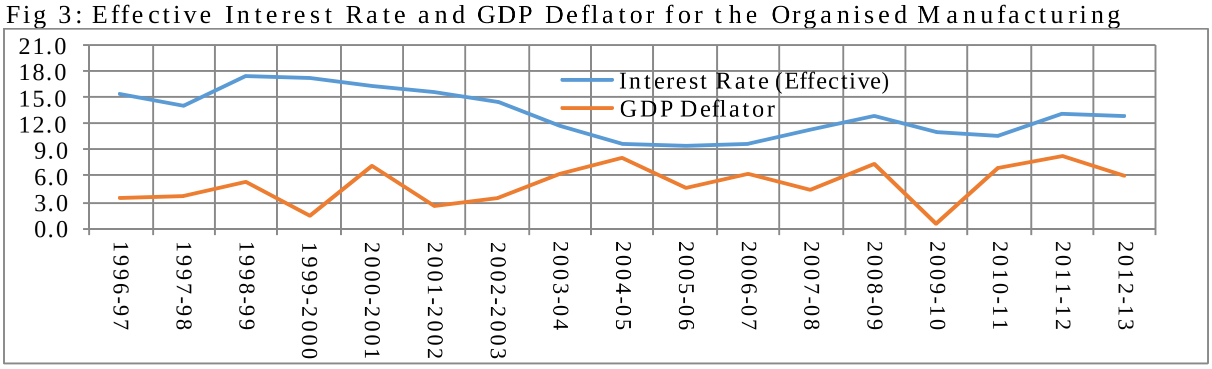
Table 2: Share of Value Added in Value of Output of Registered Manufacturing

	1980-90	1990-2000	200-2010	2010-11	2011-12	2012-13
Food products	12.6	12.5	10.8	9.9	9.9	9.9
Beverages & tobacco products	24.0	28.6	30.7	28.1	30.4	30.3
Textile products	22.1	20.5	17.4	16.6	14.6	14.7
Leather & fur products	11.8	13.4	14.8	16.8	17.8	17.8
Wood and wood products	15.8	16.2	16.3	15.4	15.6	15.6
Paper and printing etc.	25.4	24.2	23.0	23.8	19.7	19.7
Rubber & petroleum products	12.0	17.1	15.6	14.6	8.8	8.8
Chemical & chemical products	19.4	23.0	24.0	23.7	25.6	25.6
Non-metallic mineral products	29.1	29.7	30.4	29.0	29.3	29.3
Basic metals	20.1	22.1	21.2	15.7	19.7	19.7
Metal products and machinery	24.3	22.2	23.0	23.3	22.4	22.5
Electrical machinery & Equip.	23.1	21.5	19.1	18.6	18.5	18.5
Other manufacturing	40.3	23.2	19.4	17.6	16.1	16.2
Transport equipment	20.0	17.0	18.0	17.8	16.8	16.8
Registered Manufacturing	19.4	19.8	19.0	17.8	17.2	17.1

Source- Ministry of Statistics & Programme Implementation

7. Second, organised manufacturing in the post reform period continued to face high interest rates. Effective rate of interest exceeded the rate of GDP deflator for the manufacturing value added, which is a true measure of inflation. For the unorganised sector, the access itself was the issue but for the organised cost remained high (Fig 3).

Fig 3: Effective Interest Rate and GDP Deflator for the Organised Manufacturing



Source- Ministry of Statistics & Programme Implementation & ASI various issues

8. Interest rates were also higher in general relative to our competitors (Table 3)

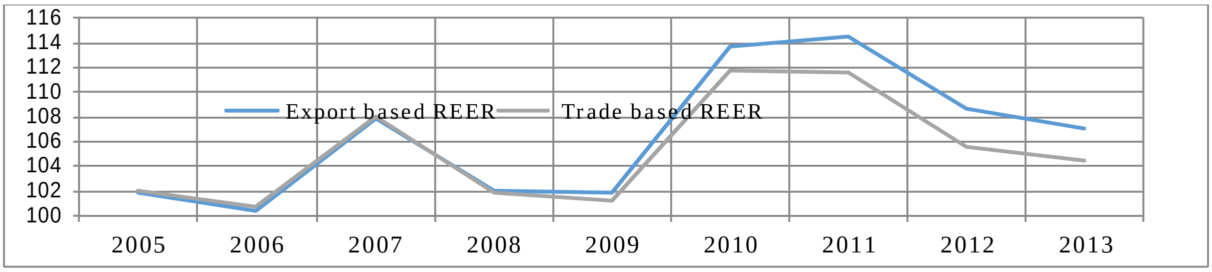
Table 3: Lending Rates (per cent)

Country Name	1990	2000	2005	2010	2011	2012	2013
China	9.36	5.85	5.58	5.81	6.56	6.00	6.00
India	16.50	12.29	10.75	8.33	10.17	10.60	10.29
Japan	6.86	2.07	1.68	1.60	1.50	1.41	1.30
Korea, Rep.	10.00	8.55	5.59	5.51	5.76	5.40	4.64
Philippines	24.12	10.91	10.18	7.67	6.66	5.68	5.77
Thailand	14.42	7.83	5.79	5.94	6.91	7.10	6.96
United States	10.01	9.23	6.19	3.25	3.25	3.25	3.25

Lending rate is the bank rate that usually meets the short- and medium-term financing needs of the private sector. (World Bank Indicators- February 2015)

9. Thirdly, while customs duties were lowered continuously, in real effective rate basis exchange rate, export and trade weighted remained overvalued (Fig 4).

Fig 4: Trade and Export weighted Real effective Exchange Rate 2004-05=100



Source- Reserve Bank of India- Handbook of Statistics

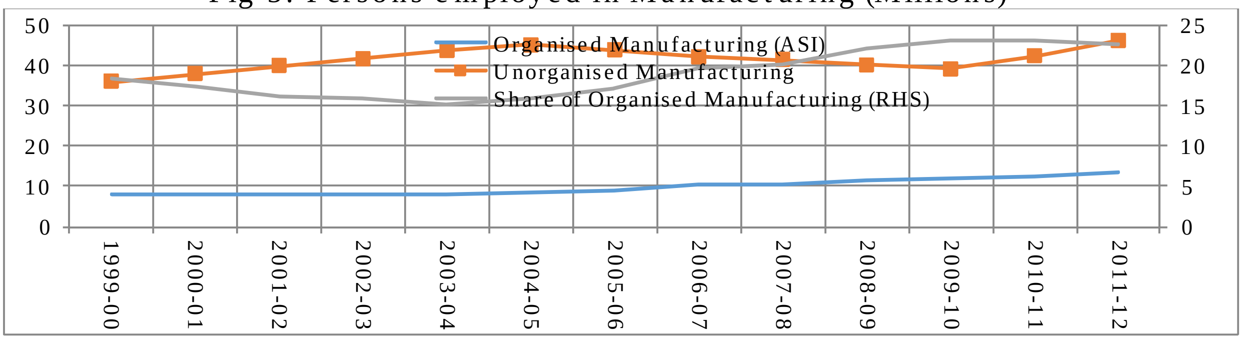
10. These factors collectively affected the competitiveness of Indian manufacturing. In exports, the high technology exports virtually by-passed India (Table 4)

Table 4: High-technology exports (% of manufactured exports)

Country Name	2000	2005	2009	2010	2011	2012
Brazil	18.73	12.84	13.20	11.21	9.72	10.49
China	18.98	30.84	27.53	27.51	25.81	26.27
United Kingdom	31.80	28.36	23.20	20.88	21.30	21.74
India	6.26	5.80	9.09	7.18	6.87	6.63
United States	33.79	29.90	21.49	19.93	18.09	17.83
World	24.41	20.83	18.40	17.69	16.63	17.56
High-technology exports are products with high R&D intensity, such as in aerospace, computers, pharmaceuticals, scientific instruments, and electrical machinery (World Bank- Key Indicators)						

11. There is hardly any evidence that restrictive labour laws played any major role in keeping the manufacturing share static. In the organised manufacturing, which would be subject to more stringent labour laws, number of persons increased from 7.9 million persons in 2003-04 to 13.4 million persons in 2011-12. As against that the number of persons engaged in unorganised manufacturing after declining during 2005-2010 increased from 45.6 million persons in 2004-05 to 46 million persons in 2011-12 (Fig 5)

Fig 5: Persons employed in Manufacturing (Millions)



What could be possible strategies?

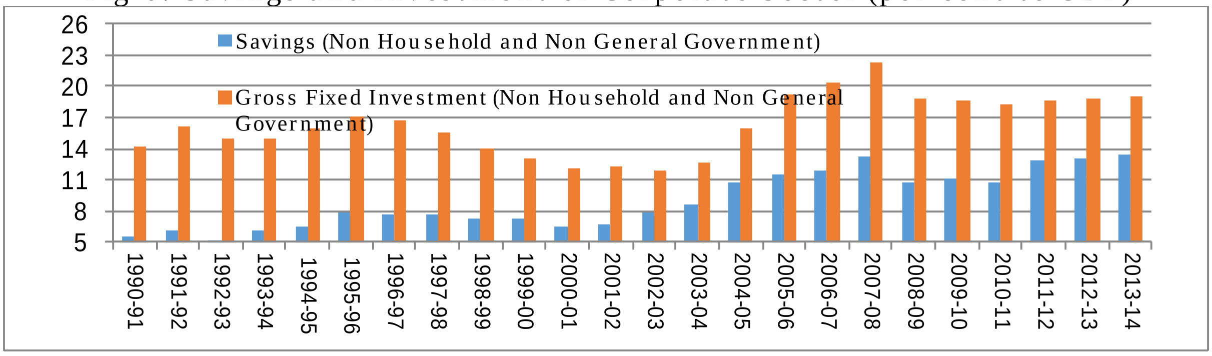
12. There has been considerable erosion in relative competitiveness of domestic manufacturing due to high transaction costs and moderating customs duties including the duty reduction commitments at multilateral and bilateral trade agreements. It may, therefore, be desirable to keep the level of duties constant. There should not be any waiver from payment of CVD, which countervails the domestic excise duty. Further, with a moderating growth observed for industrial intermediates, while the correction of inverted duty structure may be necessary, duty reduction may not be warranted. Even an equal duty on intermediates and finished products is not inverted. It is all the more necessary to make the make in India campaign a success.

13. Customs duty reduction including nil duty, however, needs to be considered for raw materials, ores and coal and scrape of all kinds.

14. In a global economic environment location of any industry is based on cost considerations and variability concerns. It is necessary to make doing business in India more attractive. Currently we hardly have any domestic manufacturing base for most of consumer durables, like refrigerators, TVs, mobile phones, computers and laptops, washing machines or even wall cloaks. Whatever domestic industry that exists is not planning any expansion. A continuous decline in the output of consumer durables clearly signals that phenomena. Most of domestic players also have production facility elsewhere because it is cheaper to produce outside and export to India rather than have domestic facility. This trend needs reversion. Besides improving infrastructure and its costs, it is also important that production here is equally profitable. RBI study has clearly indicated of erosion in profitability of the corporate sector, particularly the small sized ones. It needs to be recognised that real interest for each industry is the nominal interest and what industry can pass on to the consumer. Since manufacturing inflation have considerably declined the real effective interest rate for industry is very high and in some cases may be inhibiting expansion or new capacity creation. Since, interest rates are independently decided by RBI, it may be necessary to consider capital incentives to industry.

15. Currently capital gains from housing are allowed to be off-setted against new capital acquisition of a house. It may desirable to consider this off setting against all investment, including investment in plant and machinery, new facility for trade, storage or other economic purposes. Gross investment, other than of the household and general Government as percentage to GDP has declined after reaching its peak in 2007-08. This decline is all the more of concern as their internal accruals are reaching back to the earlier peak levels (Fig 6).

Fig 6: Savings and Investment of Corporate Sector (per cent to GDP)



16. A differential treatment is accorded for income on account of interest and on account of dividend, though both are the income from investment. While it is true that dividend is taxed at the level of the company and it may amount to double taxation if that is taxed again with the receiver. But in India, most risk-averse investors still prefer the security of a Fixed Deposit as a safer investment options. Investors in equity are active investors while investors in FD are passive investors, but both these provide investible resources, directly in case of equity and indirectly through the institutional intermediation and deserve a similar treatment.

17. In view of the concerns for maintaining price stability which is back on expected lines, Government could consider reducing excise and services tax rates marginally.

18. A focus market scheme has been in vogue. The duty credit entitlement under the scheme may be raised to 5 per cent and list of countries eligible for availing benefits under the scheme could be widened to include Russia, Turkey, Ukraine.

19. India is one of the largest users and importers of conventional defence equipment. Its cumulative defence budget (including both-capital and revenue expenditure) grew at over 13 per cent CAGR during the financial years 2006-2014. Approximately, 40% the defence expenditure is capital expenditure. According to the estimates, nearly 70% of our defence equipment requirements are met through imports, with only 30% being met through domestic production. In spite of emerging as a large economy with strong military needs, India has a very low manufacturing base in defence equipments. The production of military equipment within the country will provide immediate impetus to the manufacturing sector in the shape of large scale ancillarization as has happened in the case of major industrialized nations like USA, France and Germany. A large number of manufacturers of defence and dual use products are finding it difficult to manage their production in western countries due to increasing costs of labour and other inputs. This is the right time for India to project itself as a new hub for manufacturing. Global equipment manufacturers for both the infrastructure sector and defence are willing to set up production bases in India in view of the sustained nature of the demand and cost advantages. Besides growth and employment, the manufacturing sector in India suffers from the lack of depth – that manifests itself in two ways: (i) the relatively low level of increase in 'value-addition' in many products manufactured in the country, and (ii) the growing imports of capital equipment – the building blocks of a country's manufacturing competitiveness – into the country. Acquiring depth in manufacturing is important for long term competitiveness. In certain industries such as defence and telecommunications, it is also important to keep the substantial value chain indigenous. Both infrastructure and defence equipment manufacturing are research intensive sectors with significant backward linkages. The domestic production base could be instrumental in improving technology levels in Indian manufacturing.

20. Leveraging infrastructure deficit and defence procurement demand could yield positive gains to the manufacturing growth. No major equipment manufacturer, be it the defence platform or any heavy machinery like turbines or earth moving equipments, etc., has in-house facilities for manufacture of all components or sub systems. Most of the well-known producers of these equipments are now system integrators with a high level of research and development. It is, therefore, quite reasonable to insert a clause in all global request for proposals (RFPs) by Government or the PSUs that system integration should take place in India. Depending upon the nature of the product/equipment and its value, apart from the system integration, we could insist on a level of local

value addition, which could be gradually increased. This can be done without disturbing the completion targets for infrastructure projects and other procurements, in terms of both time and costs. Since a number of major global players are searching for locations which are cost competitive, we may not find any problem in enforcing such conditionality.

21. There has been a sharp increase in ICOR of the construction sector. This may partly be due to large inventories of housing stock and due to the affordability issue. First time home buyers have some preferential treatment. With the cost of housing having gone up substantially, there has been an increase in interest burden. There is a need to either provide concessional finance for housing, at around bank rate, or a higher set off for tax purposes. Further, the credit for houses is restricted to 80 per cent of the cost. For first time buyers, who may have entered the job market only recently, arranging own funds to 20 per cent is difficult. With house prices continuously witnessing an increase, the worth of the collateral is always increases, raising this limit will not make the credit riskier. It should be understood that majority of Indian household are first time buyers of many consumer durables resulting in a limited replacement demand. Any incentive to housing sector, in a way is incentivising the sectors producing consumer durables. This sector has been witnessing a negative growth for last consecutive 17 months.

22. India continues to be ranked lower in doing business indicators. Table below indicates India's ranking in some areas which are easily amenable to be improved. In taxes, while rates may not undergo any significant changes, but number of payments and time spent could be reduced. In enforcing contracts and resolving insolvency also procedural improvements are like low hanging fruits.

Paying Taxes	Rank	154	156
	Payments (number per year)	33	33
	Time (hours per year)	243	243
	Profit tax (%)	25.1	25.3
	Labor tax and contributions (%)	20.7	20.7
	Other taxes (%)	15.7	15.7
	Total tax rate (% profit)	61.5	61.7
Enforcing Contracts	Rank	186	186
	Time (days)	1,420	1,420
	Cost (% of claim)	39.6	39.6
	Procedures (number)	46	46
Resolving Insolvency	Rank	135	137
	Time (years)	4.3	4.3
	Cost (% of estate)	9.0	9.0
	Recovery rate (cents on the dollar)	25.4	25.7
	Strength of insolvency framework index (0-16)	6	6

23. MGNREGA, however, could be restructured in a manner that it creates productive assets and improve productivity of agriculture. It should be conceived as a temporary measure and should not make the mainstay of any state sponsored employment generation. Though there is no conclusive evidence, but both the farming and manufacturing sector have been complaining that MGNEREGA has

raised the threshold level of wages in rural areas affecting their returns. The programme could be increasingly used for skill development for meeting critical skill gaps.

24. Manufacturing, particularly the small scale manufacturing needs to be profitable. Studies show that the manufacturing establishments have a variety of statutory obligation to discharge which are costly, time consuming and often ineffective in meeting their stated objectives. Besides reducing the compliance through self-certification, consolidation of returns and their reduced periodicity, automatic greening, there is need to conceive an alternate institutional mechanism. A new service entity, specifically created to take on the responsibility of meeting statutory obligations, and expected to be more efficient, economical and better equipped to serve the interests of both the employers and the employees could be envisaged. The entity could be a (publically created) commercial entity and could charge a fee/subscription, linked to wage bill of the industry for its services so that it maintains enough liquidity and be solvent for its day to day needs.

25. Another feature of employment in non-farm sector relates to missing middles. While growing casualization of workers in the organised sector is one manifestation of this phenomenon, lack appropriate soft skills in the other one. Though employment opportunities have been created at lower levels- security guards, data entry operators, shop floor managers, plumbers, etc., the middle level jobs or the jobs which would guarantee a regular increment (upgradation) has been missing. This trend needs to be reversed through appropriate measures.

26. While skill development and imparting skills in partnership with industry has already been initiated, there exists a considerable mis-match between the skill sets that are in demand and skill sets that are available. Many of our technical persons are found unemployable by industry requiring some kind of retraining. We are yet to fully exploit the apprenticeship route for industrial employment. Reason for the limited use of apprenticeship route for employment for the trainees is the low rates of stipend and for the enterprises its cost. It could be raised to at least 50 per cent of minimum wages so that it covers normal costs of maintenance of the apprentice. Linking it to an economic variable would also endure its getting revised automatically. A weighted deduction of 125 to 150 per cent for all apprentices hired under the Apprentice Act and for all stipends paid to the apprentices (excluding the reimbursement paid by DGE&T & Ministry of HRD) could be considered to make the scheme attractive enough.

27. A possible synergy could be established between skill development and MGNREGA. MGNREGA should lead to either long term physical assets creation or human resource development through demand based skill upgradation. Release of funds for zero material component projects under the scheme should be discontinued as these may perhaps be pure cash doles. Maintenance of the ratio of material and labour component should be observed at district level to provided project to project flexibility. Similarly, allocation for building project preparation capacity at the district level may need to be increased to a minimum of 10 per cent.

28. ICT access and penetration in India is very low and we have failed to get economic benefits from its penetration. It may be desirable to consider allowing a weighted deduction of 125 per cent for expenditure incurred on ICT in small business and other establishments below a threshold level of activity.