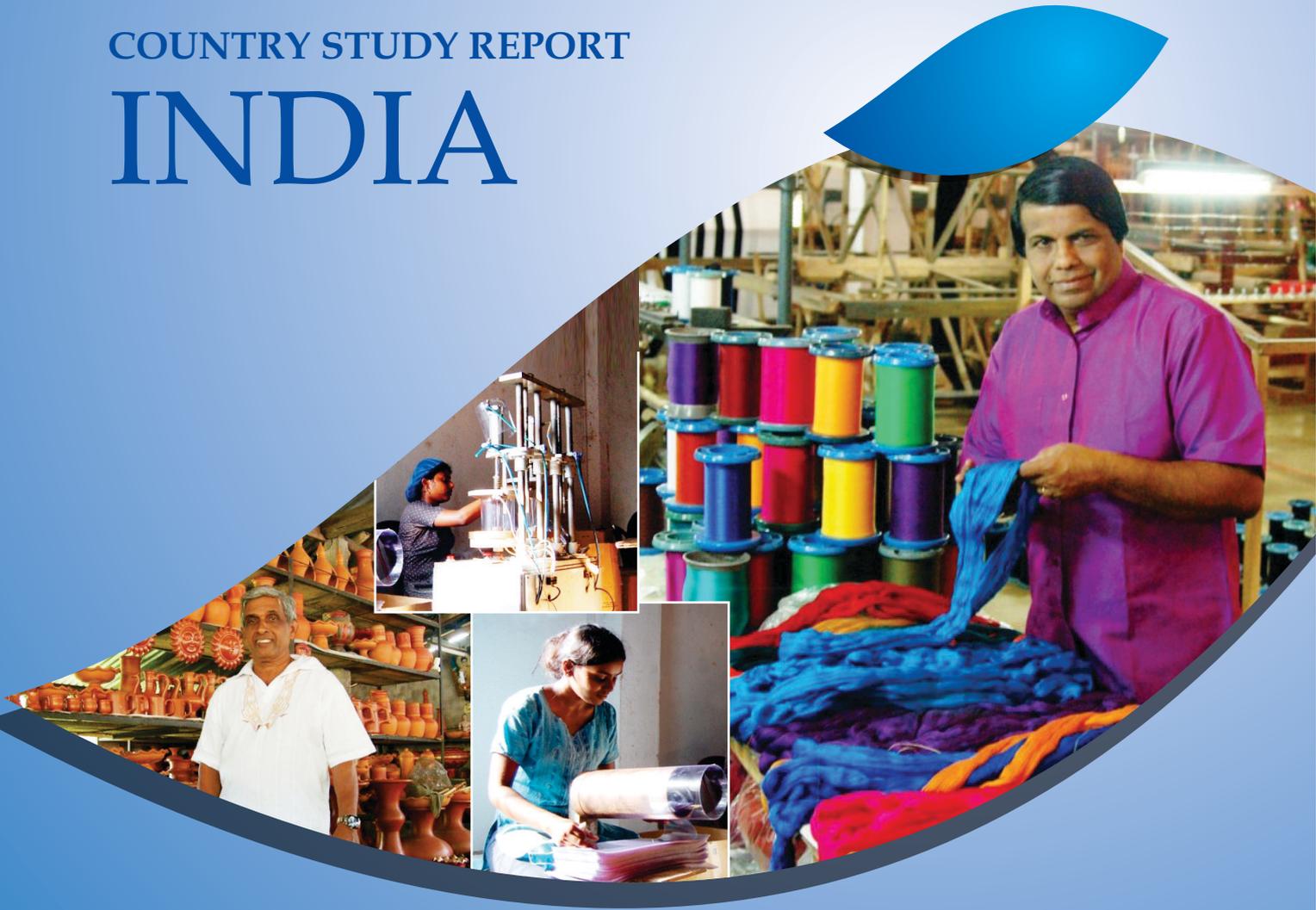




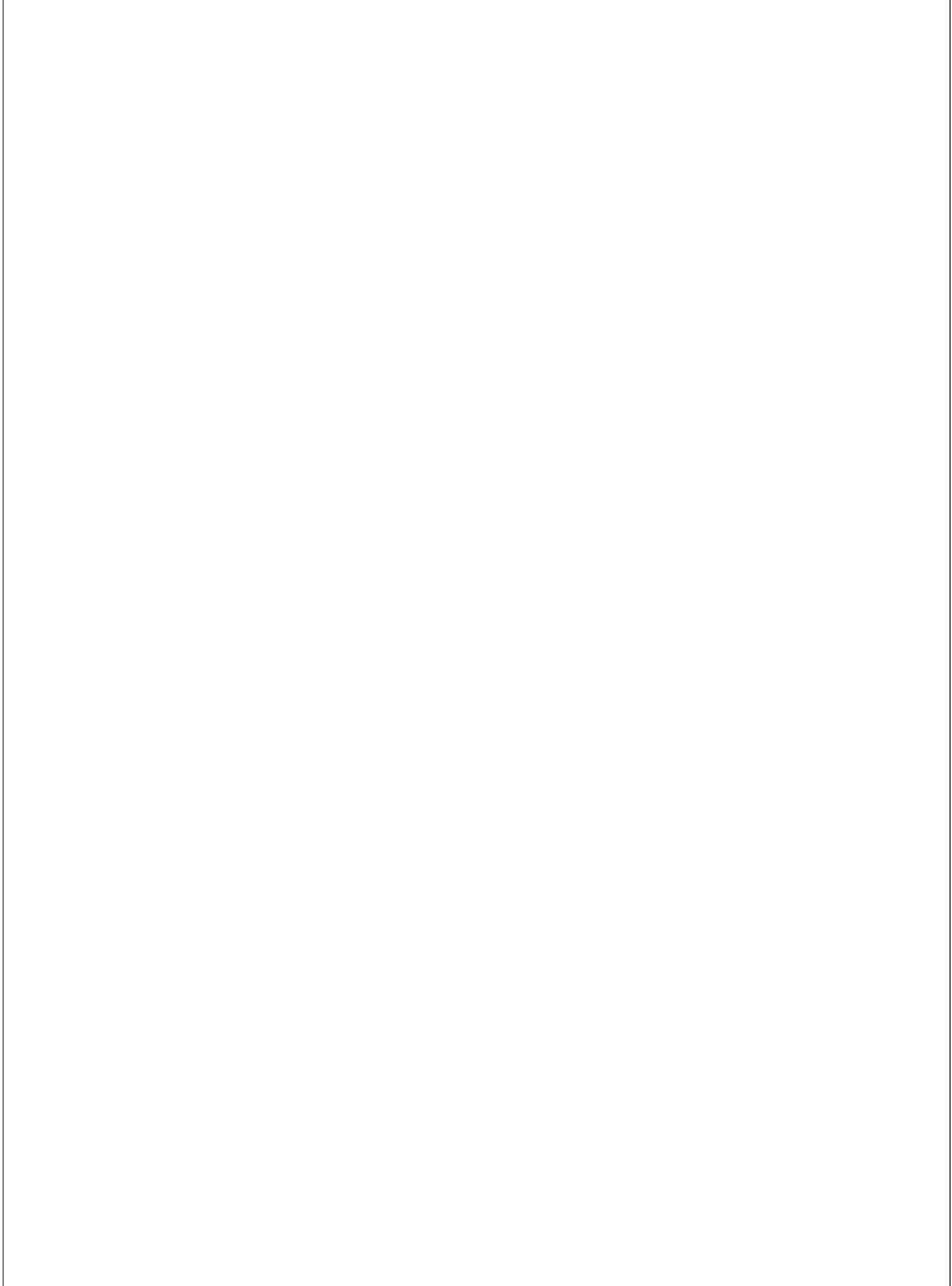
COUNTRY STUDY REPORT

INDIA



Tax Policy and Enterprise Development in South Asia





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About the Research

This research examines the impacts of property tax, value-added taxes, and tax exemptions and concessions on small enterprise development in South Asia. The goal is to provide decision-makers with data and insights to support more informed policy formulation and implementation for inclusive growth, productive employment, and enterprise development. The research also aims to examine the issues as they affect women entrepreneurs, to promote positive learning experiences among the countries, build fruitful exchanges, and foster effective policy discussions in a regional context.

The targeted outcomes include 5 Country Study Reports as well as a regional report based on Meta analysis. The reports are published and widely disseminated at the policy engagement workshops. Other project outcomes are policy workshops in all five countries and workshop reports, as well as an interactive website to support research and advocacy.

About NIPFP

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In its 37 years of existence, the institute has emerged as a premier think tank in India, and has made significant contribution to policy reforms at all levels of the government. It has maintained close functional links with the Central and State governments all along, and has built up linkages with other teaching and research institutions both in India and abroad. Although the institute receives an annual grant from the Ministry of Finance, Government of India, and various State governments, it maintains an independent non-government character in its pursuit of research and policy.

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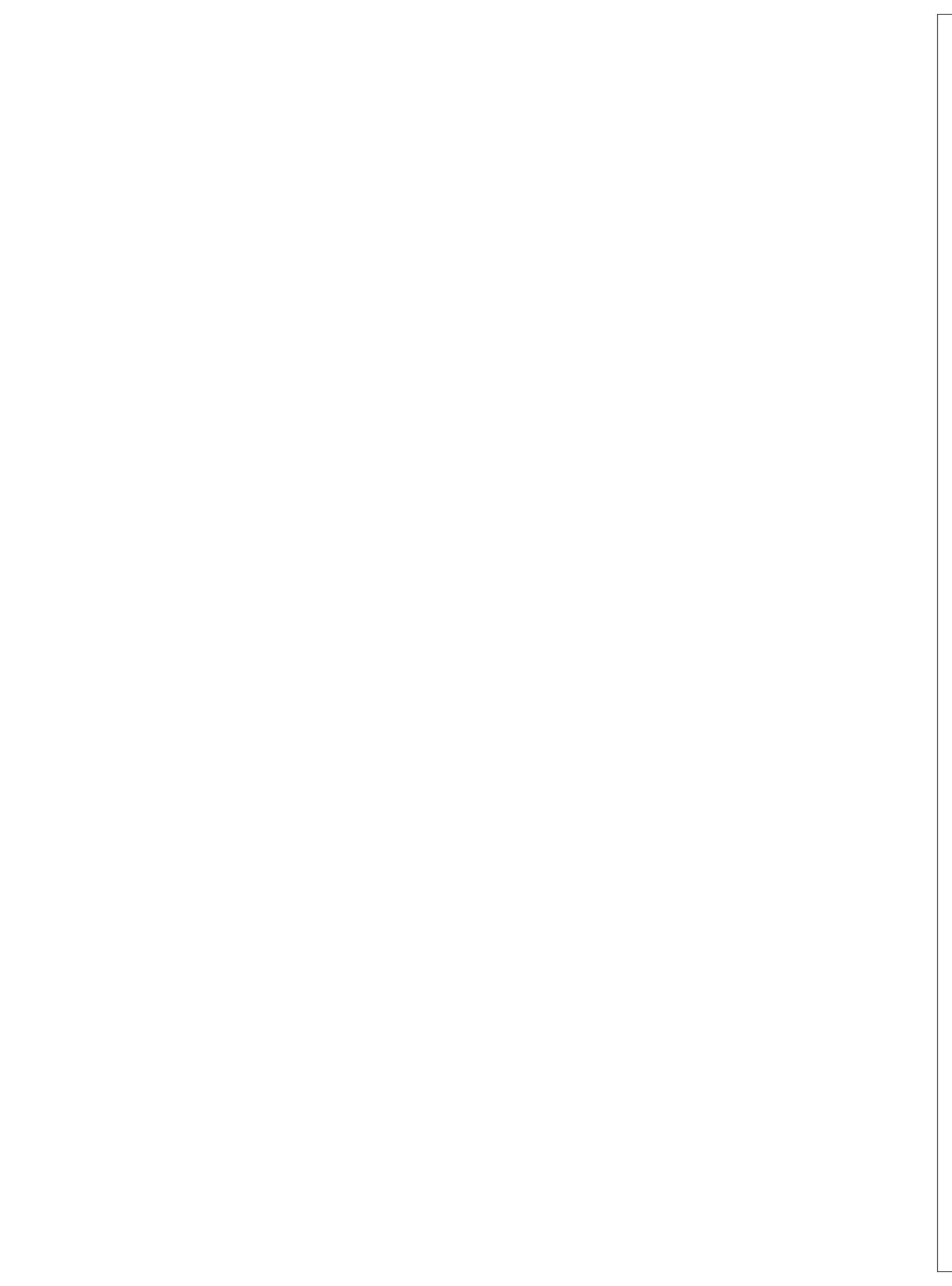


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List of Acronyms

MSMEs	Micro, Small and Medium Enterprises Development
VAT	Value Added Tax
MSMED	Micro, Small and Medium Enterprises Development
ROC	Registrar of Companies
ROF	Registrar of Companies
KIIs	Key Informant Interviews
EDA	Exploratory Data Analysis
OBC	Other Backward Classes
SC	Scheduled Caste
ST	Schedule Tribe
NSIC	National Small Industries Corporation
FISME	Federation of Indian Micro, Small and Medium Enterprises
SIDBI	Small Industrial Development Bank of India
AIIMS	All India Institute of Medical Sciences
SCD	Society of Child Development
Lakh	South Asian equivalent of 0.1 million INR
Crore	South Asian equivalent of 10 million INR

Executive Summary

This study seeks to elicit the perceptions of MSME units regarding the overall tax structure and impact of tax exemptions and concessions, VAT and property tax on the development of enterprises in this segment of the economy. The study is based on a two pronged approach – one draws on a survey of 200 enterprises across three cities and the other is based on interviews with people knowledgeable about this sector based on their association with it. The enterprises surveyed include micro, small and medium units spread across Delhi-NCR, Coimbatore and Ahmedabad. The target respondent groups are the manufacturing MSMEs (registered and non-registered both), both compliant and non-compliant with regard to VAT. Of the 200 enterprises, 100 are from Delhi NCR and 50 each from remaining two areas. This division of the sample across the cities was based on the fact that Delhi NCR has a more diverse set of industries as compared to the other two cities. Out of total 200 enterprises sampled, there are 113 micro, 70 small and 17 medium enterprises. The analysis in this report largely focuses on the differences in response between Micro, Small and Medium firms.

We also examined the registration status of these units. For the purpose of this study, registered firms are those registered with either registrar of companies or registrar of firms. Of firms which are unregistered, we found the following reasons to be important for their decision not to register: a) trouble getting information on registration process, including time required to complete the process, b) minimum capital requirements for registered enterprises in their sector is not satisfied and c) administrative burden and financial burden. Administrative and financial burden of being in the tax system is flagged by registered enterprises also as a potential reason for firms choosing not to register.

Some key observations from the survey are mentioned below:

1. There is an overwhelming perception that firms have to pay multiple taxes.
 - 1.1. They perceive that this raises the time and cost of compliance,
2. Access to credit continues to be a concern for this sector. Many firms do not want to take loans, to expand their business – 33 percent believe that they cannot get loans while the others do not want to take loans.
3. Perception on some issues like i) whether tax staff is fair and respectful in dealing with MSMEs, ii) MSMEs are facing bias regarding tax benefits in the current tax structure, iii) difficulties faced in obtaining VAT refunds, iv) performance of VAT officials, friendliness of VAT regulations etc. varied significantly between micro to small &

medium enterprises as well as between registered to unregistered firms.

4. Majority of small and medium enterprises view bribe as a problem vis-à-vis micro firms.
5. There is a consistent perception that the procedure of land acquisition is not only complex but this involves high cost and rampant corruption.
6. Among the exporters, majority of the firms want tax holiday to boost the growth of their business while majority of the non-exporters do not want tax holiday.
7. Tax exemptions are considered to be useful as a mechanism for promoting their business – this view emerges as an overwhelming response.
8. Property tax also does not emerge to be a deterrent to growth of their enterprises.
9. Majority of the respondents perceive that the overall business environment for the enterprises owned by women entrepreneurs is favorable. This is reflected even the case study reported.

Key informants have raised some crucial issues that are pointed out below:

1. For firms competing with the foreign products, their goods become less competitive because of tax structure.
2. Tax exemption is no more lucrative for MSMEs – if they avail it, then they are out of the value chain.
3. VAT refund from the central government is done timely but in some states the state VAT department does the refund after matching the invoices of the raw material purchased and the invoices of the sellers, resulting in inordinate delay.
4. Some impressions suggest that credit to the firms is mainly done on the basis of the impression of the branch manager of the bank – makes it difficult for new firms / unit to take off with assistance from formal
5. If potential borrower does not own the land, the lack of such collateral reduces their scope for getting credit.
6. In a number of KIIs, there was reference to the ease of obtaining working premises at reasonable costs in countries such as China –suggesting the need for reducing the cost of land and building for the entrepreneur in order to make MSMEs more viable.

The reason behind the overwhelming perception of paying multiple taxes is each of the taxes has its own compliance requirements in terms of accounting needs, returns to be filed and documentation to be maintained. This is further compounded by the fact that in sub-national taxes like State VATs, the rates of tax and the forms and procedures too can vary.

These raise the cost of compliance for the firms and have an adverse impact on profit and cost of production especially for micro firms. With the introduction of GST, it is hoped that some of these taxes would be merged into one tax, thereby reducing some of the compliance costs.

While individually these responses highlight the perceived impact of taxes and exemptions on firms, since there are some differences in responses, we have attempted to cross tabulate and identify some visible patterns. Some of these are discussed below:

- A. Firms that view bribes as a problem among small and medium enterprises are more likely to report that tax staff was not respectful when compared to those that do not view bribes as a problem, while in the case of micro firms; there is no relation between these two perceptions. One way to understand this difference could be as follows: small and medium firms are already a part of the tax system and possibly would like the system to function well. Any demands for bribes can then be viewed as synonymous with unfair treatment by tax officials. On the other hand, micro firms are still evaluating the merits of being in the tax system or opting out. They may even be having turnovers very close to the exemption threshold and hence could be in and out of the system for some time. For these firms, bribes might be viewed as the cost of indecision on their part more than a reflection of unfair treatment by tax officials.
- B. A substantial number of firms responded to the land acquisition related issues in a similar manner. They strongly perceive that the procedure of land acquisition is not only complex but this involves high cost and rampant corruption. The high cost of acquiring land along with limited resources available to these firms is presented as reasons for not possessing land.
- C. Of the firms that did not take loans, 67 percent report that they did not want a loan while 33 percent reported that they could not get a loan. To understand this further, this variable is cross tabulated against the perception that "Time and Cost of compliance is high". The result indicates that among firms that did not want a loan, a larger percentage perceives time and cost of compliance to be high, when compared to those that reported a perception that they could not get a loan. These factors suggest two important conclusions: first, for firms that perceive that they cannot get a loan, improvements in the procedures for getting loans and relaxation in the collateral requirements etc. can help them become a part of the formal economy. For the second group of firms that do not want a loan, there is a possibility that the perceived high cost of compliance is serving as a disincentive to come within the folds of taxation and hence they do not seek to take a loan and expand

their business. Since access to credit continues to be dominant concern, two issues need to be addressed. First, simplifying the process and documentation for getting credit would be important to bring more SME within the fold of the formal sector. Here 'aadhar' based credit histories or CIBIL based credit histories can be used to expand the access to credit. Improving the tax regime so that compliance cost is reduced too could bring in more people to the formal institutions for credit.

- D. Statistically significant difference is observed among exporter and non-exporter firms in terms of wanting tax holiday. Among the exporters, majority of the firms want tax holiday to boost the growth of their business while majority of the non-exporters do not want. Exporters could be facing competition from other countries where tax regimes could be more supportive. Alternatively since exports are to be zero-rated in VAT and GST, while local sales are taxable, the accounting requirements to deal with these two categories requiring segregated book-keeping could be seen as a burden. The tax holidays, even if temporary could ease this burden. It is also important to recognize that historically exports have always been receiving incentives and even new firms with SEZs do have access to such privileges. This could therefore make exporters more aware of the need or the benefits from tax holidays.

SECTION-I

Literature Review

1.1 Taxation in India and Fiscal Preference for Small Scale Industries

In a broad sense, Indian tax policy has changed according to its changing development strategy. At the same time, it is important to note that “the fundamentals of Indian tax structure have changed little since the Government of India Act in 1935 set out the basic assignments of revenues and responsibilities to the centre and the states. The assignments were subsequently embodied in the Indian Constitution of 1947. However, in terms of the relative importance of the sources of revenue, there have been important changes. For example, land revenue has declined almost to the point of insignificance and the salt tax has been abolished, whilst excises, sales taxes and customs duties have increased greatly” (Burgess and Stern: 1994, pp-44). Nevertheless, it should be noted that the relative importance of direct taxes has increased after the tax reforms introduced since the early 1990s.

Although, combined tax-revenue as a percentage of GDP showed more or less an increasing trend till the last half of 1980s', it had started declining due to fall in revenue mobilization of centre. The fall in tax revenue mobilization during the late 1980s and 1990s was due to the decline in both customs duty and Union excise duty as a percentage of GDP. However, during the 1990's, direct tax effort increased sharply. It should be noted that as Indian tax structure was heavily dependent on indirect taxes, the increase in direct tax revenue effort could not compensate the resultant revenue loss arising out of the decline in the tax effort in indirect taxes. Still, special provisions for small scale industries haven't entirely been lost.

The fiscal preferences given to the small scale Industries (SSI) have come under severe criticism. Prior to early nineties, there were considerable reservations for the small scale (SS) sector in terms of product profile (Bagchi, etal. 2006). Persistent criticism and more importantly, economic liberalization 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 SS sector to the exclusion of domestic large producers became untenable. Hence the ambit of reservation for SSIs has been progressively reduced. Some however still remain as also many of the other benefits extended by the government. 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, some studies have suggested that concessions need to be subject to a more rigorous cost-benefit analysis followed by suitable changes in policies. (Bagchi, et al. 2006). Not much progress has happened since.

One of the significant aspects of the effectiveness of a tax regime is the cost of compliance. Regimes with high costs of compliance cannot encourage voluntary self-compliance. While there are very few studies in India evaluating the costs of compliance, the few that exist suggest that, that the compliance cost of income tax in India is three times the cost of collecting the tax. (Das-Gupta (2004)) This study is based on a small sample of large companies and unfortunately there is virtually no information available on the compliance cost faced by the small industry and businesses.

1.2 Imposition of VAT

In many countries, the reason for levying VAT has as much, if not more, to do with replacing the cascading type sales taxes, which are often, confined to the manufacturing stage than to substitute import duties as a source of revenue. In many cases the expansion of tax base accompanying VAT both due to extending the tax to stages subsequent to manufacturing and self-enforcing nature of the tax has led to higher revenue productivity. Often, this has strengthened the information base for tax administration resulting in improved compliance in other taxes and thereby enhancing overall productivity of the tax system. Thus, as argued by Bird et al (2005), although VAT is not necessarily a “money machine”, if the tax is administered properly, the conventional conclusion that this is the best way to make up for the revenue loss from trade liberalization holds.

There are however, a few counter-viewpoints as well. Emran and Stiglitz (2005) argues that the introduction of a multi-stage tax like VAT can encourage informalisation of the economy. While this could be a valid concern in developed countries with predominantly formal economies, there are limits to extending the same to developing countries. In fact, most taxes in developing countries are levied on the formal sector. In the context of tariffs, it has been shown that smuggling – the informal sector counterpart in the case of imports – will lower both revenue and welfare (Bhagwati and Hansen, 1973; Martin and Panagariya, 1984). It is therefore not clear whether and how this criticism can be leveled against VAT alone. The extent to which VAT encourages non-formal sector will also vary from country to country. Thus, given the context of introduction of VAT, as a reform of other hitherto existing cascading taxes, in developing countries the argument of increase in

informalisation has limited significance.

Another critique of the appropriateness of the VAT in developing countries is based on the market structures. Das-Gupta (2004) argues that, under imperfect competition, since neither the gains from input-tax credit nor the entire tax burden need be passed on to the consumer, a turnover tax may be both revenue superior and welfare superior to a VAT. This result, however, is based on a static framework. In a dynamic context, the taxpayers in this system can vertically integrate thereby avoiding taxes and potentially undermining production efficiency. Further, such a tax regime would perpetuate tax spillovers both across jurisdictions within the country and across international borders. The former would violate the common market principles, while the latter would undermine the competitiveness of the domestic industry.

Given this context and the perceived need to rationalize taxes alongside raising revenues, many developing countries have adopted/adapted VAT type taxes in place of their cascading levies. India began its reform of domestic trade taxes in 1986 with a phased replacement of central excise duties by MODVAT, i.e., a modified VAT limited to manufacturing alone. Major changes followed in 1990s. The structural change in revenue raising behavior, particularly of the central government during the 1990s away from indirect to direct taxes was essentially a part of the tax reform measures undertaken since 1991. In India, reform of central government taxes in the 1990s was based on the interim and final recommendations of the Tax Reform Committee headed by Raja J Chelliah (Government of India: 1991). With regard to the direct taxes, the committee recommended the widening of tax bases and moderation of the rates of direct taxes. For indirect taxes, the committee recommended rationalisation of rates and comprehensive coverage of MODVAT within manufacturing in place of central excise and for customs duty, major recommendations were reduction in the import tariff, reduction in the spread of rates, a simplified tax structure and abolition of many concessions and exemptions.

The peak rate of income and corporation tax declined sharply during this period. Including the surcharge on income tax, the effective reduction has been from 56% to 30%. In respect of corporate tax, the effective reduction was from around 51 per cent in 1992-93 to 30%.

In case of indirect taxes, apart from rationalization in MODVAT and reduction in customs tariffs, three significant reform measures were introduced: first, introduction of a tax on services in 1996, the scope of which was gradually expanded and partially integrated with MODVAT. Second, there was a major attempt at rationalisation of the rates of tax in state level sales taxes in 2000. The number of rate categories was reduced from over 10 to 2. And the third major reform was the introduction of VAT in the fiscal year 2005-06 by 21 states

and subsequently all other states. VAT was introduced as an alternative to the current system of sales taxation, which created economic distortions through cascading, multiple tax rates, selective exemptions and incentives.

Although characterized as adoption of VAT, the reform in April, 2005 only extended the sales tax up to the retail stage with credit allowed of taxes paid on intra-state purchases for all intra-state sales, and inter-state sales. This tax did not extend to services. Further, inter-state sales tax, i.e., Central Sales Tax continues in its earlier form as an origin based tax with associated cascading. It is proposed to phase out the inter-state sales tax with the proposed introduction of a comprehensive Goods and Services tax. In this sense, the earlier reform is only a transitional measure to achieve the ultimate objective of having a destination based retail stage GST.

There are no studies on the impact of this reform on small scale enterprises. However, it is possible to speculate on the likely impact. On the positive side, the rationalization undertaken prior to the introduction of VAT reduced the number of tax rates thus bringing about a measure of harmony in the tax system across the states. This would have considerably simplified the tax system and substantially reduced the compliance cost. On the other hand, eligibility to get the tax credit on purchases from small scale industries is only possible when they register and become a part of the VAT chain. Although all manufacturers with more than Rs. 500,000 are required to register, those with less than Rs. 5 million can pay a simple tax on the turnover at about 1 per cent unless they voluntarily choose to register. This implies that a considerable proportion of these entrepreneurs could choose not to become a part of the chain resulting in their products not getting the tax credit when used as inputs or resold. Furthermore, a significant proportion of the purchases by small industry is from the informal sector which may not qualify for availing the input tax credit where there may be no input tax to be claimed. It is thus not clear whether SME units would have chosen to opt for VAT or keep out.

1.3 Mismatch of Policies between Centre and States

Tax reforms at the state level were not coordinated with those at the centre. While individual state governments tried to appoint committees from time to time and reform their tax structures, there was no systematic attempt to streamline the reform process even after 1991 when market oriented reforms were introduced. Most of the reform attempts were ad hoc and were guided by exigencies of revenue rather than attempts to modernize the tax system. In some cases, even when systematic studies were done, the

recommendations were hardly implemented. The pace of tax reforms in the States accelerated in the latter half of the 1990s with increasing pressures on their budgets and, in some cases, due to the conditions imposed by multilateral lending agencies or to meet the targets set by the medium term fiscal reforms facility. The major landmark in coordinated tax reform at the state level was in simplifying and rationalizing the sales tax system since the beginning of last decade and the introduction of value added tax in 21 states from April 1, 2005, in place of the existing cascading type sales tax. While a good deal of progress has been made in reforming the Union excise duties into a manufacturing stage VAT, the reform in the states' sales tax systems has lagged behind. These reforms are critical from the viewpoint of efficiency, for, they contribute over 60 per cent of states' tax revenues.

There have been arguments for replacing the prevailing state sales tax with destination based VAT. In most States, sales taxes were levied at the first point and this pre-retail tax made the base narrow. The multiplicity of rates made the tax system complex. The taxation of inputs and capital goods contribute to cascading, vertical integration of firms and opaqueness. In an imperfect market characterized by mark up pricing, the taxes on inputs and capital goods resulted in tax on tax, mark up on tax and tax on mark ups with consumers paying much more than the revenues collected by the government. Inter-state competition in providing liberal tax incentives, besides distorting resource allocation involved significant cost to the exchequer in tax expenditures. The tax on inter-state sale combined with input and capital goods taxation have caused significant inter-state tax exportation from richer to poorer States. In addition, in many states, the urban local bodies impose a tax on the entry of goods into a local area for consumption, use or sale. With this, there are taxes on both exports from one state to another and on imports into urban local body jurisdiction. Thus the country was divided into several tariff zones, limiting the scope and the gains from a common market. Above all, with independent and overlapping commodity tax systems at central and state levels, coordinated and harmonized development of domestic trade taxes has become difficult.

The introduction of Value Added Tax (VAT) in the fiscal year 2005, and the introduction of Goods and Services tax (GST) as proposed, are seen to be important milestones in the reforms in indirect taxes in India. The changeover to comprehensive GST is expected to help consolidate and rationalize the tax base for both the Central and the State governments.

The present VAT regime at the state level taxes only goods and not services. Exclusion of services, from the VAT base is a major weakness of the present VAT design. Exclusion of services from the base, even if the states are empowered to tax selected services on a standalone basis, would not eliminate the problem of cascading from the tax system (Rao: 2004). Exclusion of services from the base also creates a discrimination of goods against

services and has given rise to serious problems in separating out the service component in sale of goods taking place in several instances, e.g., in the case of execution of works contracts, services of food in restaurants and so on (Bagchi: 1997). For the Central government, this would replace complex and separate service tax and central excise duty laws with a single tax. This would bring within the tax base the transactions involving sale of goods beyond the stage of manufacturing.

In order to have an integrated GST, Union Finance Minister made an announcement in the central budget of 2006 that GST would be introduced from April 1, 2010. GST implementation, however, has been delayed. But a series of changes has happened in service taxation in India both by bringing in more and more services under service taxation and also by periodic revision of rates of taxation. In the fiscal year 2010-11, Centre was levying service tax on 104 selected services. The budget 2012-13, introduced the concept of negative list in service taxation, which implies except selected services all other services will be subject to taxation. The Budget 2012-13, has listed the 17 services that will be in negative list. Introduction of the negative list concept in service taxation has the potential to eliminate discretion in service taxation and can boost revenue growth in a significant way by broadening the base. Currently, both central and state governments have been working together to prepare a road map for the implementation of GST. However, the design of GST is still not clear. Available indications suggest that it will be a dual GST with both centre and states taxing within an overlapping tax jurisdiction on supply of all goods and services upto the retail level. The new government which has come to power after the general elections of 2014 has announced April 2014 as the date for introduction of GST. While considerable preparation is required for making this transition, a firm deadline might motivate quicker decision making on key issues that remain unresolved.

1.4 Review of Government Policies and Schemes

The small scale industries (SSI) in India are considered as having potential for higher employment at the same capital cost compared to large scale industries because SSI's are considered to be more labor intensive implying thereby a higher employment per unit of capital expenditure. It is also considered that they have a high potential for exports. If we look at the Union Budget, every year SSIs have found a place in the budget speech of the finance minister. Announcements made for this sector in budgets in recent years reflect both the concerns this sector has and the approach adopted by governments to address these concerns. Some of these are summarized below.

a) Technological Upgradation/Quality Improvement/Innovation/Infrastructure:

A number of measures have been initiated improve the competitiveness of this sector through improvements in quality of the product being offered. This is a form of direct intervention by the state. Various measures were taken by government under these headings. The most important is Manufacturing Competitiveness Program initiated in 2005-06 designed by National Manufacturing Competitive Council. Under this scheme, it was proposed that the major gaps in competitiveness for selected clusters be identified and measures be taken for filling these gaps. The measures proposed included set-up mini tool rooms, design clinic, incubators, and encourage lean manufacturing. Another initiative of the government terms as Cluster Development Schemes, focused on the development of industrial clusters. The benefit of this is that many small units together can act as one big unit and this may benefit them in using some technologies so that they can take the benefit of economies of scale. It can also help specialize and vertical “integration” across closely located units. The emphasis is on setting up of common facilities centers. These types of intervention are expected to facilitate the production process (supply side) directly. The up-gradation of technology, better quality, and new products are expected to enhance the competitiveness of the MSMEs.

Organisations such as Coir Board and KVIC have schemes for replacement of outdated looms/rats, machinery, construction of work shed as well..

b) Credit Facilities:

The most commonly discussed constraint faced by the MSME sector is inadequate access to credit from formal institutions. The government at various points has made a lot of effort to change this picture through a variety of indirect interventions. Better credit facilities will increase the credit flow to MSMEs given all other things. It will lead to higher investment. The ceilings on the composite loans from SIDBI have been increased, in almost budget. However, these measures didn't seem adequate to ensure increase in flow of credit to MSMEs for capital investment and working capital investment, since they could not provide sufficient collateral to get loan. So, credit guarantee schemes were initiated. The limits on the collateral free loans were also increased time to time.

To incentivize technological up-gradation in MSMEs, credit linked capital subsidy scheme was also introduced. The rate of subsidy and the limits on the loan were increased over time. There are relaxations in the interest rates charged to MSMEs. It is within a band of 2% above and 2% below the prime lending rates of Banks. Preferential treatments are given to the MSMEs with good credit rating in fixing the interest rates for them. The steps were taken to encourage equity investments in MSMEs, like setting up of Over the Counter

Exchange in 1990. In 2007 BSE-IndoNext was launched. However, these measures did not find success. Recently two SME exchanges were set-up. SEBI has formulated separate regulatory measure to encourage the operation of these exchanges. The limit on equity support through National Equity Fund has increased over time. It would be interesting to see how these initiatives fare.

Small Industries Development Bank of India (SIDBI) is the apex body which implements the policies regarding credit flows in the MSME sector. It refinances the State Financial Corporation (SFC) which lends to SMEs. The funds of SIDBIs are augmented time to time through various new funds and also transfers for refinancing the SFCs. Some institutional changes too were done to increase the credit flow, like increasing the number of SSI branches of public sector banks, branch managers were delegated powers to expedite the process of taking decisions on loan proposal.

The credit guarantee schemes are expected to provide a measure of comfort to both the bank and the unit, and thus aid in increasing the access of MSME sector to formal financial institutions for credit purposes. To ease the difficulties faced by MSMEs due to delayed payments, some amendments in Interest on Delayed Payments to Small and Ancillary Industry Acts have been made as well.

c) Tax Concessions and Exemptions:

These are often a part of tax design in most countries. They are introduced to address two kinds of goals – one, to encourage these units and second, since these units are argued to address the needs of the poorer segments of the economy, to indirectly address the concerns of the poor as well. Generally sales tax and other forms of commodity taxes are ad valorem in nature. So when it is imposed on goods and passed on to the consumers, it results in higher prices. To keep the price low and have a higher profit, the tax exemptions are given to MSMEs. There were exemptions from paying duty on clearance up to Rs. 30 lakhs. It has increased over time and presently, stands at Rs 1.5 crore for units with overall turnover less than Rs 4 crore. Units availing of exemption are not entitled to claim input tax credit. The firm/unit therefore has two options: i) Either full exemption on the first clearance of Rs. 1.5 crore, or ii) normal duty with cenvat credit.

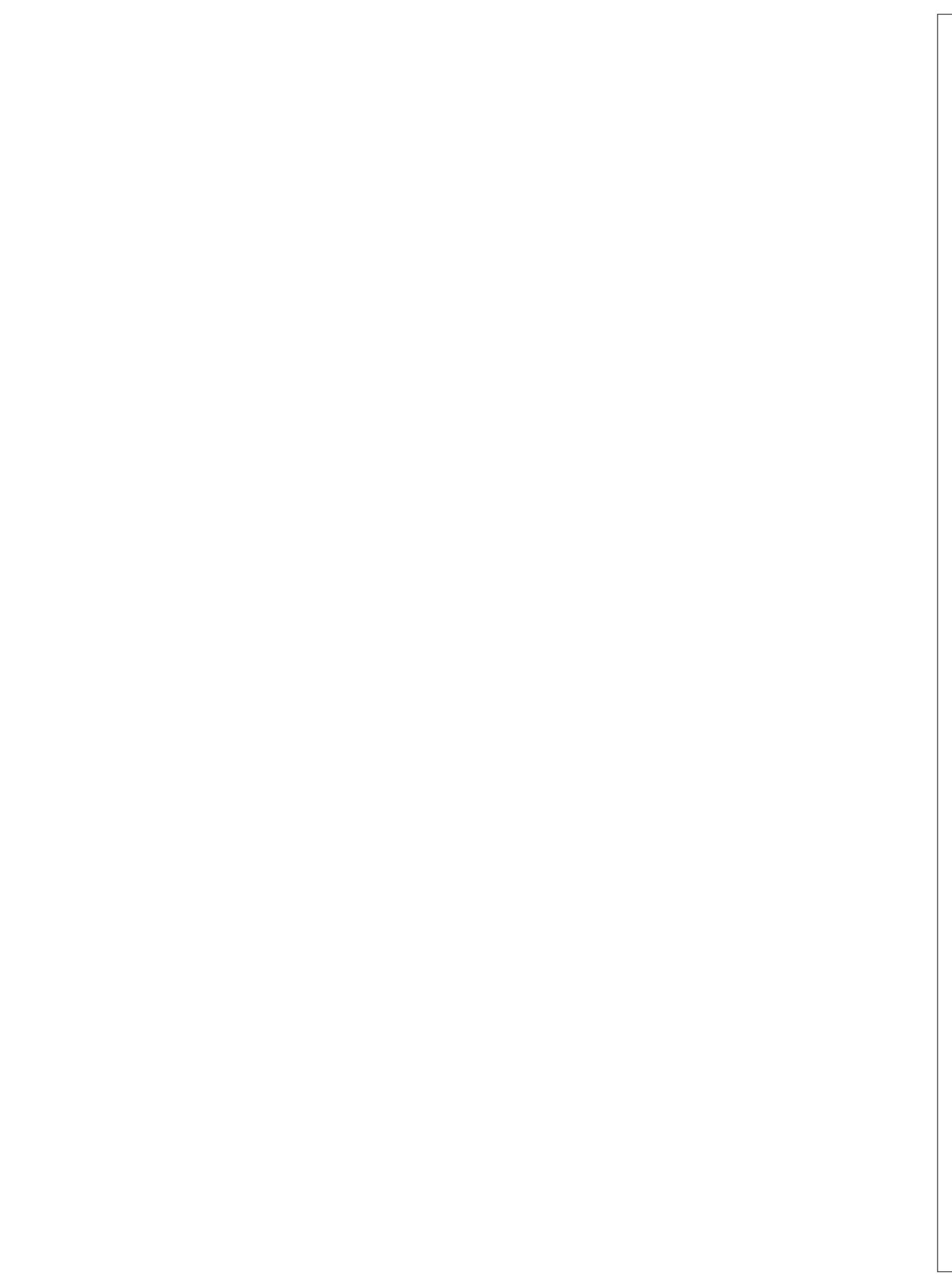
In almost every year budget few goods are included for tax exemptions and on some goods tax exemptions are withdrawn. It is done to encourage some sectors or to increase total tax collection.

d) **Preferential Public Procurement:**

In order to augment the market to which MSME units have access to, the government has been maintaining this policy. This creates an assured market for MSMEs. Since the capacities of MSEs are small, it is often difficult for them to get contracts from big private players. Under this policy, it is mandatory for central government ministries, departments and public sector undertakings to procure a minimum of 20 percent of their total annual purchases of products and services from MSMEs. There are special provisions for MSMEs owned by SC/ST entrepreneurs. Preferences to MSMEs are also given in terms of price in public tenders like L1 + 15%, no need to pay earnest money, tender sets free of cost. Initiatives like vendor development schemes etc. are taken to improve the participation of MSMEs in public procurement. NSIC, district industries board, KVIC and Coir boards play an important in implementing the schemes under this heading.

1.5 Questioning the Protection

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 in the 60s and 70s. While the policy may have helped to generate or sustain employment in the unorganized sector, such employment has been 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 the subject of criticism as a factor inhibiting the growth of SSI units as they serve as a disincentive to grow beyond the level up to which the concessions are available. Several official committees, too, have reviewed the schemes of exemption/concession and some of them have been highly critical of the regime of a tax concession and/or their design. The schemes underwent 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.



SECTION-II

Conceptual and Analytical Framework

2.1 Theoretical Framework

In India, the categorization of firms as micro, small and medium enterprises (MSME) is based on the investment on plant and machinery made by each firm. A micro enterprise is one where investment in plant and machinery does not exceed Rs. 25 lakhs. A small enterprise is one where the investment in plant and machinery is more than Rs. 25 lakhs but does not exceed Rs. 5 crores. A medium enterprise is one where the investment in plant and machinery is more than Rs.5 crores but does not exceed Rs.10 crores. Given these definitions of MSMEs, the existence of monopoly cannot be ruled out in some of the categories, since this categorization is not based on the market share or number of firms. This is especially important since in India, some of the products are especially reserved for MSMEs - no large scale firm can produce them.

In post economic reform period, a number of products have been removed from the list of products reserved for the MSME, so those products can also be produced by large scale firms⁷. In the products not explicitly reserved for the MSMEs, theoretically both MSMEs and large scale firm may coexist. Given these rigidities, it is clear that in the products reserved for MSMEs, the firms are not competing with the large scale industry. In rest of the products there may exist MSMEs and large scale industries operating together. The relationship between MSME and large scale industry could either be complementary or competitive - where both co-exist in the same product segment, and there are no economies of scale in the technology for production in that product segment the relation is competitive. If there are economies of scale in any product category, the small scale sector would need some support to remain competitive. On the other hand, if the MSME are vertically integrated with the large scale economy, as in providing inputs to the large scale units, the relation transforms into a complementary one. The important questions to ask therefore are: first, are there economies of scale in the products produced by the MSME sector, and second, are these enterprises vertically related to the large scale sector either through using their output or by providing inputs.

Clearly, in areas where there is evidence of complementarity between the MSME and large scale units, there is little reason or incentive to ask for additional intervention to protect or promote the MSME units. However, where there is evidence of competition between these

units, the question of the need for interventions needs to be explored in more detail.

It may happen that MSMEs are operating alongside the large scale firms in a sector where there exist economies of scale. Promoting MSMEs in these products or activities would appear to create a kind of inefficiency because government is giving incentive to some firms so that they can operate in the market with a higher cost. Instead if the government gives them incentive to increase their scale of operation through investment in plant and machinery, the output may increase given the same cost borne by the government. This argument however tends to breakdown where there is evidence of higher employment intensity of MSME as compared to the large scale units. It may happen that a same amount of output can be produced based on higher amount of investment on plant and machinery and less amount of employment. There may be destruction of jobs when MSMEs firms are transforming to large scale firm. *Ceteris paribus* in a developing economy with high rate of unemployment this path of production may not be suitable. Thus, in addition to assessing the possibility of economies of scale which could undermine the ability of MSME to survive, it is important to assess the likely impact on employment of supporting the MSME sector.

In the absence of economies of scale, the small scale are expected to have higher cost on account of capital but lower cost on account of concessional taxation and limited applicability of various regulatory provision such as labor laws. As our focus is to examine the impact of tax (VAT and Property Tax) on MSMEs, we need to understand the impact of tax on price and output and in turn profit. Needless to mention, the impact of tax on price and output depends on the nature of the market structure of a product. If the firms are price takers (perfectly competitive market) the incidence of tax on good can be completely transferred to the consumer depending on the elasticity of aggregate demand curve and supply curve. When market structure is oligopolistic in nature the price and output is strategically determined, the impact of tax will be completely different compared to the situation where firms are price takers. We need to study the nature of market where firms are operating and also determine the strategic variable in case market is oligopolistic in nature. Along with this, the complementarity of MSMEs with other sectors must be analyzed. We will also try to analyze the cross elasticity of the product to understand the impact of tax on other sectors. If the products are complement or substitute in nature the incidence of tax on one good may have varying impact on other goods.

When we look at tax exemption, it is only one form of incentive to promote MSMEs. There are other forms of incentives also like subsidy in borrowing, preferential procurement etc. To have a comprehensive analysis of which incentive impacts how much and in what form, we need to study the relationship of profit of MSMEs with different government schemes.

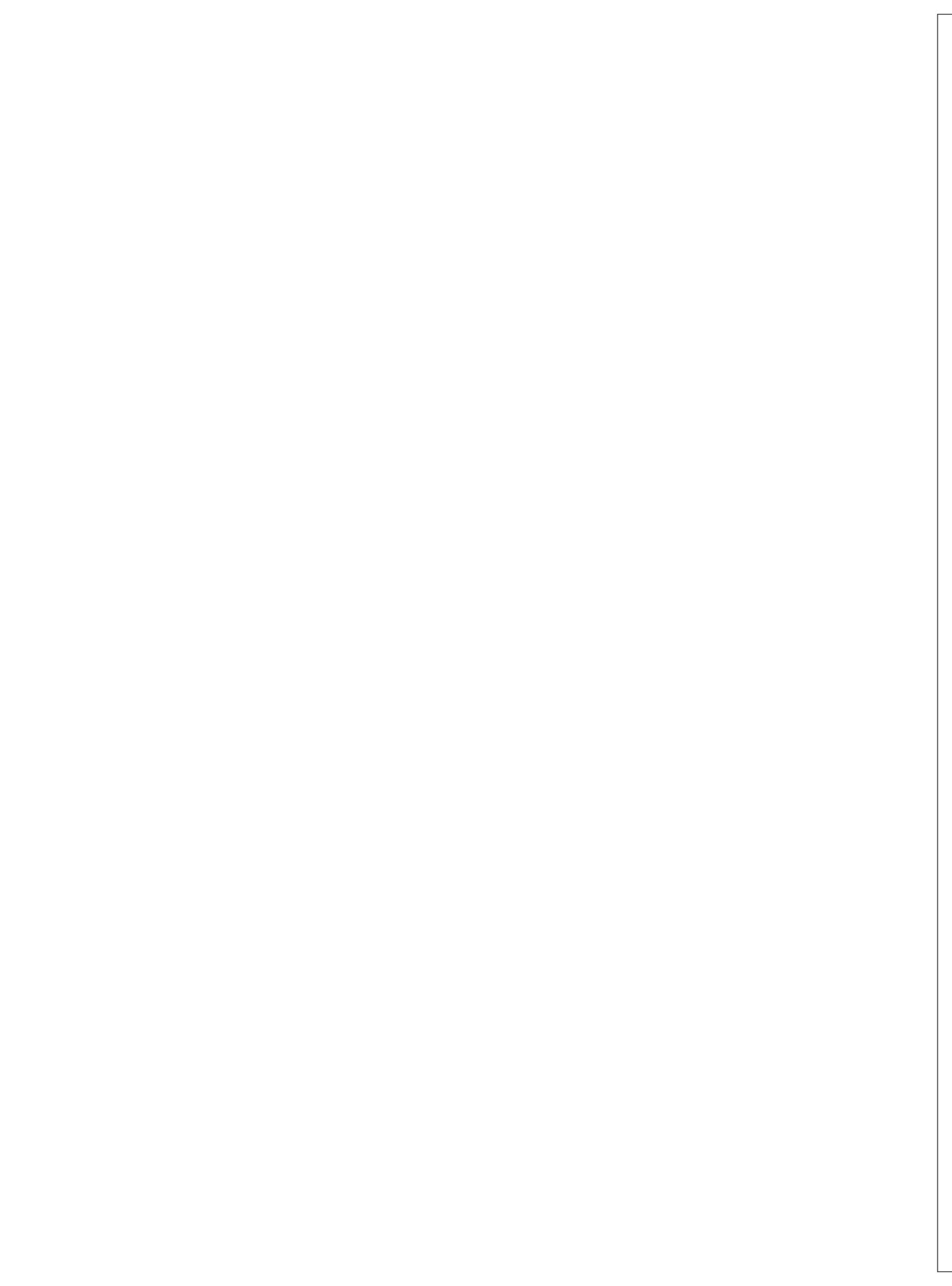
For example, the impact of property tax may be on the decision of firms regarding location to set up its unit. But even if a place has a higher property tax, firms may set up units because of agglomeration or because there are other offsetting incentives, etc. The inter linkages of firms operating in a place needs to be looked at vis-à-vis various fiscal provisions. Firms also faces compliance cost while paying tax. This cost must be part of the total tax burden borne by the firms. The study would attempt to factor in compliance cost of MSMEs as well.

2.2 Analytical Framework

As discussed in conceptual framework we need to establish a number of relationships to look at the overall picture of the impact of VAT and property tax on MSMEs. These relationships can be established through econometric analysis. In the context of India, we have secondary data from census of small scale industry. Important indicators like productivity, size, and profitability, economies of scale, employment intensity, output and price will be analyzed from those data and supplemented by the data from primary survey.

We can find out demand elasticity of the products based on the cross sectional data analysis of the price and output of firms. Based on it we can find out the impact of tax exemptions on output and prices of the MSMEs on average. To analyze the fact whether tax exemptions help, we also would look at relationship of profit and tax exemptions. The relationship of tax exemption and profit can be established through two stage regression. First the impact of tax on price and output and then the relation between price, output and profit.

We will also look at the impact of government intervention through subsidy in credit and tax exemption in a comparative framework. Through this analysis we will be able to say the relative merit of both the intervention by the government in MSME sector. The primary survey will give data on compliance cost of the firms. This will enable us to study the impact of compliance cost on the profit of firms. We can do a comparative analysis of impact of tax paid and compliance cost on profit. For facilitating these analyses, we propose to limit the coverage in the survey to a few product categories alone and choose firms appropriately.



SECTION-III

Methodology

3.1 Description of the Sample

The study is based on a two pronged approach – one draws on a survey of 200 enterprises across three cities and the other is based on interviews with people knowledgeable about this sector based on their association with it. The enterprises surveyed include micro, small and medium spread across Delhi-NCR, Coimbatore and Ahmedabad. The target respondent groups are all the manufacturing MSMEs (registered and non-registered both), both compliant and non-compliant with regard to VAT. However, purposive sampling method could not be done since there is no comprehensive listing of MSMEs. In the three cities, the survey team visited areas with a concentration of industrial enterprises. Of the enterprises located here, some were unwilling to spend the requisite two hours required for completing the questionnaire. The units surveyed finally therefore, were those located in the industrial areas and willing to devote the required time. An attempt was made to keep the coverage diverse in terms of sector profile. It may be noted that units located outside the industrial areas would not usually be reflected in the sample. Of the 200 enterprises, 100 are from Delhi NCR and 50 each from remaining two areas.

This followed from the fact that Delhi NCR has a more diverse set of industries as compared to the other two cities. Out of total 200 enterprises sampled, there are 113 from micro, 70 from small and 17 from medium enterprises. According to Micro, Small and Medium Enterprises Development (MSMED) Act, 2006, Government of India, the definitions of micro, small and medium enterprises engaged in the manufacture or production are: 1) Micro Enterprises: The investment in plant and machinery does not exceed Rs. 25 lakh; 2) Small Enterprises: The investment in plant and machinery is more than Rs. 25 lakh but does not surpass Rs. 5 crore and 3) Medium Enterprises: Here, the investment in plant and machinery is to be more than Rs.5 crore but will not surpass Rs.10 crore. However, as our samples of medium enterprises are too small vis-à-vis other two categories, thus, we have considered the small and medium units as a single category by clubbing them together for the exploratory analysis of the data.

For the purposes of the present study, this question was interpreted to reflect on the legal structure of the enterprise, i.e., is it registered as a company, a firm, a cooperative society or a society. Registering under any one of these categories does not necessarily get related to registering for taxation purposes. For the following discussion, therefore, registered units are those that obtained a registration under one of the above categories. Of total 200 units

surveyed, 74 enterprises¹ (37 percent) are registered and 126 enterprises (63 percent) are non-registered. It has been observed from table 1 that close to 70 percent or more of the micro enterprises across these three areas are non-registered enterprises. In the case of small & medium enterprises, in Delhi NCR and Coimbatore there is a relative predominance of registered enterprises, while in Ahmedabad, the non-registered enterprises dominate the picture. Besides, it is useful to look at the types of industries and its geographical distribution across the three surveyed areas to comprehend the pace of overall growth and development of the MSMEs as the different types of industries have different rate of growth, annual turnover, capital investment, employment generation capacity and per capita wages. Table 2 has been presented to show the frequency distribution of all the types of industries and table 3 to show the frequency distribution of all the types of industries among micro, small and medium categories, over the registered and non-registered types.

Table 1: Types of Industries and Their Geographical Distribution

Industry		Delhi-NCR	Coimbatore	Ahmedabad	Total
Micro	Registered	16 (26)	9 (31)	3 (13)	28 (25)
	Non-registered	45 (74)	20 (69)	20 (87)	85 (75)
	Total	61	29	23	113
Small & Medium	Registered	25 (64)	13 (62)	8 (30)	46 (53)
	Non-registered	14 (36)	8 (38)	19 (70)	41 (47)
	Total	39	21	27	87
Total	Registered	41 (41)	22 (44)	11 (22)	74 (37)
	Non-registered	59 (59)	28 (56)	39 (78)	126 (63)
	Total	100	50	50	200

Note: Figures in the parentheses are percentage shares.

Table 2 and 3 noticeably illustrates that the enterprises on 1) electronics and electrical goods, 2) metal and mechanical components, 3) textile, garments, yarn & fabrics and 4) auto-components are the dominant vis-à-vis all other types of industries. In addition to these, in the unregistered category, there are a noticeable number of enterprises in gems & jewellery and packaging products as well. This suggests that the sample is reasonably diverse, and can be considered representative of broad issues. Now we have looked at the types of industries by separating them into registered and non-registered categories and it

¹ Of which, 41 enterprises (55 per cent) are registered with “Registrar of Companies (ROC)” and residual 33 (45 per cent) are registered with “Registrar of Firms (ROF)”.

has been observed that enterprises on metal and mechanical components and textile, garments, yarn & fabrics are the foremost for both the categories while enterprises on electronics and electrical goods are significantly dominant in non-registered as compared to the registered category. In addition, further disaggregation of these data by the three areas elucidates the similar story that the above mentioned three categories are leading across all the three areas.

It is also important to highlight that, of total 200 entrepreneurs, 7 are only women and total 27 women are in managerial position. Out of these 27 women in managerial position, 10 are in micro firms while rest 27 women are in SMEs.

Table 2: Frequency Distribution of Industries, by Their Types

Types of Industry	Frequency
Agricultural products (non-food category)	3
Auto-components	17
Chemical products	4
Drugs, Pharmaceuticals & Surgicals	7
Electronics & Electrical Goods	24
FMCG products	5
Food, Food processing and allied industries	8
Gems & Jewelry	11
Leather Products	5
Metal, Mechanical Components (Engg.)	34
Packaging Products (Plastic Products)	12
Paper products	5
Rubber Products	7
Textile, Garments, Yarn & Fabrics	21
Wood products/ Furniture	12
Others	25

Table 3: Frequency Distribution of Industries among Micro, Small and Medium Categories Located in 3 Cities

Type	Industry	Registered			Unregistered		
		Delhi NCR	Coimb- -atore	Ahme- -dabad	Delhi NCR	Coimb- -atore	Ahme- -dabad
Micro	Agricultural products (non-food category)		1			1	
	Auto-components	3	1		2	3	
	Chemical products						1
	Drugs, pharmaceuticals & surgical						1
	Electronics & electrical goods	3	1		7	2	1
	FMCG products					1	
	Food, food processing and allied industries	1			2	2	1
	Gems & jewelry		1			3	3
	Leather products				3		
	Metal, mechanical components (Engg)	1	1	2	10	6	2
	Packaging products (plastic products)	1			4		2
	Paper products	1	1				2
	Rubber products				1		1
	Textile, garments, yarn & fabrics	2	1				4
	Wood products/furniture	1	1	1	4	2	
	Others	3	1		12		2
	Small & Medium	Agricultural products (non-food category)		1			
Auto-components		2	3			2	1
Chemical products		2		1			
Drugs, pharmaceuticals & surgical		2		2			2
Electronics & electrical goods		3	1		2		4
FMCG products					1	2	1
Food, food processing and allied industries				1			1
Gems & jewelry		1				1	2
Leather products		1					1
Metal, mechanical components (Engg)		4	2	3	1	1	1
Packaging products (plastic products)		1			3		1
Paper products					1		
Rubber products		2			2		1
Textile, garments, yarn & fabrics		3	4		2	1	4
Wood products/ furniture		1		1		1	
Others	3	2		2			

Of total 200 units surveyed, 56 percent were established before the year 2000 while 21 percent and 24 percent were established during 2000-04 and 2005-10, respectively.

Table 4: Age Profile of Industries

Age of Industries	Frequency	Percent
Before 2000	111	56
2000-04	41	21
2005-10	48	24
Total	200	100

Table 1.A.5 elucidates the ownership pattern of enterprises. It shows that most of them (63 percent) sole proprietor whereas 21 percent are private limited company and residual 17 percent are based on partnership.

Table 5: Ownership Pattern of Industries

Ownership Pattern	Frequency	Percent
Private limited company	41	21
Sole Proprietorship	126	63
Partnership	33	17
Total	200	100

More than 90 percent of total 200 units surveyed are being managed by owners when only 17 of them (9 percent) are being managed by hired managers.

Table 6: Managing Business Pattern of Industries

Manage Business	Frequency	Percent
Owner	183	92
Hired Manager	17	9
Total	200	100

Of total 200 units, the age of 52 percent entrepreneurs or major decision makers lies in between 41 – 60 years, 36 percent are within the age interval of 20 – 40 years while rest 13 percent are above 60 years.

Table 7: Age of Entrepreneur / Major Decision Maker

Age of Entrepreneur	Frequency	Percent
20 – 40 years	71	36
41 – 60 years	103	52
> 60 years	26	13
Total	200	100

Total years of experience of the entrepreneurs or major decision makers, is presented by table 8. 38 percent major decision makers of total 200 firms have more than 20 years of experience, 36 percent have 11 to 20 years and 18 percent are managing their business with 6 to 10 years of experience. Only remaining 8 percent have less than or equal to 5 years of experience.

Table 8: Total Experience (in years) of Entrepreneur / Major Decision Maker

Total Experience of Entrepreneur	Frequency	Percent
0 - 5 years	15	8
6 - 10 years	37	18
11 - 20 years	72	36
> 20 years	76	38
Total	200	100

3.2 Approaches for Analyzing Data

At the outset, on each question, frequency distribution and their respective percentage shares have been provided to comprehend the pattern of the data. Subsequently, we have set up some relationships by cross tabulating variables and finally we have tested some hypotheses. Chi-square is used to signify the occurrence of any significant differences either from micro to small & medium units or from registered to unregistered firms while relevant t-test has been performed to observe the same on continuous variables like, capita investment, annual turnover, per capita salaries and wages, cost of compliance etc. In addition, we have computed odd ratios. From the cross tabulation of the responses of the firms and the nature of firm we get the percentages of firms taking a specific decision or choosing a specific option. From these percentages we can calculate the odd ratio of a firm taking a specific decision or choosing a specific option depending of the nature of the firm.

Thereafter, Exploratory Data Analysis (EDA) has been used to compute the descriptive statistics of tax exemptions and concessions, Value-Added-Tax (VAT), and property tax on the basis of the information of MSME. The Box-Whisker plot will be used for the graphical presentation of the summary statistics.

SECTION-IV

Survey Results and Findings

Initially, we present a broad overview of the perception of the unit surveyed based on frequency distributions along with percentage shares. Since responses/perceptions about taxation could be related to the size of the units – relatively large units are more likely to be a part of the tax system and their primary concern might be how to optimize within the system, while micro unit could still be toying with the decision of whether to be in the tax system or not - we explore this aspect in some questions. Chi-square test² has been executed to infer about whether any observed differences in the perceptions are statistically significant or not. This test was done for all questions relating to perceptions and only those cases with significantly different results between micro and small and medium units are reported in the discussion.

This section therefore starts with question-wise frequency distribution, percentage shares and descriptive statistics. Where perceptions were found to be different between micros and small and medium enterprises, the results of a chi-square test too are reported.

4.1 Overall Firm Characteristics

4.1.1 If an Enterprise (micro, small and medium) is not Registered, what are the Obstacles they have been facing with Respect to Registering?

Out of 200 units surveyed, 74 are registered (of which, 41 firms are registered with registrar of companies (ROC) and the remaining 33 are with registrar of firms (ROF)) and 126 non-registered enterprises. As regards perceptions on obstacles to registering, we have collected perceptions not only from the non-registered firms but from the registered firms as well. These have been presented in the table 9 below:

² If the p-value is lower than the conventionally accepted significance level of 0.05 then we reject the null hypothesis. In other words, there is statistically significant difference between the factors.

Table 9: Perceptions on the Obstacles with Respect to Registering, Over the Types of Industry: Frequency Distribution

S. No	Industry	Response	Percent of 'Yes' in Total	of which	
				Registered	Non-Registered
1	Difficulty of getting information on registration process*	Yes	51	27	74
2	Time to complete registration procedures	Yes	27	18	36
3	Minimum capital requirements for registered enterprises in my sector	Yes	29	15	43
4	Financial cost of completing registration procedures	Yes	28	24	32
5	Administrative burden of complying with all tax laws for registered enterprises	Yes	33	28	38
6	Financial burden of taxes on registered enterprises	Yes	30	28	32
7	Strict labor market rules that registered businesses must comply with	Yes	23	19	26
8	Other administrative burdens imposed on registered businesses (e.g. inspections and meetings with government officials)	Yes	21	17	25
9	Complex registration forms which are difficult to fill	Yes	19	15	22
10	The place you go to register is far and therefore transport is expensive	Yes	3	1	4
11	Lack of Awareness	Yes	14	10	18
Total number of firms			200	74	126

Note: * indicates that the chi-square value shows statistically significant difference from registered to unregistered category.

While table 9 suggests that the perceptions of entrepreneurs on the obstacles that they are facing with respect to registering differ between registered to non-registered firms, these differences are not statistically significant, except for S. No. 1. In S. No. 1, the result suggests that larger proportion of unregistered firms perceive difficult in getting information on the process of registration when compared to the small & medium. A significant number of the non-registered firms mentioned chose the following variables as factors contributing to their not having registered:

- a) Trouble getting information on registration process, including time required to complete the registration process,
- b) Minimum capital requirements for registered enterprises in their sector is not satisfied

- c) Administrative burden and financial burden of complying with all tax laws for registered enterprises.

Administrative and financial burden of being the tax system is flagged by registered enterprises also as a potential reason for firms choosing not to register.

4.1.2 Characteristics of Owner/Manager (Caste and Educational Qualification of Entrepreneurs)

If we look at educational qualification wise distribution of owners, of total 200 enterprises surveyed, 3 percent, 7 percent and 26 percent are less than primary, primary and secondary, respectively while 50 percent graduates and 14 percent post-graduate owners have found. Caste wise distribution clearly shows that it is the general category who dominates mostly (77 percent). Subsequently, 17 percent are OBC and rest 6 percent comprises SCs, STs and others.

Table 10: Caste and Educational Qualification of Entrepreneurs, over types of Enterprise: Frequency Distribution and Percentage Shares

Caste	Less than primary	Primary	Secondary	Graduate	Post graduate	Total
General	1	11	34	85	24	155 (77)
OBC	2	1	15	13	3	34 (17)
SC	2	2	1	1	0	6 (3)
ST	0	0	0	1	0	1 (1)
Other	2	0	2	0	0	4 (2)
Total	7 (3)	14 (7)	52 (26)	100 (50)	27 (14)	200

Notes: 1) Figures in the parentheses are percentage shares.

2) OBC stands for Other Backward Classes, SC stands for Scheduled Caste and ST stands for Schedule Tribe.

4.1.3 Capital Investment and Annual Turnover of the Enterprises, Sales mix in terms of Domestic Sales versus Exports and Market their Produce

The level of capital investment and annual turnover is higher for small & medium enterprises compared to micro and similarly is higher for registered firms vis-à-vis unregistered. T-test shows that the mean differences from micro to small & medium and registered to unregistered for capital investment and annual turnover are statistically significant (table 11).

Table 11: Capital Investment and Annual Turnover of the Enterprises, over their Types and Legal Status
In Thousand Ruppes

Variable	Registered	Unregistered	t-value
Capital Investment	66667.39	14307.45	0.0157
Annual Turnover	88696.22	20361.29	0.0003
Variable	Micro	Small & Medium	t-value
Capital Investment	4784.95	72467.95	0.0010
Annual Turnover	7646.13	94708.05	0.0000

Note: t-value gives the p-value associated with the t-statistic for testing the hypothesis the registered firms have higher values than unregistered and small & medium have higher values than micro firms.

Figure 1: Capital Investment and Annual Turnover of the Enterprises, over their types

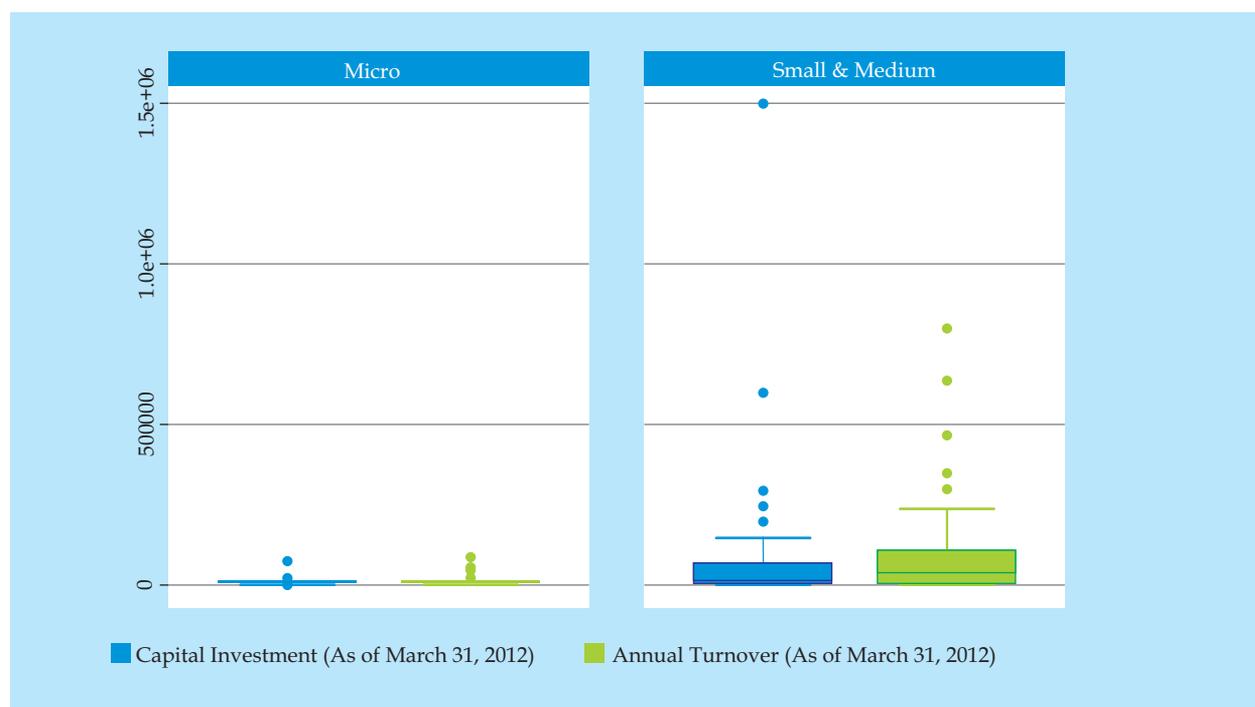


Figure 2: Capital Investment and Annual Turnover of the Enterprises, Over Their Legal Status**Table 12: Sales Mix in Terms of Domestic Sales Versus Exports**

Sales Mix	Frequency
Local Market	192
Export Market	33

It is clearly evident from table 12 that majority of them are selling their products in the domestic market and not exporting. Of total 33 exporting firms, almost all the exporters are relatively big firms (in terms of annual turnover) within the category of Micro, Small and Medium Enterprises. We run a logistic regression where dependent variable is a dummy relating to whether firms export or not and the independent variable is the annual turnover. The dummy variable takes value 1 if the firm is an exporter and zero if the firm is non-exporter. We get that annual turnover is statistically significant at 5% level of significance. The odd ratio of annual turnover is 1.000005. This implies that one unit increase in annual turnover leads to increase in the odds of being exporter to non-exporter by 1.000005 factors. The overall model is statistically significant because p-value of the chi-square test is 0.004. It is significant at 5% level of significance. It is shown by table 13.

Table 13: Exporters and Annual Turnover: Logistic Regression

Export	Odds Ratio	Std. Ratio	z	P> z
Annual Turnover	1.000005	1.67E-06	2.88	0.004
Log likelihood = -83.769531 Prob. > chi2= 0.0012				

We have also looked at whether the way products are sold by the firms like “directly in the market” or “to dealers” have differences in impact of tax. Most of the firms in the survey sell their products directly in the market. Around 30 percent of firms do both things – sell directly in the market and to the dealers. While 55 percent sell directly to the market and rest 15 percent sell their products directly to the dealers. In this case, the odds ratio is estimated to be -1.734601 (See table 14). This shows that the probability of choosing to market at least a part of their products directly is higher than the probability of operating only through independent dealers. In other words, selling through dealers is not a preferred mode of sale for firms and only a small fraction of the firms follow it.

Table 14: How they Market their Produce: Logistic Regression

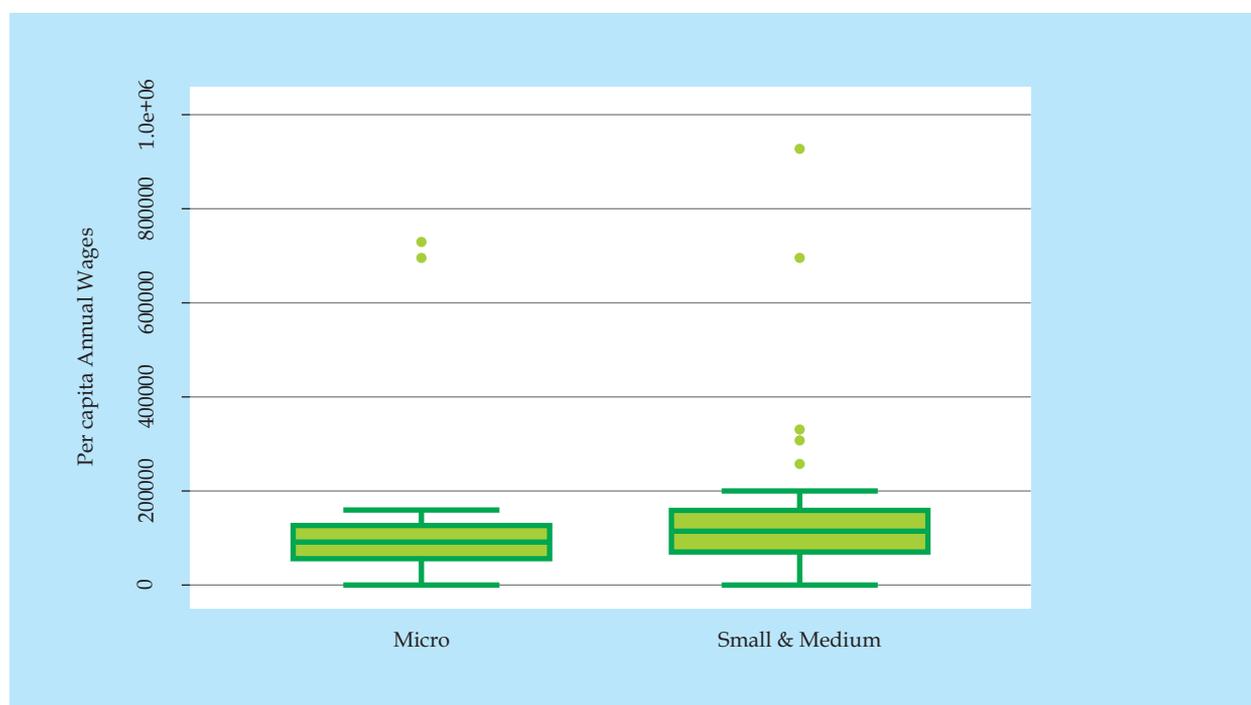
Log (odd ratio of selling only to dealers)	Std. Ratio	z	P> z
-1.734601	0.19803	-8.76	0
Log likelihood = -84.541818			

4.1.4 Staff Employed, Annual Wages Paid and Per Capita Annual Wages

Total 1454 and 4856 employed staffs were found in micro and small & medium categories, respectively. The mean employed staff in micro is 13 while it is 56 in small & medium category. T-test has shown that the mean difference from staffs employed in micro units to the staffs employed in small & medium category is statistically significant. Similarly, the mean per capita annual wages is significantly higher in small & medium units (Rs. 6117 thousand) than micro (Rs. 983 thousand). It has been observed from figure 3 that the median value of per capita annual wages is higher than micro, while both have some exceptionally high values (outliers).

Table 15: Total Number of Staff Employed and Total Annual Wages Paid

Descriptive Statistics	Micro	Small & Medium	Total
Staff Employed			
Observation	111	86	197
Mean	13	56	32
Minimum	2	3	2
Maximum	100	500	500
Total no. of staff employed	1454	4856	6310
t-value = -4.1554			
Per capita Annual Wages Paid (In Rupees)			
Observation	96	78	174
Mean	92487.7	125863.2	107449.1
Minimum	5714	12000	5714
Maximum	720000	900000	900000

Figure 3: Per capita Annual Wages Paid

4.1.5 Nature of Land Used by MSMEs

Of total 200 units surveyed, 106 enterprises possess 'own land' while 85 and 9 enterprises work with leased private land and land rented from local governments, respectively. The number of small & medium enterprises possessing own land is higher than micro firms and the opposite case is evident for the case of leased private land. From this table it appears that even units with own land do not often seek to register. In other words, perhaps the benefits from registration are not evident. Since the definition of a registered firm is such that even if a unit is not registered, the owner of the unit can take lease in individual capacity. Sometimes it is also possible that these units operate from their homes or other such locations where formal sanction for operation of a manufacturing unit might not be forthcoming. This makes registration difficult, maybe even undesirable from the point of view of the firm. However, this issue has not been explored in the survey.

Table 16: Nature of Land Used by MSMEs, over their Types and Legal Status

Nature of Land Used	Total	of which			
		Registered		Non-registered	
		Micro	Small & Medium	Micro	Small & Medium
Owned land	106	13	29	35	29
Leased private land	85	14	14	46	11
Land rented from local government	9	1	3	4	1

4.1.6 Access to Credit/Loan

Total 82 firms have taken loans while remaining 118 have not. Of the former, there are 48 firms from small & medium category while 34 are from micro. As the majority of them have not taken loans, therefore it is required to know the reasons behind it. It has been observed from table 18 that out of total 118 firms which have not taken loans, 67 percent have stated that they have sufficient capital and therefore they do not need loans, 22 percent have mentioned that rate of interest is not favorable and residual 11 percent have revealed some other reasons like, complex application procedure, high requirements of collateral etc.

Table 17: Whether any Loans have been taken by MSMEs, over their Types

Whether Loan Taken	Total	of which			
		Registered		Non-registered	
		Micro	Small & Medium	Micro	Small & Medium
Yes	82	11	28	23	20
No	118	17	18	62	21

Note: Chi square test not significant.

Table 18: Reasons for which Enterprises did not apply for Loan / Line of Credit

Reasons behind not applying for Loan	Total	Percent
No need for a loan - enterprise had sufficient capital	80	67
Application procedures were complex	8	7
Interest rates were not favorable	26	22
Collateral requirements were too high	3	3
Size of loan and maturity were insufficient	1	1
Total	118	100

4.1.7 Are MSME Business Support Networks Increasing?

On the whole, 103 units (52 percent) out of 200 perceive that MSME business support networks are not increasing while 62 (31 percent) perceive that it is increasing and 35 units (17 percent) could not say anything about it. If we look at this perception by their legal status, the difference from registered to unregistered has appeared as statistically significant. Whereas 46 percent of total registered units perceive that it is increasing at that time 58 percent of total unregistered units perceive that the same is not increasing.

Table 19: MSME Business Support Networks Increasing, over their Legal Status

Whether LaMSME Business Support Networks Increasing/loan Taken	Total	Percent	Registered	Unregistered	Percent	
					Registered	Unregistered
Yes	62	31	34	28	46	22
No	103	52	30	73	41	58
DK / CS	35	17	10	25	14	20
Total	200	100	74	126	100	100
Chi-square = 0.0022						

4.1.8 Lack of Technical Skills of Entrepreneurs is a Hurdle in Enterprise Development?

Although any significant difference from micro to small & medium and from registered to unregistered units, have not appeared but 45 percent of total 200 units surveyed perceive that lack of technical skills of entrepreneurs is an impediment for enterprise development whereas 38 percent perceives that it is not.

Table 20: Lack of Technical Skills of Entrepreneurs: Is it a Hurdle for Enterprise Development, over their Types and Legal Status

Lack of technical Skills of Entrepreneurs is a Hurdle in Enterprise Development	Total	Percent
Yes	89	44.5
No	77	38.5
DK / CS	34	17
Total	200	100

4.2 General Tax Behavior

4.2.1 Do You Pay Taxes?

Most of the firms reported that they pay taxes (192 of 200) while only 8 enterprises have mentioned that they do not pay taxes. Therefore, table 22 is presented to show the reasons behind not paying taxes. Of total 8 enterprises that are not paying taxes, 5 of them mentioned that turnover/sales are below exemption level, 2 of them said that tax rates are too high and filling the tax return is difficult.

Table 21: Do They Pay Taxes

Do You Pay Taxes	Total	Percent
Yes	192	96
No	8	4
Total	200	100

Table 22: Reasons Behind not Paying Taxes

Reasons Behind not Paying Taxes	Agree	No
Turnover/sales are below exemption level	5	3
Tax rates are too high	2	6
No benefit from taxes paid in services from government	4	4
Tax revenue is not fairly spent by the government		8
No one comes to collect tax	1	7
Difficulty in filling the tax return	2	6
See no need for paying taxes	1	7
No problem if Tax is not paid	2	6

4.2.2 Do you agree that Tax Laws and Procedures are too Complex?

More than 80 percent reported that tax laws and procedures are complex while close to 10 percent perceive that these are not too complex while remaining only 6 percent are indifferent, who could not say that whether tax laws and procedures are complex or not.

Table 23: Tax Laws and Procedures are too Complex

Tax Laws and Procedures are too Complex	Total	Percent
Strongly Agree	82	41
Yes	85	43
Disagree	17	9
Strongly Disagree	4	2
Neither Agree nor Disagree	12	6
Total	200	100

4.2.3 Do you think that Tax Collecting Agencies have Competent Officers?

While this result is not as skewed as the previous question on whether tax laws and procedures are complex, over 55 percent of firms perceive the tax authorities have competent officers.

Table 24: Tax Collecting Agencies have Competent Officers

Tax Collecting Agencies have Competent Officers	Total	Percent
Highly competent	9	5
Competent	104	52
Not competent	58	29
DK / CS	29	15
Total	200	100

4.2.4 Do you think that Tax Staff is Fair and Respectful in Dealing with MSMEs?

Of total 200 enterprises, 85 (42 percent) perceive that tax staff is fair and respectful while rest 115 (58 percent) perceive that they are not. If we look at this perception over the two types of enterprises, statistically significant difference can be seen. Table 25 shows a larger percentage of micro firms perceive that they are not fair and respectful when compared to small.

Table 25: Tax Staff is Fair and Respectful in Dealing with MSMEs, over their types

Tax Staff is Fair and Respectful in Dealing with MSMEs	Total	Percent	of which	
			micro	Small & Medium
Yes	85	42	41 (36)	44 (51)
No	115	58	72 (64)	43 (49)
Total	200	100	113	87
Chi-square = 0.0427				

4.2.5 Do you Feel you are Harassed by Tax Official?

Of total 200 units surveyed, 58 percent have reported that they have been harassed by tax officials while 42 percent perceive that they have not been harassed by them.

Table 26: Harassed by Tax Official

Harassed by Tax Official	Total	Percent
Yes	84	42
No	116	58
Total	200	100

4.2.6 Are there too Many Taxes?

Most of them perceive that there are too many taxes in the current tax structure. Only 20 of total 200 enterprises have stated that taxes are not too many. However, they perceive that too many taxes have been creating several important problems like, multiple accounting requirements, time and cost of compliance is high, bribe etc. Equal to or even more that 75 percent of total enterprises perceive that these three are the major problems behind the too many taxes in the current tax structure of the economy.

Table 27: Are there too Many Taxes

Too Many Taxes	Total	Percent
Yes	84	42
No	116	58
Total	200	100

Table 28: If there are too Many Taxes then what are the Problems, over their Types and Legal Status

Problems of too Many taxes	Response	Registered		Non-registered		Total	Percent
		Micro	Small & Medium	Micro	Small & Medium		
Multiple accounting requirements	Yes	18	31	55	31	135	75
	No	8	10	20	7	45	25
	Total	26	41	75	38	180	100
Time and cost of compliance is high	Yes	19	34	55	27	135	75
	No	7	7	20	11	45	25
	Total	26	41	75	38	180	100
Bribe	Yes	20	31	60	28	139	77
	No	6	10	15	10	41	23
	Total	26	41	75	38	180	100

4.3 Perception regarding the impact of Tax Exemptions and Concessions

4.3.1 Do you think that MSMEs are facing Bias Regarding Tax Benefits in the Current Tax Structure?

Of total 200 enterprises, 183 (91 percent) perceive that the enterprises are not facing bias regarding tax benefits in the current tax structure while rest 17 (9 percent) perceive that they are facing such biases. Statistically significant difference can be seen when we look at

this perception over the two types of enterprises. Micro firms report a perception of bias somewhat more frequently than small and medium firms. However, since there is an overwhelming perception of lack of bias, the differences should be interpreted cautiously. It has been understood from table 29 that 99 of total micro firms perceive that they are not facing bias regarding tax benefits in the current tax structure while 84 of total small & medium firms perceive the same. In other words, 14 of total micro firms perceive that they are facing bias regarding tax benefits in the current tax structure while only 3 of total small & medium firms perceive the same. However, the reason for biasness is being given as government does not cooperate with the micro firms and concessions and certificates are not given.

Table 29: MSMEs are Facing bias regarding Tax Benefits in the Current Tax Structure, Over their Types

MSMEs are facing bias regarding tax benefits in the current tax structure	Total	Percent	of which	
			micro	Small & Medium
Yes	17	9	14	3
No	183	91	99	84
Total	200	100	113	87
Chi-square = 0.0246				

4.3.2 Do Women Entrepreneurs get any Preference in Accessing the Incentives?

Data reported on this perception is very skewed. Over 90 percent perceive that they do not get any preference in accessing the incentives.

Table 30: Women Entrepreneurs Get any Preference in Accessing the Incentives

Women Entrepreneurs get any Preference in Accessing the Incentives	Total	Percent
Yes	17	9
No	183	91
Total	200	100

4.3.3 Do you get any Tax Exemptions and Concession?

Only 10 percent of total 200 enterprises perceived that they have got tax exemptions and concessions while most of them (90 percent) perceive that they have not got any tax exemptions and concessions³. As majority of them perceive that they have not got any tax exemptions and concessions, thus it is tricky to comprehend their perceptions about the impact of it on their firms. However, table 32 reveals that majority of them perceive regarding the impact of tax exemptions and concessions on their firms in terms of: a) increase in sales, b) increase in productivity and c) increase in competitiveness is medium while 16, 11 and 5 percent of total enterprises perceive that the impact is high.

Table 31: Got any Tax Exemptions and Concessions

Got Tax Exemptions and Concessions	Total	Percent
Yes	19	10
No	181	90
Total	200	100

Table 32: Impact of Tax Exemptions and Concessions on their Firms, over their types and legal status

Impact of Tax Exemptions and Concessions on their Firms	Registered		Non-registered		Total	Percent
	Micro	Small & Medium	Micro	Small & Medium		
Increase in Sales						
High		3			3	16
Medium	2	5	2	2	11	58
Low			2	1	3	16
No effect		1		1	2	11
Total	2	9	4	4	19	100
Increase in Productivity						
High		2			2	11
Medium	2	4	4	2	12	63
Low				1	1	5
No effect		3		1	4	21
Total	2	9	4	4	19	100

³There is possibility that firms have not understood what actually a tax exemption is and what it implies. When tax exemptions operate such that the tax becomes operative only above a certain threshold of turnover, since the exemption is available to all similar firms and does not require the firm to do anything to avail of the exemption, the firms might perceive it to be a part of the normal tax regime and not a special scheme reducing their liability. In India, most indirect tax exemptions for small units are built into an exemption threshold and similarly for income tax.

Increase in Competitiveness						
High		1			1	5
Medium	1	4	1	2	8	42
Low			1		1	5
No effect	1	4	2	2	9	47
Total	2	9	4	4	19	100

4.3.4 Did you get Tax Holiday during Establishment of your Firm?

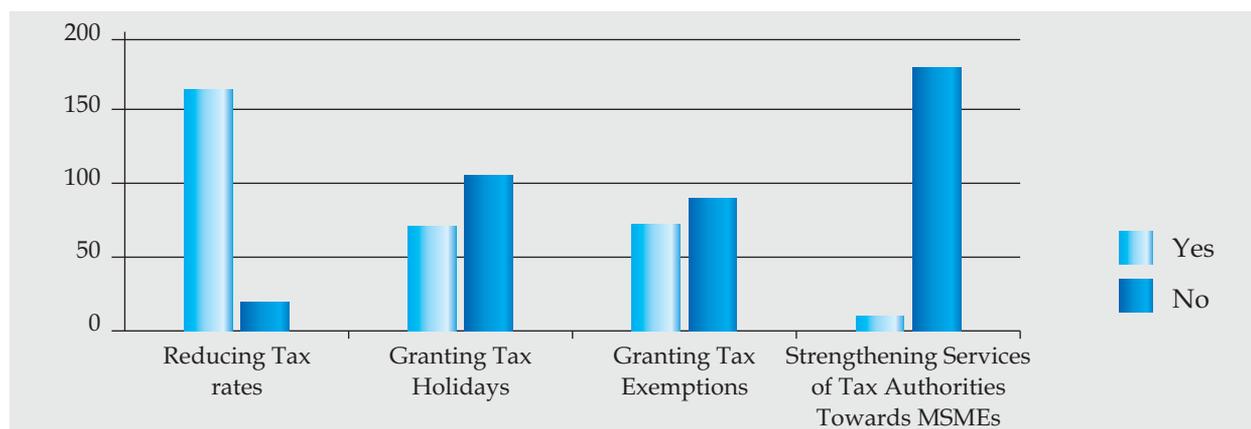
Of total 200 enterprises, only 5 have got tax holiday (of which, four are small & medium firms while only one is micro firm) during the establishment of their firms while rest 195 have not got it.

Table 33: Got Tax Holiday

Got Tax Holiday	Total	Percent
Yes	5	3
No	195	98
Total	200	100

4.3.5 Which Tax Related Government Assistance would help the Growth of your Business?

It has been observed from figure 4 that entrepreneurs are more interested in the reduction of tax rates than granting tax exemptions and tax holidays and they are not at all concerned about reinforcing services of tax authorities towards MSMEs. The similar picture is also evident across all the three cities where owners of both micro and small & medium enterprises from Delhi NCR, Coimbatore and Ahmedabad want the reduction in tax rates. The only notable matter is that the majority of the owners of small & medium enterprises from Ahmedabad want to have tax exemptions first and thereafter, reduction in tax rates (Table 34). Besides, the similar picture is observed across the various types of the industries. Both the types of industry have mentioned the reduction in tax rates as first and then granting tax exemptions in order to have tax related government assistance (Table 35).

Figure 4: Tax Related Government Assistance: What They Want**Table 34: Location (City) wise Requirements of Tax Related Government Assistance: Frequency Distribution**

Requirements	Category	Delhi NCR		Coimbatore		Ahmedabad	
		Yes	No	Yes	No	Yes	No
Reduction in tax rates	Micro	48	13	22	7	23	
	Small &medium	32	7	20	1	26	1
Granting tax holiday	Micro	23	38	5	24	13	10
	Small &medium	19	20	3	18	16	11
Granting tax exemptions	Micro	27	34	14	15	12	11
	Small &medium	13	26	8	13	14	13

Table 35: Types of Industries wise Requirements of Tax Related Government Assistance

Type of Industry	Reduction in Tax Rates				Granting Tax Exemptions			
	Micro		Small&Medium		Micro		Small&Medium	
	Yes	No	Yes	No	Yes	No	Yes	No
Auto-components	6	3	7	1	6	3	5	3
Drugs, pharmaceuticals & surgicals	1	2	6	4		1	2	4
Electronics & electrical goods	12	2	6	1	3	11	3	7
Food, food processing and allied industries	4	2	2	1	3	3	1	1
Gems & jewelry	6	4	4		3	4	3	1
Metal, mechanical components (Engg.)	18	1	11		8	14	3	9
Packaging products (Plastic Products)	6	1	5		6	1	2	3
Textile, garments, yarn & fabrics	6	3	12		4	3	4	10
Wood products/furniture	8		3		5	4	3	12
Others*	26	2	22	2	15	16	9	2
Total	93	20	78	9	53	60	35	52

Note: * Same as table 1.2.

4.3.6 Have you Registered with Tax Authority?

As discussed in sub-section 2.9 above, an overwhelming number of the units surveyed report to being registered with a tax department and paying taxes. The responses to this question are consistent with those reported earlier – 192 firms are registered with a tax authority and only 8 firms are not so registered.

Table 36: Registered with Tax Authority

Registered with Tax Authority	Total	Percent
Yes	192	96
No	8	4
Total	200	100

4.3.7 What has been your Annual Cost on Tax Related Matters (compliance cost)?

The average cost of compliance per firm is Rs. 58,412. Of these, the registered units reported a higher compliance cost when compared to the unregistered units and the small and medium firms report a higher compliance cost when compared to micro firms. The differences in annual compliance cost from micro to small and from registered to unregistered – both are statistically significant. It should however be noted that the spread of values for small firms is higher than that for micro firms and similarly for registered firms as against for unregistered firms. (See figures 5 and 6) These figures also reveal that while the median for small is higher than the median for micro, the same does not hold for registered versus unregistered. In the latter comparison, one can observe a larger number of outliers in registered units, which would explain the means being different, but medians being similar.

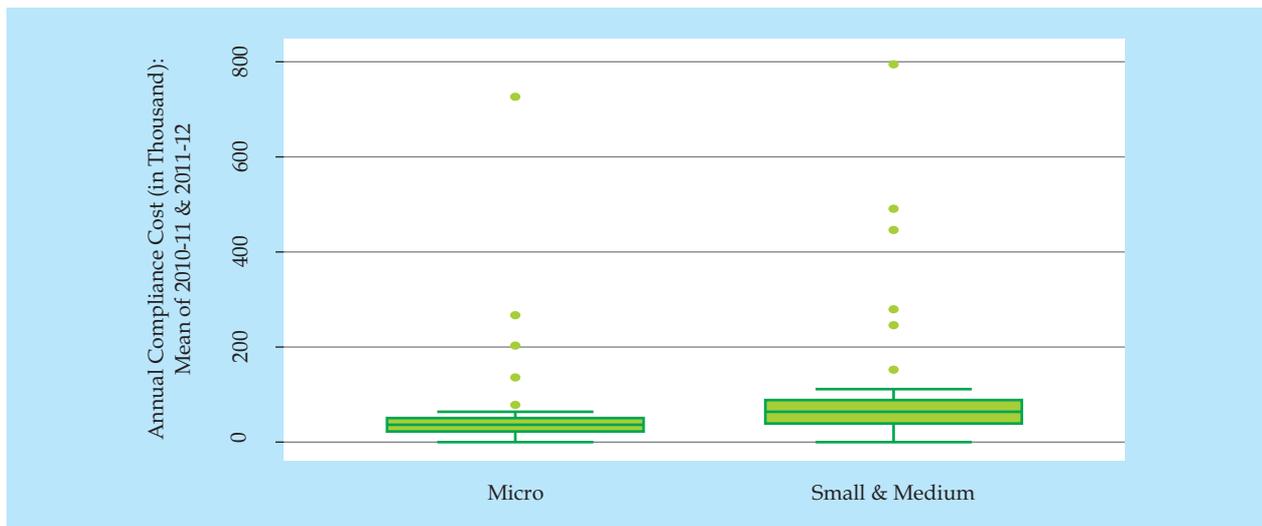
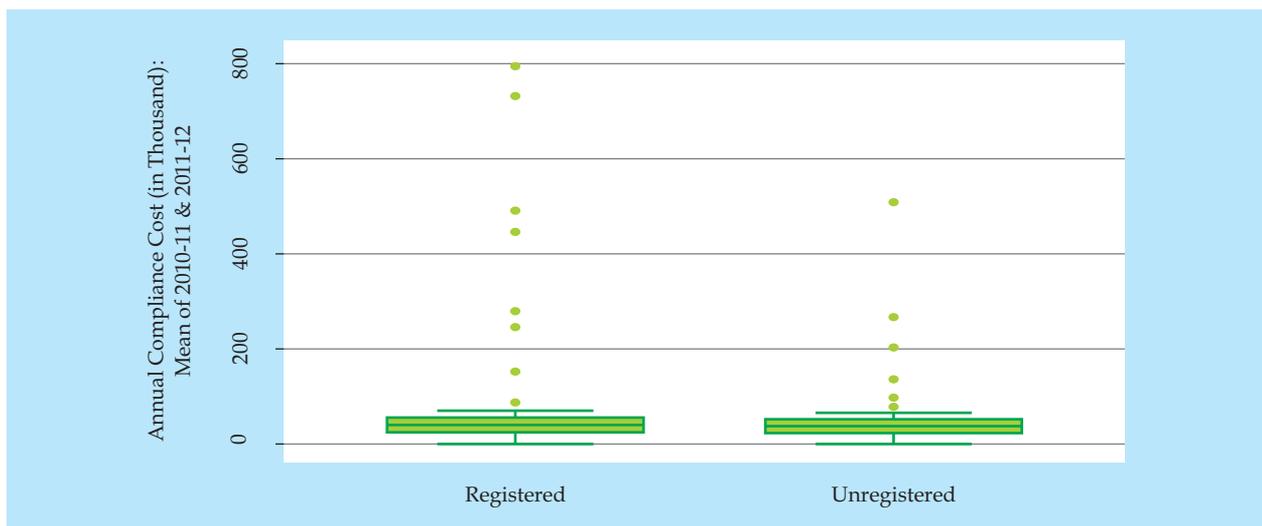
Table 37: Annual Compliance Cost (in thousands)

Types and Status of Industry	Descriptive Stat.	Compliance Cost
Micro: Registered	No. of Observation	23
	Mean	51.48
Micro: Unregistered	No. of Observation	61
	Mean	31.38
Small & Medium: Registered	No. of Observation	38
	Mean	112.62
Small & Medium: Unregistered	No. of Observation	30
	Mean	50.03
Total	Mean	58.41

⁴ To recall, unregistered in the present survey does not mean not paying taxes. Unregistered units too are registered for tax purposes and hence will incur compliance cost.

Table 38: Differences in Annual Compliance Cost (in thousands), over their types and legal status

Category	Obs	Mean	t-value
Micro	84	36.88	0.016
Small & Medium	68	85.01	
Registered	61	89.57	0.035
Unregistered	91	37.53	

Figure 5: Annual Compliance Cost, over types of Industry**Figure 6: Annual Compliance Cost, over Legal Status of Industry**

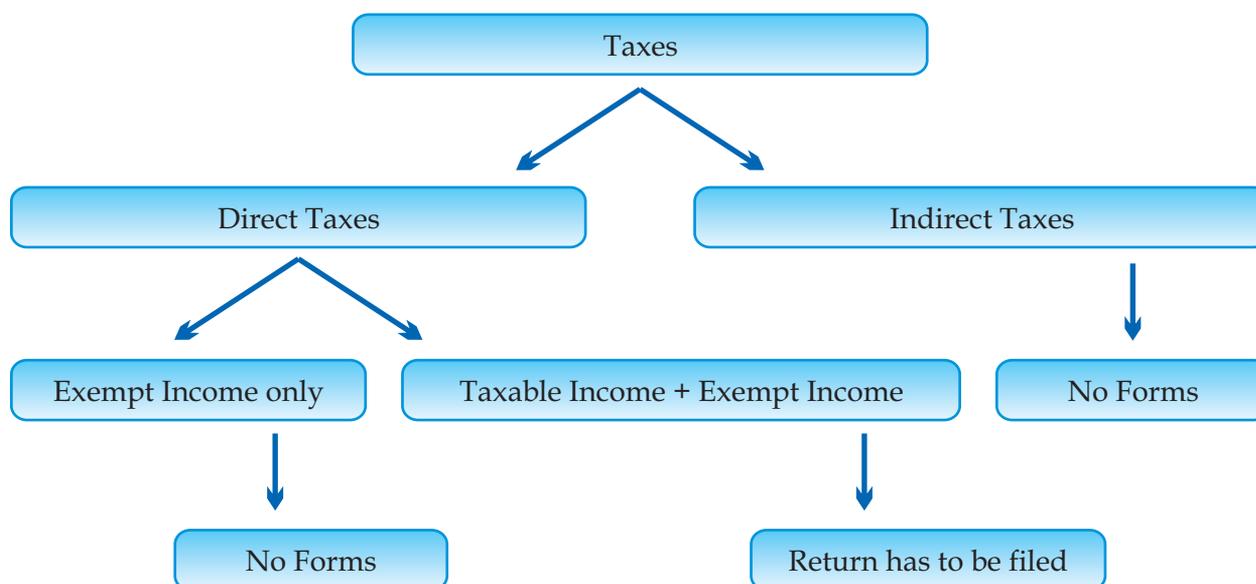
4.3.8 Do you have to fill any Form to get Tax Benefits?

For indirect taxes, exemptions do not require the firms to even be registered with the tax department. In income tax however, firms would have to file a return to claim a deduction on account of exempt incomes, provided they have other taxable incomes. Table 39 shows that an overwhelming number of firms report that they do not have to fill forms to get tax benefits. The 14 percent who do indicate that there are forms to be filled would possibly be referring to income tax or could not be poorly informed about the provisions of the tax regime. In India the structure of tax benefits and the forms needed to be filled to get tax benefit can be represented by the following tree (Figure 7). As can be seen from the tree, for most exemptions, units do not have to fill forms. Not filling forms is therefore not evidence of not getting benefits.

Table 39: Fill Form to get Tax Benefits

Fill Form to Get Tax Benefits	Total	Percent
Yes	28	14
No	172	86
Total	200	100

Figure 7: When the Forms are to be filled to get Tax Benefits in India



4.3.9 Are there Enterprises that are not interested to get Tax Benefits just to avoid the Hassles Associated with Compliance Requirements?

As suggested above, for exemptions under the Income Tax Act, the firms availing incentives would be required to file returns and report on such exempt incomes. Further, since some of the exemption schemes are time bound, availing these schemes would imply enrolling to be a part of the tax regime once the exemption period is over. Further, these firms can potentially be audited by the tax department to verify claims of exempt incomes. All of these might be perceived as hassles associated with compliance requirements. As Table 40 suggests, about 23 percent of the firms report that they are interested in tax benefits to avoid such hassles⁵. This table however, cannot be read as evidence of the existence of such hassles, but only as a perception of the possibility of such hassles.

Table 40: Enterprises that are not interested to get Tax Benefits just to avoid the Hassles Associated with Compliance Requirements

Enterprises that are not interested to get Tax Benefits just to avoid the Hassles associated with Compliance requirements	Total	Percent
Yes	45	23
No	155	78
Total	200	100

4.4 Perception regarding the Impact of Value Added Tax (VAT)

4.4.1 Compliant to VAT

Over 90 percent of the surveyed firms, reported being compliant to VAT regime in India. This number is marginally smaller than the number of firms which reported paying taxes. In other words, there are a few firms that do not pay VAT but possibly pay other taxes. This could even be because the products they manufacture are exempt.

Table 41: Compliant to VAT

Compliant to VAT	Total	Percent
Yes	180	90
No	20	10
Total	200	100

⁵ The results suggest that most of the firms prefer reduction in tax rates rather than tax holidays or tax exemptions (except for exporting firms which want tax holidays) and if tax benefits are given, majority of the firms are willing to accept it. This can be understood in the following way: given a rate of tax, if there is increase in tax benefits, the firms are willing to accept it. If the firms are asked to choose between reduction in tax rate and tax benefits (tax exemptions), they prefer reduction in tax rates. The reason may be related to being a part of the VAT regimes.

4.4.2 Do you think VAT Compliance⁶ is Beneficial or Burdensome for your Business Development?

This question seeks responses from firms which reported as being VAT compliant. Of these firms, while only 29 percent perceive this to be beneficial, 71 percent report a perception that it is burdensome for them. Now it is required to know that why do they perceive this as beneficial and why do the rest perceive as burdensome? Table 43 therefore presents some advantages for those who have stated it as beneficial and some constraints for those who have mentioned it as burdensome. Those who perceive VAT compliance as beneficial, they have emphasized that easy refund, simple process of paying and easy loan accessibility - are the reasons. The reasons behind the perception as burdensome are - less profit margin against the increased cost of production, complex procedure of refund etc. The table suggests that ease of compliance and input tax credit is seen as the main benefit, additional accounting documentation requirements and increased cost of product are perceived as the main reasons for VAT being a burden.

Table 42: VAT Compliance is Beneficial or Burdensome

VAT Compliance is Beneficial or Burdensome	Total	Percent
Beneficial	53	29
Burdensome	127	71
Total	180	100

Table 43: Some Advantages and Constraints of VAT Compliance

VAT	Benefits/Constraints of VAT Compliance	Total	of which	
			micro	Small & Medium
Beneficial	VAT: Easy refund, simple process of paying and credit	31	15	16
	Easy loan accessibility	7	4	3
	Others	11	4	7
Burdensome	Less profit margin	17	9	8
	Cost of product has increased	32	20	12
	Compliance cost, extra accounting and more documentation	44	22	22
	VAT process and refund is complex	15	9	6
	Decrease of sale	3	2	1
	Others	3	2	1

⁶ The number of firms responding in overall compliance is quite high compared to the response on VAT compliance cost. Only 56 firms have reported their VAT compliance cost whereas 152 firms have reported their overall compliance cost. The analysis has been done based on the overall compliance cost of the firm.

4.4.3 Has this Enterprise faced Difficulties in Obtaining VAT Refunds?

Of total 200 enterprises, 55 enterprises (31 percent) report difficulties in obtaining VAT refunds. If these, it is found that relatively larger percentage of small firms are reporting difficulties when compared to micro firms – 38 percent of small as against 24 percent of micro firms reported difficulties in obtaining VAT refunds. The Chi Square test for differences in responses shows the differences to be statistically significant. It is possible that while for micro enterprises, the quantum of refund would be smaller which can potentially be subject to smaller degree of cross-checks within a tax department when compared to refunds that a small or medium firm can claim. Larger refunds would require authorization from higher level officials and potentially get scrutinized more closely thereby contributing more frequently to a perception of difficulties in obtaining VAT refund for small units when compared to micro units.

Table 44: Difficulties Faced in Obtaining VAT Refunds, Over their Types

Difficulties faced in Obtaining VAT Refunds	Total	Percent	of which	
			Micro	Small & Medium
Yes	55	31	23	32
No	125	69	73	52
Total	180	100	96	84
Chi-square = 0.0400				

4.4.4 Is it More Difficult to Sell Products with VAT?

Majority (66 percent) have stated that selling products after the imposition of VAT is not difficult while rest 34 percent perceive that it is difficult. While the difference in perception between micro and small and medium firms is not statistically significant, differences across locations emerge to be statistically significant. (Table 46) firms in Coimbatore are less likely to report a perception of difficulty to sell products with VAT as compared to Ahmedabad and Delhi.

Table 45: Is it More Difficult to Sell Products with VAT

Difficult to Sell the Products with VAT	Total	Percent
Yes	68	34
No	132	66
Total	200	100

Table 46: Frequency Count of City-Wise Firms Having Difficulty in Selling Products with VAT

Difficult to Sell The Products With VAT	City		
	Delhi & Ahmedabad	Coimbatore	Total
Yes	57	11	68
No	93	39	132
Total	150	50	200
Chi-square = 0.0400		Pr = 0.039	

4.4.5 Perception on Performance of VAT Officials

Of total 196 (rest 4 have not answered to this question) enterprises, 5 (3 percent) perceive that the performance of VAT officials is very poor and only 1 percent perceives that the performance is very good, and remaining 25, 43 and 28 percent of them perceive that their performance is poor, indifferent and good, respectively. The differences in their perceptions from micro to small & medium have appeared as statistically significant. While 84 percent of small firms consider the performance indifferent to good, in case of micro firms only 63 percent support this view.

Table 47: Perception Regarding Performance of VAT Officials

Performance of VAT Officials	Total	Percent	of which	
			Micro	Small & Medium
Very Poor	5	3	2	3
Poor	49	25	38	11
Indifferent	85	43	44	41
Good	55	28	23	32
Very Good	2	1	2	
Total	196	100	109	87
Chi-square = 0.0025				

4.4.6 How do you perceive the Friendliness of VAT Regulations towards MSME Development?

This sub-section provides almost similar picture as the earlier sub-section (4.4.5). Of total 196 (rest 4 have not answered to this question) enterprises, 7 (4 percent) perceive that the friendliness of VAT regulations towards MSME development is very low and only 1 percent perceives that the same is very high, and remaining 34, 44 and 18 percent of them perceive that the friendliness of VAT regulations is low, indifferent and high, respectively.

The differences in perceptions of micro as against small & medium firms have appeared as statistically significant – a larger percentage of micro firms (47 percent) are reporting a poor response when compared to small and medium firms (25 percent).

Table 48: Friendliness of VAT Regulations towards MSME Development, over their types

Performance of VAT Officials	Total	Percent	of which	
			Micro	Small & Medium
Very poor	7	4	3	4
Poor	66	34	48	18
Indifferent	86	44	47	39
Good	36	18	10	26
Very Good	1	1	1	
Total	196	100	109	87
Chi-square = 0.0004				

4.4.7 How Frequently do the Tax Officials Perform Official Visit at your Firm?

Of total 200 units, 197 have responded to this question. 38 percent mentioned that tax officials never visit at their firms, while 35 percent report an annual visit. Very few enterprises have mentioned the frequency of their visit as monthly and quarterly.

Table 49: Tax Officials Visit at Firm

Frequency of Tax Officials' Visit at Firm	Total	Percent
Monthly	10	5
Quarterly	24	12
Biannually	19	10
Annually	69	35
Never	75	38
Total	197	100

4.4.8 Do you feel that VAT Regulatory Authorities are Less Administrative Friendly with the Entrepreneurs?

Over 50 percent of the firms responded with a “Don’t know / Can’t say” to this question. It is possible that since many of the firms interact with the tax department through their Chartered Accountants, they may be ill-equipped to answer the question. Further, in a settled regime, it is possible that firms may not seek explicit assistance from the tax

department and hence cannot comment changes in this aspect of tax administration. We don't find any significant difference in the opinion of the micro firms and small & medium firms. There is a difference in opinion of the firms located in different cities. We find that number of firm saying yes is very low in Ahmedabad compared to Delhi and Coimbatore. This difference is statistically significant at 5% level of significance (table 52)

Table 50: Less Administrative Friendliness of VAT Regulatory Authorities

VAT Regulatory Authorities are Less Administrative Friendly	Frequency	Percent
Yes	43	22
No	52	26
DK / CS	105	53
Total	200	100

Table 51: City-wise Less Administrative Friendliness of VAT Authorities

Less Administrative Friendliness of VAT Authorities	City		
	Delhi & Coimbatore	Ahmedabad	Total
Yes	40	3	43
No	39	13	52
Don't Know/ Can't Say	71	34	105
Total	150	50	200
Pearson chi2(2) = 10.5004	Pr = 0.005		

4.5 Perception regarding the Impact of Property Tax

4.5.1 Does your Enterprise Pay Tax on Its Property?

While 49 percent of the firms report that they pay property tax, the others report that they do not. Now it is required to look at the consequences of not paying property taxes, presented in table 54. On nonpayment of property tax, the maximum numbers of firms say that they have to pay penalty, out of total 85 respondents. The percentage of firms responding the above option is 53 and the percentage of firms reported that government sends legal notice is more than 20. These two options are the main consequence for the firms on non-payment of property taxes.

The majority of the firms operating in owned land are paying property tax but the majority of firms operating in leased private land are not paying property tax. This difference is statistically significant at 5% level of significance (table 55).

Table 52: Pay Property Tax

Pay Property Tax	Total	Percent
Yes	97	49
No	103	52
Total	200	100

Table 53: Consequences of not Paying Property Tax

Consequences of not Paying Property Tax	Frequency	Percent
Penalty	45	53
Legal notice	19	22
MCD controls the property legally	7	8
Extra taxes payable	5	6
Harassed by tax authorities	6	7
Property sealing and acquisition	3	4
Total	85	100

Table 54: Frequency Count of Nature of Land Ownership of Firms Property Tax

Land Nature	Property Tax Paid		
	Yes	No	Total
Owned land	94	12	106
Leased private land	3	82	85
Total	97	94	191
Pearson chi2(2)=136.8441 Pr= 0.000			

4.5.2 Did Property Tax Payment Play an Important Role in Selecting Location for your Business?

A substantial 74 percent of the firms reported that property tax regimes did not significantly influence their choice of location for business.

Table 55: Importance of Property Tax in Selecting Business Location

Property tax important in selecting location for business	Total	Percent
Yes	52	26
No	148	74
Total	200	100

4.5.3 Does the Type of Property you operate on affect your Decision to Develop Your Business?

Of total 200 enterprises, 21 (11 percent) perceive that the types of property they operate affect their decision to develop their business while 179 (90 percent) perceive that it does not. The differences in their perceptions from micro to small & medium have appeared as statistically significant. A slightly larger percentage of micro units report being influenced by the property tax regime compared to small firms – 14 percent as against 6 percent.

But among the firms for whom property on which they operate plays an important role in business expansion the maximum are those whose annual turnover lie in the lowest quartile, all of them are micro firms (table 58). Their reason is that favorable location will increase the business.

Small & Medium firms have owned land while micro firms have leased in land. This may be a constraint for some of the micro firms. Since a very firm has reported that types of property affects the decision to develop their business, we can say that type of property may not be a dominant reason affecting their decision to expand the business.

In Ahmedabad the majority of the firms have owned land but in Delhi and Coimbatore the majority of the firms have leased private land. This difference in ownership pattern is statistically significant (table 59).

Table 56: Types of Property and Decision to Develop your Business

Does type of property you operate on affect your decision to develop your business	Total	Percent	of which	
			Micro	Small & Medium
Yes	21	11	16	5
No	179	90	97	82
Total	200	100	113	87
Chi-square = 0.0544				

Table 57: Types of Property and Decision to Develop your Business with Interval-wise Annual Turnover

Annual Turnover_Interval	Yes		No	
	Micro	Small & Medium	Micro	Small & Medium
0 – 3500	9		38	
3500 – 9000	6		31	9
9000 – 30000	1	2	22	27
> 30000		3	4	46
Total	16	5	95	82

Table 58: City-wise Pattern of Ownership

Land Nature	City			
	Delhi	Coimbatore	Ahmedabad	Total
Owned land	45	23	38	106
Leased private land	47	26	12	85
Total	92	49	50	191
Pearson chi2(2)= 11.5782		Pr=0.003		

4.5.4 Do you think that the Procedure of Land Acquisition is Complex?

The overall procedure of land acquisition is perceived to be complex in the States of India. Of total 200 enterprises surveyed, 58 percent perceive that the procedure is complex while 33 percent perceive that it is not and 10 percent could not say anything.

Table 59: Complex Procedure of Land Acquisition

Complex Procedure of Land Acquisition	Total	Percent
Yes	115	58
No	66	33
DK / CS	19	10
Total	200	100

4.5.5 Does Land Acquisition Involve High Cost?

A substantial number of firms responded to this question with a yes. 83 percent of the responds believe that land acquisition involves high cost.

Table 60: High Cost involved in Land Acquisition

High Cost involved in Land Acquisition	Total	Percent
Yes	165	83
No	15	8
DK / CS	20	10
Total	200	100

4.5.6 Do you think that Corruption is Rampant in Land Acquisition Process?

To this question, once again an overwhelmingly large number have responded with a yes. This could be attributed to fact that most land that can be acquired for setting up or

expanding an industry would be in rural areas, i.e., agricultural land. While the actual purchase of the land might only involve a high cost, the change in land use from agricultural to non-agricultural use requires official sanction and could involve extended interaction with bureaucracy and potential situations of corruption.

Table 61: Rampant Corruption in Land Acquisition Process

Rampant corruption in Land acquisition process	Total	Percent
Yes	146	73
No	23	12
DK / CS	31	16
Total	200	100

4.5.7 If you do not Own Land, What are the Reasons?

The high cost of acquiring land along with limited resources available to these firms is presented as reasons for not possessing land. It is the latter, i.e., lack of capital, which has been flagged by a relatively larger number of firms – 52 percent of the firms that responded to this question.

Table 62: Reasons of not Possessing Land

Reasons of not Possessing Land	Total	Percent
Lack of capital	44	52
High cost of property	40	48
Total	84	100

4.6 Women Entrepreneurs and the Business Environment

These following paragraphs explore general biases and their impact of enterprises owned by women entrepreneurs.

4.6.1 Are most People not Cooperative towards Women Entrepreneurs?

Of total 200 units surveyed, 36 percent perceive that people are not cooperative towards women entrepreneurs, while 49 percent do not perceive any such problem. If we consider the responses of firms with women entrepreneurs or those with women in management position, then while the percentage of firms which perceive a problem remains 37 percent, those that respond with a NO is higher at 55 percent, when compared to the total.

Table 63: Most People are not Cooperative towards Women Entrepreneurs

Most people are not cooperative towards women entrepreneurs	Total	Percent	Female	Percent
Yes	72	36	10	37
No	97	49	15	55
DK / CS	31	16	2	8
Total	200	100	27	100

4.6.2 Is there some kind of Non-professional Behavior of Male Entrepreneurs towards Women?

In this case as well, 29 percent of the firms reported perception of non-professional behavior of male entrepreneurs towards women. The perceptions reported by firms with women in management positions indicate that relatively higher percentage of firms perceive non-professional behavior by male entrepreneurs towards women. However, there is a pre-dominance of the view that such behavior is not there – 62 percent of these firms report No as the answer.

Table 64: Non-professional Behavior of Male Entrepreneurs towards Women

Non-professional behavior of male Entrepreneurs towards women	Total	Percent	Female	Percent
Yes	58	29	9	33
No	109	55	17	62
DK / CS	33	17	1	4
Total	200	100	27	100

4.6.3 Is Payment Recovery a Problem for Women Entrepreneurs?

28 percent of all firms and 33 percent of firms with females in management position report that in firms of women entrepreneurs face some problems in recovery of their dues.

Table 65: Payment Recovery is a Problem for Women Entrepreneurs

Payment Recovery is a problem for Women Entrepreneurs	Total	Percent	Female	Percent
Yes	56	28	9	33
No	106	53	15	56
DK / CS	38	19	3	11
Total	200	100	27	100

4.6.4 Is it a Problem to Attract Customers for Purchasing Products made by MSME, run by Women Entrepreneurs?

25 percent of all firms believe that enterprises by women entrepreneurs face problems in attracting customers. Interestingly, the response of firms with women in management positions is somewhat different: while 14 percent of these firms do agree an overwhelming 81 percent disagree. In other words, firms with women in management positions generally do not perceive such a problem.

Table 66: It is a Problem to Attract Customers for Purchasing Products made by MSME, run by Women Entrepreneurs

It is a problem to attract customers for purchasing products made by MSME	Total	Percent	Female	Percent
Yes	50	25	4	14
No	106	53	22	81
DK / CS	44	22	1	4
Total	200	100	27	100

4.6.5 Will you buy a Product Produced by a Women Entrepreneur?

An overwhelming 71 percent respond with a yes in this question. Firms with women in management positions responding with a higher 85 percent as Yes.

Table 67: Will you buy a Product Produced by a Women Entrepreneur

Will you buy a product produced by a Women entrepreneur	Total	Percent	Female	Percent
Yes	141	71	23	85
No	37	19	3	11
DK / CS	22	11	1	4
Total	200	100	27	100

4.6.6 Government Departments were not Cooperative towards MSME run by Women Entrepreneurs?

Of total 200 enterprises, 34 percent perceive that government departments are not cooperative towards enterprises run by women entrepreneurs, while 36 percent perceive that they are cooperative. If one considers the responses of firms with women in management positions, while 33 percent perceive that government departments are not cooperative, 48 percent express the view that there is no such problem.

Table 68: Government Departments are not Cooperative towards MSME run by Women entrepreneurs

Government departments are not cooperative towards MSME run by women entrepreneurs	Total	Percent	Female	Percent
Yes	67	34	9	33
No	72	36	13	48
DK / CS	61	31	5	18
Total	200	100	27	100
Chi-square = 0.0284				

4.6.7 Are the Costs of Running a Business Higher for MSME run by Women Entrepreneurs?

In the responses across 200 firms, 27 percent report that the cost of running a business would be higher for women entrepreneurs, while 48 percent report that there should be no difference. If one considers the firms with women in management positions, while 26 percent continue to report that costs could be higher, 63 percent report that costs would not be different. This difference is significant. The chi-square value is 0.0204.

Table 69: Costs of Running a Business are higher for MSME run by Women Entrepreneurs

Costs of running a business are higher for MSME run by Women entrepreneurs	Total	Percent	Female	Percent
Yes	54	27	7	26
No	96	48	17	63
DK / CS	50	25	3	11
Total	200	100	27	100
Chi-square = 0.0204				

4.6.8 Is Access to Credit for MSME Difficult for Women Entrepreneurs?

In the overall responses, 37 percent of the firms perceive that women entrepreneurs would face difficulties in gaining access to credit meant for MSME sector, while 43 percent opined that such a problem would not arise. The response from firms with women in management positions is somewhat different – a larger percentage of firms report that access to credit is not a problem.

Table 70: Access to Credit for MSME is difficult for Women Entrepreneurs

Access to Credit for MSME is difficult for Women entrepreneurs	Total	Percent	Female	Percent
Yes	73	37	8	29
No	86	43	17	63
DK / CS	41	21	2	7
Total	200	100	27	100

In all the questions where the likely problems faced by women entrepreneurs are being explored, the firms with women in management positions are presenting a picture different from the overall scenario – the responses of these firms suggest that they perceive these problems as being less prevalent or relevant as compared to the perceptions of the firms with only men in management positions. While this cannot be taken as a sign that there are no problems or fewer problems faced by women entrepreneurs – the fact that there are only 8 firms of women entrepreneurs⁷ in the sample of 200 suggests that women entrepreneurs are not yet so common – it does suggest that possibly women managers and women entrepreneurs are more confident of handling these problems and/or do not perceive them as women specific problems.

⁷ It is to be noted that 27 out of 200 firms have women in the management position. It includes the firms with women entrepreneur.

SECTION-V

Differences in Perceptions: Some Explanations

5.1 Impact of Taxes on Business Development

How do firms perceive the imposition of any tax on its business? The opinion of firms on the impact of tax on its business has been categorized⁸ into four factors: 1) adverse impact on profit and cost of production; 2) increase in compliance cost; 3) difficulty in market access; and 4) bribe. The mapping of the options given into these categories is shown in table 71. The majority of the firms rank category 1 as the most important concern and category 2 follows. The Pearson's chi square test was performed for rank one in order to verify whether the response of micro and Small & medium firms are different in terms of their ranking of impact of taxes on business. The results shown in table 72 suggest that there is statistically significant difference in responses if only the first three categories are considered. It may be noted that very few firms have chosen category 4 as the most important factor.

The odds of saying category 1 as rank one is .82 from table 72. But there is difference among the responses of micro and small & medium firms in this ranking. The odds of micro firms saying category 1 to category 2 is 2.54 i.e. the probability of selecting "adverse impact on profit and cost of production" at rank one is 2.54 times more than that of choosing "increase in cost of compliance" for a micro firm. In rank one the odds ratio of category 2 to category 3 is .61 for micro firms whereas odds ratio of category 2 to category 3 for small & medium firms is 1.65.

⁸ The response of the firms has been categorized into twelve options. It is difficult to do analysis of these twelve options together and also these options can be part of some broad options. Many of these options are meaning almost same only the phrasing is different. For example options like less profit and company goes to loss or high cost of production can be put together under one category that is adverse impact on profit and cost of production. Proceeding in the similar lines we have made these broad categories.

Table 71: Categories of Impact of Taxes

Old category	Old option name	New category	New option name
1	Less profit	1	Adverse impact on profit and cost of production
2	Compliance cost	2	Higher compliance cost
3	Multiple documentation problems/ requirement		
4	Complication in accounting		
5	Cost of product becomes high and direct or indirect tax increases our production cost	1	Adverse impact on profit and cost of production
6	Growth is decreasing	3	Market access
7	Decrease in sales/demand		
8	More formalities	2	Higher compliance cost
9	Company goes into loss	1	Adverse impact on profit and cost of production
10	Multiple taxes are more complex to handle	2	Higher compliance cost
11	Promotes bribe	4	Bribe
12	Due to tax burden price war came into existence	3	Market access

Table 72: Frequency Count of Type of Firms and Impact of Taxes in rank One

Impact of Taxes - Rank 1	Micro	Small and Medium	Total
Adverse impact on profit and cost of production	52	27	79
Higher compliance cost	22	9	51
Market access	25	20	45
Bribe	4	2	6
Total	103	78	181
Pearson χ^2 (2) = 6.5175 Pr = 0.038			

Table 73: Frequency Count of Impact of Tax and Type of Firms in rank two

Impact of Taxes - Rank 2	Micro	Small and Medium	Total
Adverse impact on profit and cost of production	19	13	32
Higher compliance cost	32	30	62
Market access	20	5	25
Bribe	1	0	1
Total	72	48	120

The observed differences in perception could be on account of differences in profit margin of firms. If for instance micro firms operate at low profit margins compared to small & medium firms, the surplus of the former would be less, taxes could then be perceived as squeezing these already narrow margins. The medium & small firms on the other hand, might be running at higher profit margin where imposition of taxation on their profit and cost of production could be less important. If surpluses are not significantly affected, then impact of compliance costs can be perceived to be more important.

As a first step, to test the above explanation, we explore the evidence for differences in surplus as percentage of turnover between micro firms and small & medium firms. From the survey we have data on annual turnover of firms, annual payment on wages and investment on plant and machinery. The difference between annual turnover and sum of annual wage and discounted investment on plant and machinery⁹ can be considered a workable indicator of the surplus¹⁰ of the firms. This surplus as a percentage of turnovers is used as an indicator of the profit margin.

Profit Margin

$$= \frac{\text{Annual Turnover} - (\text{Annual Wages} + \text{Discounted Investment In Plant \& Machinery})}{\text{Annual Turnover}} \quad 11$$

Table 74 presents the results for difference in average profit margin between micro and small & medium firms. The result suggests that the average for micro firms is significantly lower than the average small & medium firms. While this supports the conjecture outlined above, one can argue that the above indicator is not a true reflection of the profit margin of the firms, because the cost of raw materials has not been corrected for. If we only use the above indicator as a measure of profit margin then one cannot distinguish between the two possibilities, first, where for same level of profit margin small & medium units have higher cost of raw material than micro firms and second, where cost of production is the same across all units. In order to reflect on this aspect, we explore the efficiency as measured by annual turnover per unit of expenditure on wages and discounted capital. The sum of wages and discounted capital can be viewed as factors payments, explicit and implicit. The table 74 shows that, on average the amount of turnover generated by (row 2) spending unit amount on factor payments is significantly higher for small & medium firms compared to micro firms.

⁹ This could be treated as proxy for opportunity cost of capital.

¹⁰ While surplus should be exclude the cost of raw materials, there is no data available in the survey on the same.

¹¹ Average interest rate reported in survey results was used for purposes of discounting.

$$\text{Efficiency Indicator} = \frac{\text{Annual Turnover}}{\text{Factor Payments}}$$

Factor Payments = Annual Wage Payment + Discounted Investment In Plant & Machinery.

Table 74: Difference in Performances of Enterprises

Row No.	Variable	Mean (in ratios)		t-value	p-value
		Micro	Small & Medium		
1	Profit margin	0.6763	0.8272	-1.9086	0.0292
2	Efficiency indicator	8.3838	12.0545	-2.4104	0.00085
3	New profit margin	0.1273	0.30978	-1.5024	0.0683
4	Compliance cost (in thousands)	36.8821	85.0074	-2.4435	0.0081

Since the expenditure on raw materials are not accounted for in the above discussion, we construct another indicator assuming two third of revenue being spent on raw material¹². The new indicator is the difference of annual turnover and sum of annual wages, compliance cost, and amount of VAT paid, discounted investment in plant and machinery and two third turnovers as a proxy for cost of material inputs. This indicator would be quite close to actual surplus or profit from production.

$$\text{New Profit Margin} = \frac{\text{Annual Turnover} - \text{Cost}}{\text{Annual Turnover}}$$

Where,

Cost=annual Wage Payment + Discounted Investment In Plant & Machinery + 2/3 Annual Turnover

¹² We make the assumption that two third of annual turnover as proxy for the cost of raw materials. We make this assumption based on the calculation of input cost as percentage of total value of output in industry from the input-output data of the Indian economy. It comes out that it is around seventy percent, for goods and services.

The results (table 74) show that on average, the percentage of this surplus to annual turnover is significantly less for micro firms as compared to small & medium firms, once again supporting the hypothesis we began with.

One possible way to understand the results obtained- micro firms reporting adverse impact on profits and cost of production while small & medium firms reporting high compliance cost- could be as follows. Small & medium firms are already a part of tax regime and have settled to this idea. Therefore, even though taxes affect their surplus, they treat taxes as an unalterable fact of their business. Compliance cost however is a daily irritant that can potentially be reduced, through activities such as lobbying and hence the later emerges as a more dominant concern. For micro firms on the other hand, while they might be a part of the tax system, they might be new entrants and could have competitors who don't comply, thereby adversely affecting business of micro firms. The exemption threshold too suggests that some of them could be at the margin of entering the tax system. The predominant concern therefore is to protect their surpluses.

It may also be noted that total compliance cost for small & medium firms considerably larger than that for micro firms. This expenditure on activities which may not directly be beneficial to the business can be viewed as a burden. Larger amounts would register more sharply – akin to money illusion, thus proving the observed response in small & medium. This can also be understood as money illusion. The firms while responding to the questionnaire they have revealed the factor that immediately affects them rather than replying based on the analysis of full consequences. In the case of micro firms it is adverse impact on profit and cost of production. In the case of small & medium firms it is higher compliance cost. Thus we have a plausible reason that explains the fact that there is a difference in perceiving the impact of tax between small & medium firms and micro firms.

We explored the factors that might explain why small & medium firms perceive that impact of tax is higher on compliance cost while micro firms say that adverse impact on profit and cost of production. Given that firms have responded extensively on issues relating to VAT, we found that majority of firms say VAT compliance is not beneficial but burdensome. There are no statistically significant differences between small & medium firms.

The constraints or disadvantages of VAT compliance have been categorized into ten options in the questionnaire. We have clubbed these ten options into four broad categories as shown in the table 75. In the identification of the most important adverse consequence of VAT, overall 43 percent of the firms reported “adverse impact on profit and cost of production” while 39 percent reported “high compliance cost”. Explaining further, some differences are discernable. Among micro firms, large number of firms reported adverse

impact on profit and cost of production (45 percent as against 34 percent reporting higher compliance cost). On the other hand, for small & medium firms, a larger 44 percent reported high compliance cost. So VAT compliance is a burden because of higher cost of compliance for small & medium firms and adverse impact on profit and cost of production for micro firms. It is summarized in table 76. This result¹³ is similar to the analysis on impact of overall taxes as discussed earlier.

Table 75: Categorization of Options

Old category	Option name	New category	Option name
1	Less profit margin	1	Adverse impact on profit and cost of production
2	Cost of product has increased	1	
3	Compliance cost is of excessive burden	3	High compliance cost
4	Extra accounting work	3	
5	More documentation	3	
10	Refund of VAT is complex	4	Administrative bottleneck
11	Decrease of sale	2	Decrease in sales
14	Unnecessary harassment	4	Administrative bottleneck
15	VAT process is complex and follow up system is poor	4	
17	VAT slab is too high for customer	2	Decrease in sales

Table 76: Frequency Count and Percentages of Rank 1 Response on VAT Compliance as Burdensome by Type of Firms

Constraints of VAT Compliance - Rank 1	Micro	Small & Medium	Total
Adverse impact on profit and cost of production	29(45.31)	20(40.00)	49(42.98)
Decrease of sale	3(4.69)	2(4.00)	5(4.39)
High compliance cost	22(34.38)	22(44.00)	44(38.60)
Administrative bottleneck	10(15.63)	6(12.00)	16(14.04)
Total	64(100.00)	50(100.00)	114(100.00)

Note: Figures in parentheses are percentage shares.

¹³ The result is not statistically significant but the overall direction of the analysis is similar.

5.2 Being Treated Fair and Bribes being a Problem

In the discussions in section two, there were two features about the perceptions of firms that need to be examined a little more closely. One question asks for perceptions of the firms regarding whether the tax department and its officials treat them fairly. There was considerable difference in the responses of the micro and small firms – among the micro firms, a larger percentage (64 percent) believe that tax staff is not fair, while among the small and medium firms, close to half of the firms believe that they fair, while the other half believe they have not been fair. It is useful to explore whether perceptions on this front are related to the perception relating to bribes. This cross tabulation is presented in Table 77. From the table an interesting pattern emerges: while in the case of micro firms, there is no relation between these two perceptions, in small and medium enterprises, there is a relationship emerging. Firms that view bribes as a problem among small and medium enterprises are more likely to report that tax staff was not respectful when compared to those that do not view bribes as a problem. One way to understand this difference could be as follows: small and medium firms are already a part of the tax system and possibly would like the system to function well. Any demands for bribes can then be viewed as synonymous with unfair treatment by tax officials. On the other hand, micro firms are still evaluating the merits of being in the tax system or opting out. They may even be having turnovers very close to the exemption threshold and hence could be in and out of the system for some time. For these firms, bribes might be viewed as the cost of indecision on their part more than a reflection of unfair treatment by tax officials.

Table 77: Perceptions of Micro and Small & Medium Enterprises on whether Tax Staff are Fair and Respectful, over Bribe

Perception on Bribe	Micro		Small & Medium	
	Respectful	Not respectful	Respectful	Not respectful
Bribe YES	29	51	25	34
Bribe NO	5	16	15	5
Chi-square	0.2830		0.0117	

5.3 Preferred Form of Government Assistance

The firms of all types micro and small & medium are adversely impacted from taxes in terms of lower profit, high cost of production or higher compliance cost. So naturally a question arises what form of tax related government assistance they prefer to boost the growth of their business. The data shows that majority (85.5 percent) of firms want reduction in tax rate. On performing the Pearson's chi square test we found that there is no

statistically different opinion about reduction in tax rates between micro and small & medium firms. Majority of both the types of firm (82.30 percent micro firms, 89.66 percent small & medium firms) want reduction in tax rates. It is summarized in table 78.

Table 78: Frequency Count and Percentages of Firm Wanting Reduction in Tax Rates, over their Types

Reduction in tax rates	Micro	Small & Medium	Total
Yes	93(82.30)	78(89.66)	171(85.50)
No	20(17.70)	9(10.34)	29(14.50)
Total	113(100.00)	87(100.00)	200(100.00)

The log of odd ratio of saying reduction in tax ratio to no reduction is 1.774368. It means that a significantly large proportion of firms want reduction tax rates. The result has been summarized in table 79.

Table 79: Log of Odd Ratio of Firms Wanting Reduction in Tax Rates

Log of Odd Ratio of Reduction in Tax Rates	Std. Err.	Z	P>[z]	[92% conf. interval]	
1.774368	0.2008251	8.84	0.000	1.380758	2.167978

Given the firms wants the reduction in rates, it is important to know whether they want tax exemptions as well. Interestingly around 57.31 percent of the firms who asked for reduction in tax rates do not want tax exemptions (table 80). We have got the log of odds of firms wanting tax exemption to not wanting tax exemption as -.294508. It is significant at 10 percent level of significance (table 81).

If we do similar analysis in the response to question whether the firms want tax exemptions or not to boost the growth of their business then we don't get a clear picture.

Table 80: Frequency Count and Percentages of Firms wanting Reduction in Tax Rates and Tax Exemptions

Reduction in Tax Rates	Tax Exemption		Total
	Yes	No	
Yes	73(42.69)	98(57.31)	171(100.00)
No	15(51.72)	14(48.28)	29(100.00)
Total	88(44.00)	112(56.00)	200(100.00)

Table 81: Log of Odds Ratio of Firms Wanting Tax Exemption Given the Firms wanting Reduction in Tax Rates

Log of Odd Ratio of Tax Exemption	Std. Err.	Z	P>[z]	[95% conf. interval]	
-.294508	.154605	-1.90	0.057	-.5975283	.0085122

But in the case of tax holiday as a measure to boost the growth of their business we find a clear picture that a significant majority of firms don't want tax holiday. The log of odd ratio¹⁴ is -.4263427 and significant at 5 percent level of significance. This is shown in table 82. Interestingly, this result is driven by the response of the micro firms. If we the log of odds ratio for micro firms, it is significant at 5 percent, and coefficient is -.5630941. But for this, we don't get any unambiguous result (table 82).

Table 82: Log of Odd Ratio of All Firms Wanting Tax Holiday

Log of Odd Ratio of Firm wanting Tax Holiday	Std. Err.	Z	P>[z]	[95% conf. interval]	
-.4263427	.1446468	-2.95	0.003	-.7098452	-.1428402

Table 83: Log of Odd Ratio of Micro Firms Wanting Tax Holiday

Log of Odd Ratio of Firm wanting Tax Holiday	Std. Err.	Z	P>[z]	[95% conf. interval]	
-.5630941	.1956505	-2.88	0.004	-.9465621	-.179626

Table 84: Log of Odd Ratio of Small and Medium Firms Wanting Tax Holiday

Log of Odd Ratio of Firm wanting Tax Holiday	Std. Err.	Z	P>[z]	[95% conf. interval]	
-.2542341	.2161572	-1.18	0.240	-.6778945	.1694263

Thus, we see that firms of both the types want reduction in tax rate but majority of micro firms do not want tax holidays. The reason for such observation may that imposition of taxes lead to adverse impact on profit and cost of production for majority of firms, which has been flagged as an important concern by both micro and small & medium firms. If taxes are reduced the profit of the firms will increase given all other things constant.

The above analysis should also mean that the firms should want tax exemptions/holidays. The responses of the firms do not say so. The reason is that if the firms are taking tax exemptions they are not part of the value chain in the sense that they cannot take input tax credit of taxes paid on the raw materials. Secondly, if the firms are selling their output to the big firms, the big firms wants to take refund/ rebate of the taxes they have paid on their raw material. Since the price of big firms and small firms won't be much difference, the big firms would prefer to buy from the firms which are paying VAT. So the firms of both types want reduction in tax rates and not tax exemptions.

Further, being outside the value chain might deprive the firms from other benefits such as credit from commercial banks.

¹⁴ We construct the dummy variable which takes value one if firms want tax holiday and zero otherwise. We run a logit regression on this dummy variable to calculate the log of odd ratio.

5.4 High Compliance Cost as a Deterrent to Growth

Table 87 shows that there is a positive significant relation between loans taken and average size of the firms whether it be measured in terms of capital investment, investment in plant and machinery or annual turnover. However, only 41 percent of all firms report having taken a loan to finance the operations of the firm. It is important for the growth of the MSME sector to understand what the underlying dynamics could be.

To understand this aspect, it is important to understand why the firms did not take loans. Of the firms that did not take loans, 67 percent report that they did not want a loan while 33 percent reported that they could not get a loan (table 85)¹⁵. To understand this further, this variable is cross tabulated against the perception that “Time and Cost of compliance is high” (See Table 86). The result indicates that there some relation between these two variables. Among firms that did not want a loan, a larger percentage perceives Time and cost of compliance to be high, when compared to those that reported a perception that they could not get a loan.

These factors suggest two important conclusions: first, for firms that perceive that they cannot get a loan, improvements in the procedures for getting loans and relaxation in the collateral requirements etc. can help them become a part of the formal economy. For the second group of firms that do not want a loan, there is a possibility that the perceived high cost of compliance is serving as a disincentive to come within the folds of taxation and hence they do not seek to take a loan and expand their business. Improvements the administration of the tax regime to reduce the costs of compliance can induce some of these firms to join the formal sector as well.

Table 85: Reasons for which Enterprises did not Apply for Loan

Reasons	Frequency	Percent
Don't Want	80	67
Can't Get	39	33
Total	119	100

¹⁵ Here options “No need for a loan” is described as “did not want”, while the others are clubbed together as “could not get”.

Table 86: Reasons for which Enterprises did not Apply for Loan against Time and Cost of Compliance

Time and Cost of Compliance	Don't Want	Can't Get	Total
Time and cost of compliance high	56	23	79
Time and cost of compliance low	14	15	29
Total	70	38	108
Chi-square = 0.0292			

Table 87: Impact of Loans on Capital Investment and Annual Turnover

Variable	Mean (In thousands)		t-value	p-value
	Loan Taken	Loan not Taken		
Capital investment	54893	19644	1.6100	0.0550
Plant & machinery	13176	6729	2.1256	0.0177
Annual turnover	75949	24660	2.8719	0.0025

5.5 Location Specific Issues

If we look at the response of firms located at three different cities where survey has been conducted, we get some variations in the perceptions on impact of taxes on the business of the firms. Firms located in Delhi and in Ahmedabad have almost the same pattern, in rank one the maximum number of firms think that taxes adversely affect their profit and cost of production (category 1) and secondly the cost of compliances increases (category 2). The response from the firms located in Coimbatore is different, in rank one maximum number of firms think that imposition of taxes lead to difficulty in market access and secondly profit and cost of production is adversely affected (table 88).

If we disaggregate the table further and look at the response of the types of firms located in these three places, we see that for small & medium firms located in Delhi the majority of the firms identify the significant impact is in terms of higher cost of compliances, the percentage of which is 54.29percent, while 31 percent report an adverse impact on profit and cost of production. For micro firms however, response is opposite, the adverse impact on profit and cost of production is more frequently flagged when compared to higher cost of compliance. In Coimbatore the picture is different. Both categories of firms identify access to market as the most frequent response, and then come adverse impact on profit and cost of production. In Ahmedabad too, there is not much difference between responses from micro to small & medium. There is similarity between the micro firms located in Delhi and Ahmedabad in terms of impact of taxes on their business. This is presented by the table 89.

The observed differences in perception could be because of differences in business environment in three places or may be the product segments which they operate in. It is possible that Coimbatore firms pass on the taxes forward and thereby face a decrease in demand because of an increase in price while firms in Delhi and Ahmedabad absorb part of the increase in taxes into their profits since they can't shift it forward and hence perceive a decrease in margins and profits. The definition of registered and non-registered firm in the survey include only those firms which are registered with registrar of companies, registrar of firms, registrar cooperative society, registrar of societies. A firm may register with the tax authorities and may not be registered in any of the above defined way. In Ahmedabad, a higher percentage of firms have been shown as unregistered. Here, these firms are unregistered as per definition used in the survey so these firms are registered with the tax authorities.

The property tax is paid mostly by the firms owing land (table 2.31.3). In the percentage of firms owing land is highest in Ahmedabad compared to Coimbatore and Delhi (table 2.33.3). Since the firms in Ahmedabad owned their land, they may not be required to register since registration is voluntary as per the definition. In Delhi and Coimbatore, the majority of the firms have leased private land so they may be required to register, it may be easier for registered firm to get lease. So there is difference in proportion of registered firms among the three locations.

Table 88: Frequency Count of City Wise Impact of Taxes

Impact of Taxes	City			
	Delhi	Coimbatore	Ahmedabad	Total
Adverse impact on profit and cost of production	41	13	25	79
Higher compliance cost	35	2	14	51
Market access	8	27	10	45
Bribe	5	0	1	6
Total	89	42	50	181

Table 89: Frequency Count and Percentages of Impact of Taxes, Location-wise and Types of Firm

Impact of Taxes	Delhi		Coimbatore		Ahmedabad	
	Micro	Small&Medium	Micro	Small&Medium	Micro	Small&Medium
Adverse impact on profit and cost of production	30(55.56)	11(31.43)	10(38.46)	3(18.75)	12(52.17)	13(48.15)
Higher compliance cost	16(29.63)	19(54.29)	1(3.85)	1(6.25)	5(21.74)	9(33.33)
Market access	5(9.26)	3(8.57)	15(57.69)	12(75)	5(21.74)	5(18.52)
Bribe	3(5.56)	2(5.71)			1(4.35)	

Note: Figures in parentheses are shares in total responses by location and type of firm.

5.6 Exporters versus Non-exporters

Among the exporters, the dominant response is that imposition of taxes lead to higher compliance cost, its percentage is 43. According to non-exporter firms, however the dominant response is adverse impact on profit and cost of production. It is clear from table 90.

We know that majority of the firms do not want tax holiday as measure to boost the growth of their business. However, among the exporters, majority of the firms do want tax holiday as a measure to boost the growth of their business. It is around 58percent. The majority of the non-exporters (63 percent) do not want tax holiday as a measure to increase the growth of their business. The Pearson's chi square test is significant at the 5% level of significance. This is presented by table 91. With respect to other measures like tax exemptions and reduction in tax rates, the nature of response of exporters and non-exporters are almost similar.

Table 90: Frequency Count and Percentages of Impact of Taxes on Exporter and Non-exporter

Impact of Taxes	Non-exporters	Exporters	Total
Adverse impact of profit and cost of production	69(46)	9(32)	78(44)
Higher compliance cost	39(26)	12(43)	51(28)
Market access	38(25)	6(21)	44(25)
Bribe	5(3)	1(4)	6(3)
Total	151(100)	28(100)	179(100)

Table 91: Frequency Counting of Exporters and Non-exporters Wanting Tax Holidays

Tax Holiday	Non-exporters	Exporters	Total
Yes	60	19	79
No	104	14	118
Total	164	33	197
Pearson chi2(1) = 5.0391	Pr = 0.025		

Exporters could be facing competition from other countries where tax regimes could be more supportive. Alternatively since exports are to be zero-rated in VAT and GST, while local sales are taxable, the accounting requirements to deal with these two categories requiring segregated book-keeping could be seen as a burden. The tax holidays, even if temporary could ease this burden.

It is also important to recognize that historically exports have always received incentives and even new firms with SEZs do have access to such privileges. This could therefore make exporters more aware of the need or the benefits from tax holidays.

5.7 Impact of Property Tax on Enterprise Development

The majority of firms responded that property tax is not a burden on their business. The log of odds¹⁶ ratio of property tax as burden is -.5753641. This implies that the probability of property tax being perceived as a burden on the business of the firms is significantly less than not being burden. The log of odd ratio is significant at 5% level of significance (table 92).

Table 92: Log of Odd Ratio of Property Tax being Burden on Business

Log of Odd Ratio of Property Tax being Burden	Std. Err.	Z	P> z	[95% conf. interval]	
-0.5753641	0.147314	-3.91	0	-0.86409	-0.28663

We have got that VAT compliance is burdensome for the majority of firms but the property tax is not reported to be burdensome. This may be because the average share of VAT paid on annual turnover is significantly higher than average share of property tax on annual turnover. The average¹⁷ share of VAT paid on annual turnover is .0214807. The average¹⁸ share of property tax on annual turnover is .0023447. The t test supports the hypothesis that average share of VAT on annual turnover is significantly higher than the average share of property tax on annual turnover (table 93).

Table 93: T-test for the Difference of Average of VAT share on Annual Turnover and Share of Property Tax on Annual Turnover

Variable	Obs	Mean	Std. Err.	Std. Dev.	[95% Conf. Interval]
VAT as share of annual turnover	131	0.0214807	0.0036668	0.0142263	0.0287351
mean = mean(vat_at2)		t=5.2187			
Ho: mean = .0023447		degrees of freedom=130			
Ha: mean < .0023447		Ha: mean != .0023447		Ha: mean > .0023447	
Pr(T < t) = 1.0000		Pr(T > t) = 0.0000		Pr(T > t) = 0.0000	

Since the quantum of property tax payments is very small, it is not flagged as an important matter, by firms.

¹⁶ We have calculated the log of odd ratio of property tax being burden on firms' business as discussed earlier.

¹⁷ The sample average of share of VAT on annual turnover is significant at 5% level of significance.

¹⁸ The sample average of share of VAT on annual turnover is significant at 5% level of significance.

SECTION-VI

Key Informant Interviews (KIIs)

For this part of the study, the team had the opportunity of discussing with representatives of MSME sector, as well as from some of the institutions which work for the development of this sector in India. These were free flowing interactions aimed at getting a sense of their perceptions of the impact of the existing system of indirect taxes on the development of this segment of enterprises as also their assessment of the constraints faced by this sector in its development. While summaries of some of the interviews are reproduced at the end of this section, a few of the experts were not comfortable with summaries of their interviews being individually included in the report. In deference to their views, while their views have been used to refine the overall perspective on the sector, the summaries of the discussion with them have not been reproduced. The people we interacted with are:

1. Rajeev Mishra, Director, Office of the Development Commissioner, MSME
2. P. Udayakumar, Director (Planning and Marketing), NSIC
3. P. P. Sinha, DCM (RD&PS), Oriental Bank of Commerce
4. Sohan Jindal, Punjab National Bank
5. Bipin Sapra, Partner - Tax & Regulatory Services - Indirect Tax, E&Y
6. M. Vinod Kumar, Tax Research Unit, Central Board of Excise and Customs
7. Anil Bhardwaj, Secretary General, Federation of Indian Micro, Small and Medium Enterprises (FISME)
8. Sunil Nanda, President, Toy Association of India
9. Vinod Sharma, Managing Director, Deki Electronics Ltd., Noida
10. Arun K Agarwal, Director, Vimal Organics Limited, Ghaziabad
11. ChanderShekharGoel, Goel Engineers India and Treasurer, FISME.

In this section, we present a summary of the issues that emerged from the Key Informant Interviews (KIIs). It should be mentioned at this point that some of the issues flagged in these interviews relate not so much to the MSME but to the entire manufacturing sector in India. However, since these are concerns for the MSME and the MSME are likely to be more vulnerable to factors that affect the manufacturing sector, these factors too are discussed here.

6.1 Overall Tax Structure

There is an overwhelming perception that firms have to pay multiple taxes. Each of the taxes has its own compliance requirements in terms of accounting needs, returns to be filed and documentation to be maintained. This is further compounded by the fact that in sub-national taxes like State VATs, the rates of tax and the forms and procedures too can vary. These raise the cost of compliance for the firms. With the introduction of GST, it is hoped that some of these taxes would be merged into one tax, thereby reducing some of the compliance costs.

Specific to present system of taxation, within central taxes, are a few issues that were flagged:

- There has been some change in the scope of service tax recently. The system went from taxation of a positive list of services to the defining of a negative list which would not be subject to tax, all the rest of the services now becoming taxable. In this transition, there has been some lack of clarity on whether certain services were liable to tax or not. While this issue does not directly affect the manufacture of goods, there can be some services which are in the nature of inputs to manufacturing, where the lack of clarity can make things uncertain.
- While the tax credit rules allow for credit of taxes paid on services to be utilized against taxes payable on goods and vice versa, but, some firms perceive that there is some uncertainty in the way these rules play out. This could be partly due to the fact that tax authorities interpret the input tax credit rules using an implicit notion of nexus between inputs and outputs.

For firms competing with the foreign products, their goods become less competitive because of tax structure. Many finished goods come in the country duty free. If there is tax on the domestically produced goods then prices of those good increases. So domestically produced good may not be able to compete with the foreign goods. Therefore, closer coordination between various policy formulating bodies is required to ensure domestic industries are not adversely affected.

To produce domestically, in some cases raw materials are imported. If the finished good comes in duty free (zero custom duty) in the country, but the raw material is taxable, even if the final good is not subject to tax in the domestic economy, the domestic manufacturers would be put at a disadvantage when compared to imported goods. To mitigate this problem, the manufacturers of such finished goods are allowed concessional imports of such raw materials, but to avail of such a scheme a concession certificate has to be issued by

the excise department. While the rationale of such a provision is to reduce the possibility of arbitrage and diversion of concessional imports from intended use, these processes can add considerably to the cost of compliance, and potentially become avenues for side payments or corruption.

The tax commissioners have given targets on the collection of taxes. These targets are not always made based on the business cycle of the economy, mainly based on last year's collection. If the economy is stagnating then the sales falls or don't grow fast enough, so the firms pay less tax, or the growth in voluntary tax payments do not match the required growth in targets. In such situations, tax authorities may issue show cause notices and sometime haul up the units. Presently the tax administration system may not have adequate tools to map the scale of economic activity in their jurisdiction. However, efforts in this direction could reduce the uncertainty faced both by the tax payer and the potentially unrealizable targets faced by tax administrators.

6.2 Exemptions

The MSME units are given tax exemption up to the turnover of Rs. 1.5 crore. It is generally believed that MSME units do not expanded their capacity beyond the stipulated level of MSME definition to avail the benefit of tax exemption. Instead of expanding their capacity and reaping the benefit of economies of scale they set up new units to keep on taking the tax exemptions. A number of the KIIs therefore argue that tax incentives may not useful for encouraging growth of the MSMEs.

Another opinion with regards to tax exemption is that tax exemption is no more lucrative for MSMEs operating in many industries. If the MSME units avail tax exemptions then they are out of the value chain. If the MSME units are producing inputs then the buyer would hesitate to buy from the units which are not paying VAT since they want to take input tax credit. The firms taking tax exemptions are cannot claim input tax credit. The benefit of the tax exemptions is very small it is less than 2%.

To incentivize the firms to expand their capacity, the government is taking steps like expanding all non-tax benefits of MSME sectors for three years to the units which have recently expanded their capacity and move out of the definition of MSME sector, while with the proposed GST regime, the exemption threshold is likely to be brought down to bring units within the ambit of taxation and input tax credit.

An overwhelming view from KII is that in the present environment, given tax credit based regimes, firms would prefer to pay taxes. The firms do not want more tax exemptions but want compliance made easier. The only sectors which continue to rely on tax exemptions are recycling of steel, rubber, plastic and agro food processing - these are either sectors dealing with final consumption goods or manufacturers who work with other exempt manufacturers or dealers.

6.3 VAT

Manufacturers perceive a distortion in the design of VAT - while VAT registration is mandatory for the manufacturer if the turnover is over 1 lakh, for traders, VAT registration is not mandatory until their turnover exceeds Rs. 25 lakhs (Rs. 2.5 million). Since the manufacturers would be reflected in greater detail in the tax department's database, they are likely to be subject to more intense scrutiny and even more regular audit than traders. This is often read as one of the many signs of the government not encouraging manufacturing in India.

In the sub-national VAT, sales within the same state are subject to VAT, while sales across state borders can either be subject to a concessional tax under the central sales tax regime or to the standard VAT in the exporting state. Since the rates of central sales tax are lower, firms would like to pay central sales tax rather than state VAT. But to avail the benefit of central VAT, the seller has to take a c-form from the buyer and submit the same with his tax return, as evidence of inter-state sales. The buyer in turn has to get this form issued by the tax department of the importing state. Each C-form is expected to cover all transactions between a pair of dealers over a quarter. It is reported that firms face difficulties in getting C-forms. If the c-form is not submitted to the tax department of the exporting state, the firm is liable to not only the regular tax in place of the concessional tax, but potentially some penalty/interest for delay in payment as well. In order to avoid this situation, firms may pay the state sales tax, and adjust the excess payment when C forms become available. But the firms make the loss in terms of interest because of excess payment.

In cases where the firm produces products which face different rates of tax, or even a combination of exempt and taxable goods, the firm is required to maintain separate accounts for each of these commodities so that tax credit claims can be verified. So the book keeping cost increases. To keep the cost of book keeping minimal, many a time's firms choose to forego tax exemptions.

The refund from the central government is done timely but in some states the state VAT department does the refund after matching the invoices of the raw material purchased and the invoices of the sellers. It takes lot of time.

6.4 Compliance related issues

While there have been considerable efforts by tax departments to reduce the interface between the tax departments and the tax payers, there remain a few areas of concern. Some of these are flagged here. It should however be noted that with increase in computerization some of the issues could be resolved.

The firms have to deal with multiple tax agencies and lot of document is required. It increases the compliance cost to prepare the documents. Now a days the payment of CENVAT and service tax have been made online. Even for some state taxes, there is online filing of returns and even payment of taxes. But even now, hard copies of returns are required to be submitted to the department. Thus, while changes are happening for improving the system of tax administration, there remain some areas of concern.

One of the issues flagged in the KIIs is the additional burden arising from the fact credits of taxes paid in one tax cannot be used to pay other taxes. While tax payments are not fungible, since refunds are not timely, funds can get locked in the system, thereby increasing the cost of operation.

All the major taxes have a provision for audit of the accounts of the firm. Firms feel that auditing is not an effective mechanism for catching evasion. They feel that the audits can only verify clerical mistakes. However, audit requires considerable time and involvement by the employees of the firm thereby imposing additional cost on the firm. There are even suggestions that sometimes, these provide occasions for corruption.

The discussions also reveal that firms believe that discretionary, certifying and verifying powers available to tax departments are used by officials for rent seeking. While these interfaces cannot be completely eliminated since there is always the possibility of misuse of provisions, there is need to explore various mechanisms for reducing the interface without undermining the interests of revenue generation.

The tax officials of the central government are of the opinion that compliance cost has come down drastically. Earlier the tax department used to do physical checking of the goods.

Nowadays self-assessment of the invoices is done only that too through online submission in case of input tax credit. The auditing is also done randomly for MSME units.

The tax officials of central government are of the view that the entrepreneurs are reluctant to take the matters to the higher officials in the tax department. They prefer to settle the issues mostly with low rank officials. So the incidence of the side payment would persist.

6.5 Inadequate Credit Flow and High Interest rate

Credit is one of the main hurdles faced these firms both initially while the firm is being setup and later when the firm seeks to expand its operations. In principle, there are guidelines issued by the Reserve Bank of India which constitute the basis for lending to the MSME sector. Lending to these firms qualifies as lending to priority sectors and potentially can help the bank fulfill its obligations on priority sector lending. However, firms still claim that credit remains a difficult issue.

Some impressions suggest that credit to the firms is mainly done on the basis of the impression of the branch manager of the bank.

Further, the bank would require some form of collateral for the loan. For pre-existing firms, the factory and its land can potentially service as collateral. Further, the balance sheet of the firm too provides information that can be used by the bank to judge the performance of the borrower and decide on credit worthiness. On the case of new firms however, both the lack of a collateral and a verifiable performance history or/and credit history could contribute to new borrowers facing greater difficulties in getting loan.

Another problem related to provision of collateral springs from the fact that some of the MSME units operate on plots provided by the government on a long term lease. Since the documents would indicate that the borrower does not own the land, there are difficulties in using this as collateral for borrowing.

To address the problem of collateral, and at the same time to protect the balance sheets of the lending institutions, the government has introduced a credit guarantee scheme to increase the flow of credit to MSME sector. In the event of a default on MSME loan, the bank can recover its dues from the central government. Under this scheme, the firm has to pay credit guarantee premium of about 1.5% of the quantum of loan. Given the fact that the interest rates faced by the MSME units tend to be high, addition of the premium of credit

guarantee increases the cost of borrowing even further. Further, the documentation required to process a loan in the formal institutions is quite extensive and considerable amount of time may be required to process the loan. All of these might continue to push the MSME towards borrowing from non-formal institutions.

Here is it pertinent to mention that banking officials suspect that with a credit guarantee scheme, the default rate in small scale industries might even increase. And on the other hand, if the payment of dues to the banks in the event of a default is not prompt, they might continue to remain unwilling partners in lending to these units.

6.6 High Land Price

The prices of land have gone up in India. In some places it is four times the circle rate. With high prices and high nominal interest rates, it is very enticing to withdraw the money from real estate or from the associated business and convert it into even a simple financial instrument like a fixed deposit. The returns, it is argued would be considerable. On the other hand, for manufacturing, considerable effort is required, apart from the investment in land, building and machinery and the yields are not commensurately higher. In other words, the present system of high prices of real estate could induce a switch from manufacturing where lot of effort is required to real estate business or even a reliance on passive incomes such as interest incomes. Since the price of land is quite high it is difficult for firms to expand its capacity also as more land is required in some cases.

Even for new firms, the cost of land tends to be prohibitively higher. However, it is difficult for firms to move into the hinterland since the costs of doing business and of accessing the market could be considerably higher - lack of power and poor road connectivity are examples.

In India, it is common knowledge that for buying land from non-government sources, in most places a sizeable portion of the cost has to be paid in cash. Since this part of the value is not reflected in the official documents for the transaction, it is not possible to access any bank finance for this component. In the process, individuals who do not have deep pockets find it difficult to set up a firm. Corruption is also recorded by agencies like the CAG in the allocation of government lands.

In some locations in India, like in Haryana, in government allotments of land for development of industry, the price of the land does not get fixed even at the time of

handing over the plot. Litigations on the fair price of land acquired from farmers for industrial or residential use in newly developing urban areas have sometimes increased the compensations amounts significantly. This in turn has been passed on by the governments to the buyers. Since the litigations take time for being resolved, the governments are choosing to keep the final price of the land indeterminate. This however places the firm in a difficult situation since it is difficult for the entrepreneur to decide whether the chosen economic activity would be economically viable at the final prices that prevail.

In a number of KIIs, there was reference to the ease of obtaining working premises at reasonable costs in countries such as China. This, it is argued, reduces the cost of land and building for the entrepreneur thereby making their activity more viable. At the same time, it reduces the time required to setup a business. Following this approach, some of the experts suggested that government should consider setting industrial estates and providing land or land and building at cheap rates on lease if it seeks to encourage entrepreneurs. Since there is a perception that such allocations can be cornered by powerful people or deep pockets and converted to real estate propositions, some safeguards in terms of quick commencement of production may be incorporated. In case of government led initiatives, if they take the form of clusters, it should be possible to move the cluster some distance from existing urban conglomerations, thereby reducing the cost of the project as well.

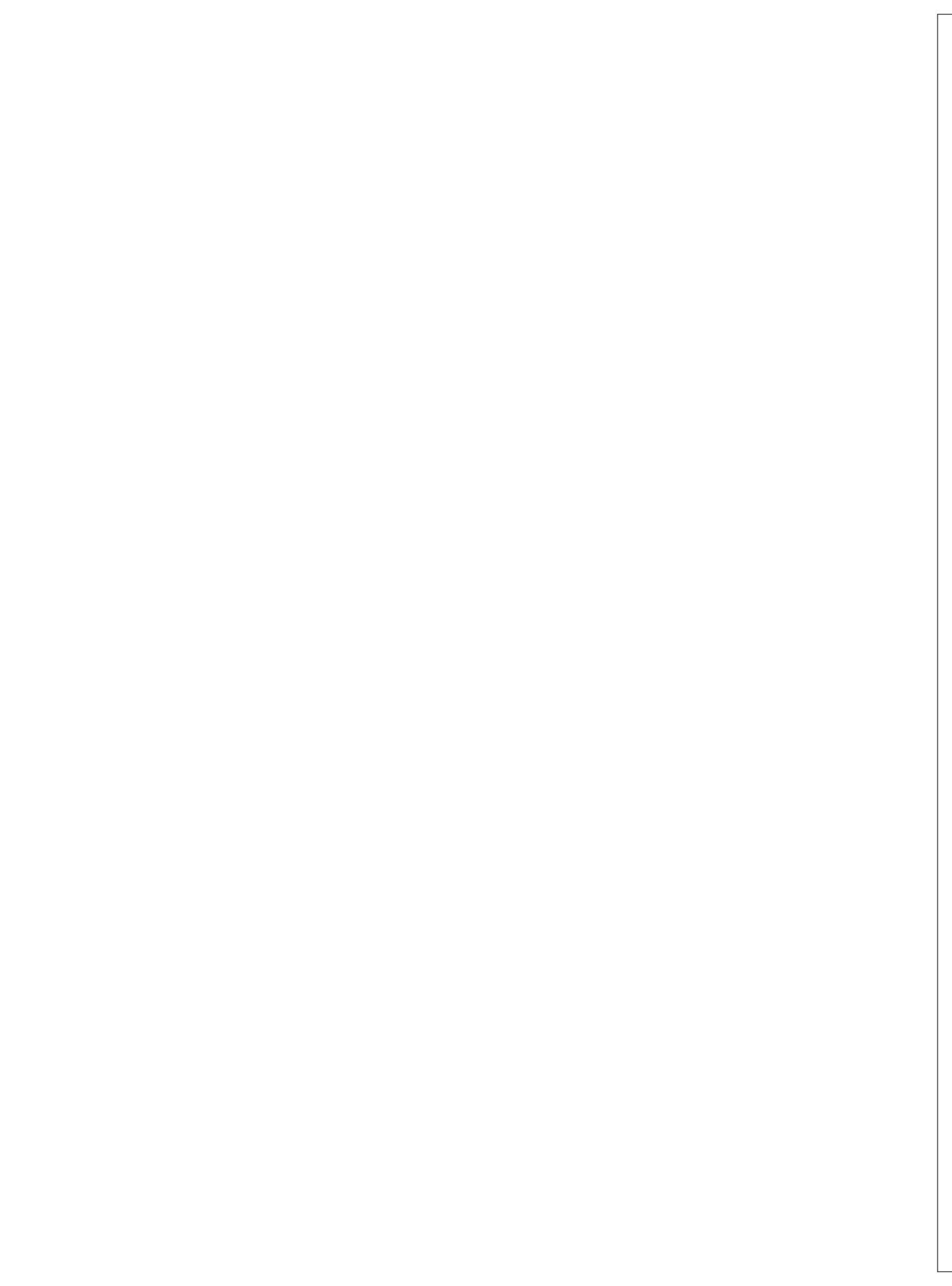
6.7 Other Issues

In the context of exploring non-urban areas or areas somewhat removed from existing urban settlements, a number of the KIIs reiterated the need for improvements in the infrastructure to make this feasible. The suggestions can be summarized as follows:

- There is a need for better infrastructure like continuous supply of electricity. The electricity should be provided in cheaper rate.
- Many traditional clusters are not well connected through roads. They lack modern design especially handicraft sector.
- Improvements in the port infrastructure and other infrastructure to augment the speed of clearances at Indian ports, both by the port authorities and the customs authorities.

- Streamlining check posts if they exist to minimize the on-road time and increase the predictability of arrival of shipments. This can reduce the quantum of inventory that the firms need to maintain.

Apart from the infrastructure related concerns, some of the KIs indicated that restructuring in MSME units is made difficult by the fact that there are no bankruptcy provisions in India. The only way a firm officially goes out of business is when it is liquidated. In the face of changes in the business environment where certain activities become unviable for various reasons, the firms may remain locked in for want of suitable mechanisms to declare bankruptcy. While this protects the interests of all the other stakeholders, the entrepreneur is not similarly protected, which can work as a disincentive for entrepreneurs or might induce corrupt practices.



SECTION-VII

Case Study (Trash to Cash; Dr. MadhumitaPuri)¹⁹

7.1 Introduction

The Delhi based NGO “Trash to Cash”, set up and being run by Dr. MadhumitaPuri, is a bold attempt to address the question of unemployment faced by disabled persons in India. She is a doctorate in Psychology with specialization in disability. Earlier, she has worked with the All India Institute of Medical Sciences (AIIMS) for 10 years as a Senior Research Officer and Psychologist at the Genetics Unit, Department of Pediatrics. In 1992, she founded the Society of Child Development (SCD), an NGO that works in the area of providing services to disabled children. The organization has experimented in alternative and innovative delivery models to encourage and enable access to education to children with disability. They have been actively advocating for the creation of equitable opportunities for children and adults with intellectual and other disabilities. The focus of the SCD was on poor households with children with disability. They undertook an informal survey in the neighborhood to assess the needs and constraints of this group. SCD attempted to address the concerns emerging from this survey and to fill the void in access to education, overtime, there emerged the need to find employment and livelihood for these children as well. This is the background for the creation of “Trash to Cash” in 2008. “Trash to Cash” has been visualized as serving two needs of the society – encouraging reuse and reducing wastage as a payback to a clean society and to meet the livelihood needs of handicapped people. The revenue from this endeavor has helped them to provide schooling, food and hostel facilities to more than 65 disabled children without fees, especially disabled children from poor income group. Dr. Puri also holds the position of Director of Prabhat, a special school for mentally handicapped children and she is also the Convener of Disability India Network, an information website (www.disabilityindia.co.in) on issues related to disability in India.

7.2 Broader Significance and Overall Aim of “Trash to Cash”

Given the financial constraints and discriminating behavior of the parents of disabled children, ‘Trash to Cash’ is a spectacular initiative to raise awareness among the parents of children with disabilities, about the possibilities of gainful employment so that they could

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encourage their children to raise their capability through the education and vocational training. Education and training are the two major inputs towards employment and the twin organizations of SCD and “Trash to Cash” are not only providing education but also providing vocational training. Education is both an indicator and an instrument of development and vocational training adds the ‘skill’ component to it. In particular, the organization emphasizes on the skill which is deeply linked with the market requirements as Dr. Puri believes that in India, employment opportunities are many but there is a shortage of skilled manpower, even though we have large number of unemployed people. This would thus help the disabled persons to be confident in competing with the others. The products produced by the trainees are marketed as well, generating incomes for them while illustrating the possibility of sustainable incomes. In what follows, an attempt is made to highlight first the achievements and then the challenges that these initiatives face.

7.3 Business Strategy and Achievements

The name “Trash to Cash” in itself highlights their earning source and the broad intent. Their strategy is to use waste material as raw material to generate products, especially handicrafts. By this approach, the organization saves the cost of raw materials. The waste material being recycled includes: flowers from temples, floppy disc, CD, cassette, videotape, tape, newspapers, fabric, banners etc. From these materials, they make rangoli, agarbatti, ladies’ bags, purse, eco-friendly kits for conferences and seminars, tray, pen stand, show pieces and many more creative and catchy products. By using the combination of purchased raw materials and discarded materials, the organization has produced several unique products of which, one is ‘Tapric’ bags for conference and seminars. By combining the tape from rejected videotapes and other fiber, they have produced a fabric, which has been named ‘Tapric’. Products such as bags are produced using it. Given the small scale of operation, their initiatives for marketing have been localized in various colleges and their personal contacts. Timely delivery and good quality they feel, have made people come back to them again and again. However, with expansion in scales, other alternatives would need to be explored.

One of first products produced by Trash to cash was ‘holi’ colours from discarded temple flowers. Discarded flowers will arrive on a regular basis and need to be processed in timely manner. However, holi is an annual festival – meaning thereby that while expenditure is spread through the year, the revenue stream is confined to a brief period once a year. The cash-flow problems this mismatch represents / results in, and the need for finding more activities, led to the search for alternative products – ‘Tapric’ being one of them.

Eventually, they have been able to produce several other products. However, there is a persistent challenge since even trash involves. For instance, tapes would be unavailable in near future. Thus, the trash to be used and uses to which it can be put to, needs to be a continuous and ongoing process.

In training and education, too these institutions report several significant achievements. Since children with disability often do not find place in 'normal' schools, the SCD has been working with children to prepare them, so that they can coop with, and fit into such regular schools. Over the years, while kids with extreme disability have remained with SCD, those with relatively minor disability have been able integrated into mainstream schools. This is a considerable achievement, both for the children and the institution. For the children, it opens up doors for regular education and access to a wider range of livelihood options. For the institution, mainstreaming of these children vacates space, which can be used to help other similar children.

For children who remain with SCD, as mentioned earlier, Trash to Cash initiative provides vocational training and potentially absorbs some of them into the production activity of the enterprise. Dr. Puri feels that by focusing on quality of the product, they have been able to build a niche for themselves where people return for repeat purchases. The incomes that the children and adults working in Trash to Cash earn there through this process, makes them productive members of their families and of society, thus changing perceptions away from being perceived as burden.

7.4 Financial Constraints

Their annual receipts of the two organizations put together for FY 2012-13 was about Rs. 90 lakhs. Trash to Cash has been incorporated in July, 2013. But they are not yet paying VAT since their annual turnover has not surpassed the threshold limit. Predominantly, they have two sources of financing: one is selling products and the other is donations from their network of supporters. While Dr. Puri considers this a financially viable model, she interprets the difficulties in getting regular financial assistance as the society's inability to visualize the sustainability of this model. Therefore, while their finances have improved eventually, their ability to expand rapidly has been constrained.

7.5 Issues of Being a Woman Entrepreneur

In India as well as in other part of the world, there is an overwhelming perception that women entrepreneurs are at a disadvantage when compared to male entrepreneurs. It is believed that women might face difficulties in procurement and collecting payments and get harassed by officials from various regulatory and tax departments. However, Dr. Puri expresses a completely different view – she argues that the two strengths her organization has are: 1) that she and bulk of her staff are women and 2) that they work in the disability sector. She has never been harassed by any officials or anyone, who have been providing them such trash raw materials. She explicitly mentioned that most people are cooperative and it is not a problem to attract customers for purchasing products made by her NGO. Even in procurement of waste material and for getting access to informal credit for procurement, she believes, people have been more supportive because they are women and work in the disability sector.

However, as this overall idea has synergistic consequences on the development of disabled children, she believes that unless some remedial steps are taken towards them, the move towards such systematic approach may continue to ring hollow not only for her organization but for all such functional institutes in the country as well.

SECTION-VIII

Conclusions and Suggestions

The important conclusions emerging from the present study can be summarized as follows:

1. There is an overwhelming response that micro small and medium firms do not believe that tax exemptions are useful as a mechanism for promoting their business. This is validated both by the survey data and the KI interviews. Instead, there is a larger support for lower rates of tax. But there is an exception, the majority firms which are exporting their outputs wants tax holidays. There is significant difference in the opinion of the exporting firms and non-exporting firms in this aspect.
2. Firms perceive the impact of taxes mainly in two ways – as adversely affecting profits and costs, and high compliance costs. There are some differences between responses of micro firms and small & medium firms: the more frequent response in the former is perceived adverse impact on profits and cost of production while that the small and medium firms perceive high compliance costs as the more important effect.
3. Compliance cost is consistently perceived to be high and seems to affect other decisions like decisions to expand as well.
4. Property tax does not emerge to be an important issue in this study.
5. While the study sought to identify whether there is brain drain and loss in economic activity in these segments of the economy, from the present study, in the context of India, we find the brain drain does not seem to be from India to other countries, or even from one region of India to the other, but from manufacturing to trading. While this issue is not captured in the survey, it appears to be a consistent refrain in the KI interviews.
6. Non-tax issues are emerging as more important constraints for the development of the sector.
 - a. Cost of land is emerging as an important constraint for the development of the SME sector. While the cost of land is high in urban areas, the entrepreneurs are constrained to these areas since the availability of infrastructure and the access to markets is relatively better here.
 - b. Related to the above, there are concerns raised on the overall quality of infrastructure in the country, all of which raise the cost of inventory for the firms. Poor road infrastructure and inadequate port infrastructure

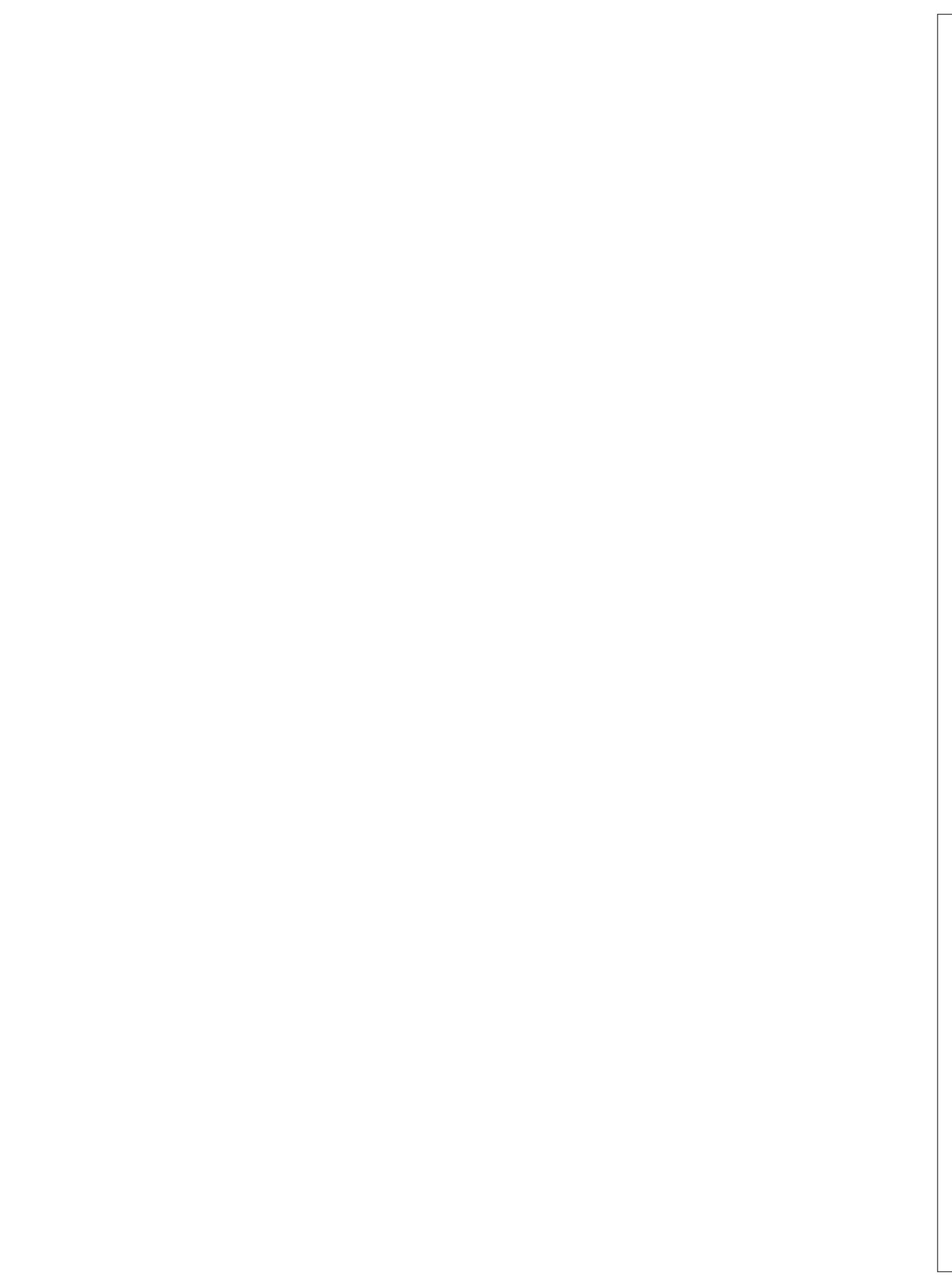
contribute to uncertainties in the time taken for transportation of goods across the country. Firms therefore would need to hold larger stocks of inventories to meet their demands in a timely manner.

- c. Access to credit continues to be a concern for this sector. The survey results suggest that a number of firms do not take loans either because the process is cumbersome or they do not believe they can get institutional credit. The KI interviews too flag concerns of high cost of borrowing and the need for collateral for borrowing. Some of the discussions also flagged concerns that new firms are less likely to get credit since they do not have pre-existing history to support their case.

Following from the survey and the discussions with experts in the field, some suggestions for improving the performance of the MSM enterprises in India can be summarized as follows:

1. Given that firms are looking for reduction in compliance costs, a prime driver of which is the existence of a large number of taxes and related tax administrations, the GST reform initiative can be used to streamline both the tax design and the tax administration to reduce the compliance costs with being in the regime.
2. Since firms seem to perceive that there are too many audits, from the perspective of the firms, it would be very useful if there can be more coordination among the tax departments so that joint audits can be done or the audits done by one department can be shared by others. Alongside this, it would be useful to explore if it is possible to develop transparent indicators of tax compliance for tax payers, like the CIBIL for credit scores in India. These measures can then be monitored both by the tax authorities and the tax payers and measures to improve these scores can be discussed so that the tax payer can identify steps by which his score can increase and the interface with the tax department can thereby be reduced. While this appears to be a far-fetched idea, within tax departments, they do use risk assessment scores.
3. Development of clusters or industrial estates where plots or factory sheds can be provided for lease with adequate infrastructure seems to be the need of the day for encouraging SME and to prevent the brain drain from manufacturing to trading.
 - a. While Indian experiments with industrial estates in the past have not been very successful, the time may be ripe for another such experiment maybe with short term leases. Some such experiments are being done in some states and compilation of the experiences may be useful in developing a perspective in the matter.

Since access to credit continues to be dominant concern, two issues need to be addressed. First, simplifying the process and documentation for getting credit would be important to bring more SME within the fold of the formal sector. Here 'aadhar' based credit histories or CIBIL based credit histories can be used to expand the access to credit. Improving the tax regime so that compliance cost is reduced too could bring in more people to the formal institutions for credit.



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