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A Case of Government Failure

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ABSTRACT

In this paper, we address ourselves to an evaluation of government policy designed for the modern small scale industrial segment of the small scale sector. We argue that the policy has been and continues to be supply-driven in being paternalistic and atomistic in the sense of individual unit-centred and is dominated by continuous protective and discretionary promotional measures with adverse side-effects for the healthy growth of this segment. We underline the need to move away from perpetual protection and bureaucratic discretion-based promotion and argue for a radical shift in this policy towards a demand-driven and group-oriented and collective effort-based (rather than atomistic) approach with a plea for the abolition of indiscriminate reservation of production lines for exclusive production in the small scale sector and introducing and strictly enforcing the time bound character of promotional concessions to get out of the syndrome of remaining small and inefficient. The suggested shift in policy is necessary in order to flexibly adjust to changing circumstances so as to better serve the long-standing and as yet unattained objective of developing a vibrant and self-reliant modern small scale industry.

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1. Introduction

Small manufacturing units in India contribute nearly 50% of production and 80% of employment of total manufacturing sector[1]. This is often taken to be an indicator of success of small industry policy. But is it? Should the policy be judged by certain aggregate relative shares or should it be judged by the extent of its success in attaining the objective it was expected to serve? In this paper where we call it a case of government failure, we adopt the latter criterion. It is also necessary to emphasise an obvious but often neglected point that policy constitutes a means to an end and not an end in itself. Consequently, it is also essential to flexibly adjust the policy to the changing circumstances even though the end may remain unchanged.

In the context of small industry units, it has been observed that these units mainly survive on product and geographical market segmentation and policy protection[2]. The importance of all the three factors are expected to go down once the economy is globalised, liberalised and moves over to a higher growth path[3]. Ultimately, small scale units have to sustain themselves on their own competitive strength by successfully facing competition from large scale units including multinationals. Are they in a position to do so? The answer appears to be negative if one were to go by the existing evidence. Before we suggest what needs to be done, it is important to diagnose the factors responsible for the present situation. In this context, it is necessary to evaluate the past policy package as it has evolved over the past four decades with the avowed aim of improving the competitive strength of small units. The paper is devoted entirely to the policy for one segment of the small industry, namely, what we

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[1] Eighth Five Year Plan, p. 122.

[2] Underdevelopment of infrastructure like transport created sheltered local markets for small units by segmenting the market geographically. Product differentiation in terms of quality with existing income inequalities segmented the product market into two parts: price-sensitive & quality-insensitive and price-insensitive & quality-sensitive. Small units being producers of low quality but cheaper products cater mainly former segment. Policy protection comes through reservation and fiscal concessions.

[3] Growth necessitates development of infrastructure which would reduce geographical market segmentation. Growth is also expected to reduce the relative share of price-sensitive quality-insensitive segment via rise in per capita income. Policy protection comes down by overall reduction in duties as a part of globalisation and liberalisation.

distinguish in section 2 below as the modern small scale industrial units. We do not consider other segments of the small industry in this paper.

The paper is organised as follows. The next section starts by distinguishing various segments within the small manufacturing sector. Section 3 traces the origins of the policy and its objectives. In section 4, we study the rationale for policy measures. The fifth section attempts an evaluation of the efficacy of the policy package using *a priori* reasoning backed by available *ex post* evidence from various studies. Section 7 explores some of the possible alternatives. Section 8 briefly comments on the measures proposed by the recent expert committee. The final section contains concluding observations.

2. Village and Small Industries (VSI) Sector

All small manufacturing units in India are referred under Village and Small Industries (VSI) sector. It is important to underline the fact that this sector is not homogeneous but heterogeneous with respect to technology, organisation and nature of the product. For our purpose the relevant distinction on the basis of technology is between `**traditional**' and `**modern**' industries.

Traditional industry is characterised by technology that is craft-based and is passed on from one generation to another through on-the-job-training. It produces an output mostly for final consumption that is non-standardised with more an element of art than manufacture and is carried on usually in rural households with very little hired labour. All cottage and village industries including Khadi, Handlooms, Handicrafts, Coir and Silk are usually taken to be traditional industries. They mainly produce consumer goods using mostly locally available materials and skills[4]. For administrative purposes, Government deals with them separately through the specialised agencies namely, Khadi and Village Industries Commission, Handlooms Board, Handicrafts Board, Silk Board and Coir Board.

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[4] Staley and Morse (1965), pp. 1-25. Dhar (1979), pp. 172-175.

"*Modern*" small scale industries occupy an intermediate position between traditional cottage and village industries and large scale industries. They are nearer to large scale industries as regards the nature of product and the use of mechanised and often power-driven technology that is capable of producing standardised output for intermediate or final consumption on a scale larger than that of traditional industry. They are carried mostly in urban workshops using mostly hired labour[5]. These include Powerlooms and other small scale manufacturing industries. While powerlooms come under the jurisdiction of the Textile Commissioner, other modern small scale industries come under the purview of Small Industries Development Organisation (SIDO) and include units[6] that are defined in terms of original value of investment in plant and machinery with a maximum ceiling limit. This ceiling level has been undergoing upward revision over time. Currently, it is Rs. 30 millions for small scale unit and Rs. 2.5 million for tiny units[7]. This paper focuses solely on policies toward modern small scale industries (other than Powerlooms) which account for 80% of production, 30% of employment and 50% of exports of the VSI sector[8].

3. Policy: Compulsions and Objectives

The first major policy initiative regarding small scale industries was formulated during the Second Plan period which has continued more or less in the same form till today. Government focused on small scale industries partly because of ideological commitments of political rulers and partly due to social realities which created political compulsions.

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[5] Staley and Morse, *op. cit.*, pp. 1-25. Dhar, *op. cit.*, pp. 172-175. *Second Five Year Plan*, p. 450.

[6] `Unit' (or enterprise or firm) is usually referred to the ownership or decision making unit in the production of goods and services. The term `industry' is taken to consist of all units - small and large in the production of a specified product. Accordingly, `small scale industries' shall refer to those industries in which all units are small. It is appropriate to cottage and village industries like Khadi in which all units are usually small. On the other hand, `small scale units' would be more appropriate description of modern small scale sector which covers firms operating on small scale in various industries which otherwise also have large firms. Like many other studies on the subject we use units, firm, enterprise and industry synonymously.

[7] *The Hindu*, Saturday, February 8, 1997, pp. 1.

[8] *Eighth Five Year Plan*, vol. 2, pp. 149-151.

Independent India was ideologically committed to creating "Socialist Pattern of Society" that sought to stress equitable distribution along with rise in real incomes[9]. Equity with the then prevailing poverty and inequalities in wealth required - (a) the creation of broad-based employment opportunities and (b) the wide dispersal of industrial production. Small scale industries were taken to be legitimate instruments of generating employment opportunities and enabling wide dispersal of industrial production[10]. Here, small scale vis-a-vis large scale units were axiomatically taken to generate more employment and lead to regional dispersal of industrial production. However, these propositions are not universally valid and require empirical verification. Economic theory shows that under scale-neutral technology where small scale units can be viable, labour usage is a function of technology and relative factor prices and that the scale of operation or size of unit is indeterminate. The empirical evidence on the positive association between size and labour usage is mixed and requires restrictive assumptions about technology[11].

Indian industry which consisted mainly of craftsmen and rural artisans suffered serious set back during British Colonial Rule[12]. Rural artisans were driven out of their traditional occupations because of new tastes and products[13]. Many of these artisans were forced to become agricultural labourers. This increased pressure on the available limited cultivable land and intensified rural poverty[14]. Same apprehensions were anticipated once the large industry took off[15]. This situation created political compulsion to revive village and small industries to - (a) rehabilitate displaced artisans and (b) avoid further technological unemployment. Thus came the focus in policy on village and small industries.

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[9] *Second Five Year Plan*, ch. 2, pp. 21-24.

[10] *Industrial Policy Resolution*, 1956.

[11] Bhavani (1980), ch. 2.

[12] Gadgil (1973), pp. 163.

[13] *Ibid.*, pp. 162-164.

[14] Myrdal (1968), pp. 1208.

[15] *Karve Committee* 1956, pp. 15.

Having focused on small industries, the following perceptions of the planners and policy makers regarding these industries set the policy objectives as well as the basic framework for policy measures. (1) Because of their numerical dominance, the initial policy was directed exclusively towards traditional cottage and village industries and did not take due account of the distinct segment of modern small scale industries[16]. (2) As traditional industries mainly produced consumer goods, all modern small industries too were taken to be producers of consumer goods and were perceived to be directly in competition with the corresponding modern large scale industries[17]. In doing so, policy makers ignored two other possibilities i.e. competition between the two segments within the group of small industries, namely, traditional and modern[18] and complementarity between modern small and large scale industries[19]. (3) In view of the perceived handicaps of the traditional industries in terms of technology and organisation, their immediate need was taken to be protection from their large scale counterparts[20]. Protection was, however, recognised to be temporary during the period of transition towards attaining their competitive strength.

Accordingly, the long term objective of policy was to improve economic viability of small scale industries so that they would compete in the market without handicaps. It was stated explicitly in the Industrial Policy Resolution 1956 -- ".......the aim of state policy will be to ensure that the decentralised sector acquires sufficient vitality to be self-supporting ....The state will therefore, concentrate on measures designed to improve the competitive strength of the small scale producer." It should be clear that while the employment generation and regional dispersal remained primary objectives, small industry as an instrument was expected to serve these objectives by attaining competitive strength and economic viability.

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[16] Mahalanobis (1963), pp. 72-73. *Karve Committee* 1955 and *Report on Small Scale Industries in India* by International Planning Team (IPT) 1954.

[17] See, Mahalanbis, *op. cit.*, pp. 23. *Karve Committee* 1955, pp. 19 and *Report of IPT* 1954, pp. 13.

[18] Its consequences can be seen in the current structure of Textile industry where restrictions on mill sector have not been able to protect Handlooms. Instead they led to the growth of Powerlooms.

[19] This had been considered in the common production programme where areas of production were demarcated for small and large firms.

[20] Mahalanobis, *op. cit.*, pp. 72, *Karve Committee* 1955, pp. 18, *Report of IPT* 1954, pp. 1 and 12, *Memorandum of Panel of Economists* 1955, pp. 9.

Hence, the trade-off between efficiency and equity though important in the short run, was not expected in the long run.

Protection was suggested as a transitional measure mainly to give time interval for small scale industries to reorganise so as to improve their competitive strength. Thus the famous Karve Committee (p. 30) stated that "In fields where modern industry exists side by side with large numbers employed in traditional industry the above involves regulating, for the time being, ... expansion of the total capacity of modern industry............such measures provide an interval of time during which rehabilitation or reconstruction of traditional industry can take place." (emphasis added). Mahalanobis in his classic work (p.23) observed that " Until unemployment is brought under control there should not be, therefore. any fresh investments to expand factories which compete with the small and household units of production............." He advocated (p. 71) a `transition phase' in which preference would be given to what he called `small scale and household industries' and visualised this need for preference to decrease over time and eventually `a gradual and steady change-over would be made to more efficient forms of production by the increasing use of machinery driven by power' (emphasis added). Thus the primary objective of policy was to improve the competitive strength of small scale industries and protection was suggested merely as a transitional measure. More than forty years down the road, the Expert Group headed by Dr. Abid Hussain (report submitted in January, 1997) starts its report thus: "The Expert Group recommends that the guiding principle of future course of small scale enterprise (SSE) development policy should be their accelerated growth and competitiveness. Hitherto, the accent of small enterprise development policy was infant industry protection[21]." It is thus clear that the primary objective of policy remains unattained even after forty years. Clearly, therefore, it deserves a close and critical re-examination.

The major drawback of the policy has been that the instrument of temporary protection from competitive pressures of large scale industry (meant initially to minimise technological unemployment during the transitional period) paradoxically got translated into the virtually perpetual protection of small scale industries as a goal in itself. In the process, the primary

[21] *Report of the Expert Committee on Small Enterprises*, Ministry of Industry, Government of India, New Delhi, January 1997, pp. s-1.

objective became secondary initially and eventually appears to have disappeared altogether. This is what we argue in the subsequent analysis. This is the major point of departure of the present paper.

Competitive strength of any enterprise is determined by a combination of technology, organisation, product composition and scale of operation. All these are highly interconnected and differ across industries. Policy statements emphasised mainly technological upgradation to improve the competitive strength and ignored other aspects. As our subsequent analysis shows, instead of inducing small units to attain their optimal size on the basis of economic viability the policy managed to generate vested interest in remaining small and often non-viable in the absence of policy support. Even the choice of industries exclusively reserved for small scale production appeared indiscriminate and not governed by rational considerations of scale neutrality.

4. Rationale For Policy Support

In comparison with the large scale manufacturing units small scale units had been perceived to suffer from the handicap of limited access to input and output markets which were taken to make it difficult for these units to improve competitive strength[22]. In our view, limited access of small units to different markets had been and continues to be due to the underdevelopment of institutional pre-requisites like infrastructure and partly due to market imperfections.

Underdevelopment of basic institutions like efficient and non-corrupt public adminisatration and physical infrastructure like transport and communication network leads to an underdevelopment of functioning markets and organisational dualism in the economy. Small units being mostly in the unorganised activities are either loosely connected or totally disconnected with the supporting organised activities like banks and government machinery[23].

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[22] This had been noted by those who are concerned about the sector. Mahalanobis, *op. cit.*, pp. 73, *Industrial Policy Resolution* 1956.

[23] Myint (1985). The importance of well developed markets for small units was noted earlier by Lewis (1955), pp. 77.

Whatever access small units have to organised markets, is limited by imperfections like non-linear pricing enabling economies in bulk purchases and information asymmetries. All these factors put small units at a greater disadvantage in the markets for output and credit and as a consequent their limited access to technology. We argue this point now.

Taking capital market first, it is imperfect due to the risk of default in repayment of loans. Assessment of various attributes which determine risk involves high information costs in loans given to a large number of small borrowers. Collateral is one way of reducing risk but some costs are there in arranging collateral and foreclosing if need be. Administrative and monitoring costs of numerous small loans is also very high. All these raise the cost of making a large number of small loans. Hence, lenders show a rational preference for small number of large borrowers over a large number of small ones. This limits the access of small units to organised institutional credit market[24].

Even where the manufacturing process is scale neutral so that small units do not face handicaps in this respect, there exist economies in bulk purchases of materials due to discount rates and economies in selling costs which enable large units to sell at lower costs (given quality). Where the manufacturing process is also subjected to scale economies, the small units are at an insurmountable disadvantage. It is impossible for small units to be competitive in this case. Small scale units cannot reap scale economies because of their size and cannot have superior marketing strategies and develop distribution channels because of resource constraints. These factors together with their limited access to market information, restrict the access of small units to the product market.

Finally, access to technology requires - (a) access to information about alternative technologies as well as modalities of acquisition; (b) access to capital market as technology raises the scale of investment and (c) access to product market. The first two factors facilitate the acquisition of technology whereas the third provides incentive to adopt upgraded technology.

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[24] Staley and Morse, *op. cit.*, pp. 370. Little *et. al.* (1987), Ch. 15.

In one respect, namely, the labour market, small scale units were taken to possess an advantage in terms of access to low-wage labour in the unorganised sector. The overprotective labour market legislation applicable to the large scale units did not apply to the small units at all or wherever applicable, their stringency was much reduced.

In order to protect small units from the competition of large units in the short run and to improve their access to markets so as to enable them to improve competitive strength in the long run, Government initiated a wide variety of measures which we take for discussion.

5. Policy Measures: Character and Implementation

In this section, we discuss the efficacy of the policy measures in terms of the objective they serve and the mode of implementation. For this purpose, policy measures may be distinguished along three dimensions, namely, **promotional vs. protective, one shot vs. continuous and discretionary vs. non-discretionary.**

Promotional vs. Protective

Promotional measures seek to impart competitive strength to small units by improving their access to different markets. Some of the promotional measures that are in operation relate to the provision of infrastructure like developed land, consultancy and training services, industry facilities like tool rooms and quality testing stations, supply of machinery on hire-purchase and supply of credit and materials.

Protective measures seek to protect small units through a preferential treatment of these units vis-à-vis large units. Examples are: reservation for exclusive production in small scale units, purchase preference extended by government agencies, concessional input prices like lower interest rates and the whole gamut of fiscal incentives including excise and custom duty exemption and subsidy on capital.

One Shot Vs. Continuous

Except for a few measures like allotment of land, most others such as supply of credit and materials, industry facilities, concessional input prices and fiscal incentives are continuing in the sense they can be availed by a given small unit any number of times as and when needed. As long as a firm remains a small unit (by official definition), it is eligible to have the relevant facilities.

Discretionary Vs. Non-Discretionary

Outcome of discretionary measures for a given unit depend on the discretion of the individual official implementing it on a case-by-case basis. Outcome of non-discretionary measures, in contrast, based as they are on objective criteria, becomes independent of the individual official implementing the policy. Most of the protective measures are non-discretionary. For instance, any small unit producing lower than specified amount of production automatically gets excise duty exemption. Majority of promotional measures like allotment of land, machinery on hire-purchase and finances are discretionary in nature.

The promotional and protective measures each can be either discretionary or non-discretionary, or can be continuous or one shot. In the context of modern small scale industries, policy measures have been dominated by **continuous protective measures and discretionary promotional measures.** From the point of view of efficacy, continuous protection and discretionary promotional measures have adverse side effects.

Persistent protection leads to a proliferation of small units to get under the protective umbrella and thus usually result in overcrowding[25]. Continuous provision of various facilities at lower than market prices induces wasteful use of resources[26]. Protection to small units in combination with various statutory regulations on large scale organised industry, provide

[25] Sandesara (1982), pp. 112 and 121, reports that there exists overcrowding in the sector.

[26] There exists evidence to this extent. See Sandesara, *op. cit.*, pp. 44-49. Goldar (1985), Ramaswamy (1990).

perverse incentive to remain small. **Continuous protection thus gives positive disincentive to improve competitive strength.**

Promotional measures being discretionary, limit the number of small units that can avail policy assistance. These measures also provide temptation to influence the concerned authorities' decision and thus induce unproductive rent-seeking activities[27]. This tendency will be more so when assistance is in limited amounts and made available at lower than market prices as is the case in the current context. Case-by-case disposal involves delays in decision making even in the absence of rent-seeking.

Further, policy measures - protective as well as promotional - are implemented through a wide network of organisations with a considerable overlap of functions and without specific responsibility entrusted to each organisation. For instance, technical consultancy has been provided by Small Industries Service Institutes, National Small Industries Corporation, District Industries Centres and Technical Consultancy Organisations. Implementation of each one of these measures involve many formalities and cumbersome procedures[28].

Effective implementation of this policy requires several conditions to be fulfilled. One, small units have to approach on their own to the concerned agency to avail a specific policy assistance. For this purpose, wide dissemination of information about various types of policy assistance available and the agencies providing them is necessary. Two, numerous formalities and complex procedures require expertise to deal with the paper work. Three, multiplicity of agencies and organisations makes it essential to ensure co-ordination among these agencies. Four, for efficient and prompt application of discretionary measures, the staff of promotional agencies has to have intimate knowledge of industry and capacity to process the firm-level information. Finally, specialised services like technical consultancy demand technical competence of staff of the promotional agencies.

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[27] Staley and Morse *op. cit.*, pp. 346, discussed about this possibility long ago.

[28] Even after Government pronouncement in the Policy Measures For Promotion. Strengthening Small, Tiny and Village Enterprises , April 1991, to simplify procedure and formalities and debureaucratise this sector, the problem persists. This is what recent NCAER' survey shows (1993, pp. 6, 134-135).

Ground realities, however, indicate gross violation of the above mentioned conditions for effective implementation of policy measures. As mentioned earlier, small units are widely scattered and loosely connected to the organised sector which makes dissemination of information to these units difficult. There is evidence that most small units are unaware of most policy measures specifically designed for the small scale industries[29]. Owners of many small units do not have the required expertise to deal with the complicated procedures nor can they hire experts. Hence, numerous formalities and cumbersome procedures have an unintended consequence of deterring small units from availing of policy assistance. Empirical studies confirm this[30]. Available evidence also throws doubts about the competence and industry knowledge of the staff of the promotional agencies[31]. Evidence reveals absence of co-ordination among promotional agencies[32].

Inadequate dissemination of information and numerous formalities and complex procedures tend to favour urban based larger units in the sector as these units are better connected to government machinery and expected to have the required expertise to deal with the complicated procedures[33]. Virtual absence of inter-institutional co-ordination and technical competence and industry knowledge of the staff contribute further toward the ineffectiveness of the stated policy measures.

Now we turn to the appropriateness of policy measures i.e. whether these are capable of removing the handicaps that restrict the access of small units to different markets. As discussed earlier, access of small units to capital market is limited because of higher risk and lending costs. Solution to this would be to reduce risk and lending costs to small units. In this context, the government has undertaken numerous measures to improve the access of small units to institutional capital such as Priority Sector Lending (PSL), Credit Guarantee

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[29] Aradhya (1969), Bose (1978) and Mishra and Sharma (1986).

[30] Sandesara, *op. cit.*, and Mishra and Sharma, *op. cit.*

[31] Little *et. al.*, *op. cit.*, pp. 31 and Goldar and Gupta (1989).

[32] Vepa (1988), pp. 47, SIDO. *Annual Report 1988-89*, pp. 30. Goldar and Gupta *op. cit.*

[33] Many studies observed this. For instance see, Little *et. al.*, *op. cit.*, pp. 289, Sandesara *op. cit.*, pp. 119. *Corporate Study Group* (1983), ch. 3, pp. 27-72. *Eighth Five Year Plan*, pp. 123.

Scheme (CGS), Equity Fund and Refinance Schemes. Small units were placed in the 'Priority Sector' along with agriculture and 40% of total credit of a bank was directed to be given to the priority sector under PSL. CGS provides guarantee to a good proportion of loans given to small firms. Equity Fund provides seed capital in the form of soft loans to eligible small units. All these policy measures improve the access of small units to institutional credit not by reducing the risk and costs of lending but the government bearing the risk and higher costs of lending. Given the overall deficiency of capital and numerous obligations that the government has, this type of assistance may not be sustainable especially when loans are provided at lower than market interest rates. Government also cannot provide finances adequate enough to meet the needs of all the small units[34]. In this situation, the policy is adversely impacting on the credibility of lending institutions besides contributing to their non-viability.

Government reserved certain production lines as well as government purchases of certain items for small units, established Subcontracting Exchanges and gave fiscal concessions like excise duty and sales tax exemptions to improve the access of small units to the product markets. Fiscal concessions reduce the sale price of the products of small units and thus indirectly expand their market. Reservation of production lines to the extent it is enforced, reserves the entire market for small units. But none of them induce small units to attain their optimum size and to act collectively. Rather, all these measures (except Subcontracting Exchanges) provide strong incentive to remain small and operate in an atomistic fashion. Thus, **policy measures improve the access of small units to various markets by circumventing the obstacles not by removing them**.

In effect, lack of information dissemination and pervasive existence of complicated procedures and formalities give better access to larger among the small units to policy assistance. Promotional measures being discretionary, further limit the number of small units that can avail of policy assistance. Thus, policy assistance is out of reach for the large majority of small units. Lack of technical competence on the part of government agencies and

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[34] Many studies including Nayak Committee (1993) showed at various time points that finances to small scale sector are neither adequate nor timely, pushing small units sick. See, Patvardhan (1985), Thapar (1966), Reddy (1988), Reddy and Reddy (1988), Mishra and Sharma, *op. cit.*

absence of inter-institutional co-ordination result in ineffectiveness of whatever policy assistance is given. Policy measures do not solve the problems that handicap small units but temporarily bypass them. Relatively larger units within the small scale sector which have better access to policy assistance do not have incentives to use assistance efficiently and in fact develop vested interest in remaining small in order to continue enjoying the protective umbrella.

The combined effect of protective and promotional measures is less than minimum efficient size for many small scale units mainly those near the defined ceiling limit of small industry for availing assistance. This handicap is compounded by their inability to avail of scale economies in bulk purchase of inputs and in marketing costs. Existing policy measures are directed atomistically to individual units and do not induce collective efforts for bulk purchase of inputs and sharing sales costs. Thus, policy measures have paradoxically acted against the primary objective of improving the competitive strength of small units. Instead, what were originally intended to be a transitional measures, have persisted despite their adverse effects on the primary objective of imparting competitive strength.

6. Possible Alternatives

As discussed earlier, small units have been unable to improve their competitive strength because of their restricted access to markets. The access of small units to markets is limited due to underdevelopment of pré-requisite institutions and market imperfections. We recommend that Government should focus primarily on the further development of institutional pre-requisites like physical infrastructure such as transport and telecommunication network. As regards market imperfections, these are inherent given the size and large number of small units. Government alone cannot remove them even if it is genuine and sincere in its efforts. Primary solution, in our view, is to encourage growth in size and collective efforts of small units and participation of private parties like large scale units, financial institutions and consultancy organisations. We argue this in detail in subsequent paragraphs.

Take for instance, capital market. To improve the access of small units to the institutional capital market, risk of default and costs of lending to small units need to be reduced. This can be done by encouraging small units to organise themselves into industry associations / credit co-operatives so as to approach collectively and to undertake collective responsibility for monitoring the use and ensuring repayment. Financial institutions can also reduce lending costs through innovative practices. We already have an example in this respect. Syndicate Bank before nationalisation confined itself to rural sector including small industries and made its costs comparable to those of other banks which specialised in lending to large scale corporate sector units using novel practices[35]. Privatisation of and competition in the financial sector might force them to specialise and seek innovative ways. Alternatively, one can explore other sources of finances such as large units providing loans or finances through equity participation to small units. Large scale units may involve themselves only if they have ancillary relations or marketing tie-ups with small units.

Limited access of small units to product market is due to scale economies in manufacturing which give large units competitive edge over small units. In order to correct for it, it is important to select production lines for small units that are scale neutral. Given such production lines, industry associations would enable small firms to have the benefit of scale economies in other respects through collective purchases of common materials, advertisement of related goods like food products with common brand name and distribution through common channels. Ancillarisation, besides giving stable long run market, reduces sales costs. Sales costs can be totally eliminated through marketing tie-ups with large firms. However, the success of ancillarisation depends critically on adequacy of supply, reliability of quality and timeliness of delivery. These are repetitive transactions where success so far has been limited possibly because of the non-fulfilment of the required criteria for success mentioned above.

In the case of technology, gathering information as well as having common facilities like tool rooms and quality testing stations - all are better served through industry associations and ancillarisation. Private consultancy organisations can also be encouraged.

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[35] Bhatt and Roe (1979), pp. 13-25.

Small industry associations, ancillarisation, marketing tie-ups with large firms, private financial institutions and consultancy organisations can also take care of the problems of information dissemination and complicated procedures. These institutions are technically more competent and well aware of industry problems. Government should try to encourage these institutions. We discuss briefly the development of some of these institutions in the current context in subsequent paragraphs.

In Japan, as much as ninety-eight per cent of government assistance to small enterprises is routed through industry associations[36]. Associations/ co-operatives is not a novel idea even to India. It was suggested by all those concerned in the beginning itself[37]. Small industry associations do exist. However, they are not functioning as expected primarily because of the existing policy measures. In the existing policy frame, Government takes initiative and assumes major responsibility of solving the problems of small units for which it is not well equipped[38]. By doing so, it is unintentionally stifling the scope for private initiative. Continuous protective measures encourage associations to focus more on lobbying for continuation of existing and extension of further concessions. Policy measures by targeting individual units transforms common problems like working or term finance into individual problem and reduced the scope for collective action. This point needs a little elaboration. Credit is one of the common problems of small units. Government through various measures ensures certain magnitude of credit to these units. As it is not adequate enough to the needs of the sector and given the fact that it is provided to the individual units at the discretion of concerned officials, units which have better access to financial institutions and can influence the decision of concerned individuals can secure credit more easily. For the remaining units, finance remains as a problem. It is high time that Government encourage private initiative and collective action through industry associations and supplement their efforts. This requires a major revamp of the existing policy measures.

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[36] *Policy of small and Medium Enterprises in Japan*, pp. 18, supplied by the Japan Small Business Corporation, Tokyo, Japan.

[37] Mahalanobis, *op. cit.*, pp. 74. *Karve Committee* 1955 pp. 24. *Report of IPT* 1954, chs. 4 and 5, pp. 43-55. *Industrial Policy Resolution* 1956.

[38] This was what initially suggested by all those concerned. See for instance, Manalanobis, *op. cit.*, pp. 73.

Government can make the associations function in a promotional way by creating pressure, setting guidelines and providing incentives. Pressure can come through the imposition of technological or quality or environmental or any combination of these standards. Government can then set the guidelines in terms of technology to be used or common quality testing stations or tool rooms or an effluent treatment plant. This was expected to force small units to approach in groups or Government can explicitly ask these units to approach in groups for any assistance. Government can then supplement their collective efforts in terms of financial assistance (a loan or a grant) and fiscal incentives. Murty et. al. (1995) have shown that it is quite possible. The threat of closure and penalties for the non-compliance with the prescribed standards by the Haryana Government and the fact that effluent treatment plants are costly made small producers in Sonepat industrial area, show keenness to adopt the common effluent treatment plants.

Though Government tried to develop ancillarisation since the Third Five Year Plan (p. 436), its slow and inadequate development may well be attributable to the existing policy measures[39] [40]. Protective measures like reservation of production lines along with product market segmentation discouraged small units to go for ancillarisation[41]. Another problem that might have discouraged small firms to go for ancillarisation or subcontracting is delays in payments made by large units[42]. Otherwise also, it has been noted that in developing economies, subcontracting is not developed due to the absence of specialisation[43]. Firms are unable to specialise in the absence of subcontracting and subcontracting cannot develop in the absence of specialisation[44]. Small firms in India have not established their technical competence in quality components. Added to it are the problems of not meeting the delivery

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[39] We use ancillarisation to indicate subcontracting i.e. supplying parts and components by small scale units to large units on a long run basis.

[40] Gupta and Goldar (1996).

[41] Little, *et. al. op. cit.*

[42] Evidence shows that there exists such problem. See, for instance, Gupta and Goldar, *op. cit.*

[43] Pack (1981).

[44] Amsden and Kim (1986).

time schedule and inability to ensure adequate supply of components[45]. Nor are large firms who had been operating in the seller's market so far interested in assisting small units to overcome their technical problems except in the case of captive ancillaries. Persistent restrictions on imports till recently, by providing sheltered markets to domestic producers did not give incentive to large units to improve quality and reduce costs - the underlying pre-requisite of ancillarisation[46]. Now the economy is being globalised and liberalised, it is expected to increase competition and expand the market. This, in turn, is expected to make large units go for specialisation and hence induce them toward ancillarisation so long as small producers can be induced to observe strict delivery schedules, quality specifications and ensure adequate supply[47]. So it is right time that Government should encourage ancillarisation by removing the hurdles like protection to small as well as large scale industries.

The development of the above mentioned institutions requires selection in terms of industry and/or location and conducive environment. Conducive environment include abolition of protective measures like reservation of production lines and government purchases. Fiscal concessions like excise duty exemptions should be strictly time bound in the sense that any unit can avail them for a pre-specified fixed period say, 5-7 years. Policies should encourage and target associations and supplement their collective efforts.

7. New Policy Directions

As mentioned in section 2, The recent Expert Committee on Small Scale Enterprises (Abid Hussain Committee) recommended that accelerated growth and competitiveness of small scale enterprises be taken as objectives of policy. To pursue these objectives the Committee proposes a strategy that include the same old policy package except protection viz., provision of adequate supply of credit facilities, services, technology assistance and

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[45] Gupta and Goldar, *op. cit.*, report some of these problems.

[46] Gupta and Goldar, *op. cit.*, report that though there are significant cost advantages, the possibilities of subcontracting and ancillarisation have not been adequately exploited by large enterprises.

[47] Prendergast (1990) shows that market growth encourage both specialisation and subcontracting. Takashi Yokokura (1988), pp. 528, reveals that in Japan it was the expansion of output in mid-50s prompted large units to go for subcontracting increasing their orders for parts and components.

infrastructure. The point of departure of their recommendation lies in the development of linkages between enterprises and their support institutions, partnership between private parties and Government, legal and institutional framework.

Some of the welcome features of the Report of the Expert Committee are: (1) focus on clusters which involve selection of regions and industries for small industry development; (2) the total abolition of reservation of production lines - the strong version of protection - is timely and (3) encouragement to private parties including associations in the provision of infrastructure and capital.

One of the important suggestions of the Committee that has already been implemented is to raise the ceiling limit on the value of plant and machinery to define a small unit. Hike in ceiling limit is welcome as it widens the range of technologies that small units can adopt and/or scope for modernisation of these units. Definition in terms of ceiling limit however, remains a constraint on growth and hence on technology if policy package consists of continuous protective and discretionary promotional measures targeting individual units. Such policy also allows a few larger units of the sector to avail of assistance-thereby limiting the access of large number of smaller units to assistance. To avoid these problems, (a) protection and promotional facilities should be **time bound** for a given unit and (b) policy should encourage **private initiative** and **collective efforts** of small units and should **supplement** these efforts as regards promotional facilities.

Although the Expert Committee has recommended reduction in the extent of protection and promotional facilities provided by the Government they do not make them time bound. Though the Committee recommends the abolition of reservation of production lines, it supports the existing excise duty exemptions which are provided without time limits, as they are. As it provides disincentive to grow in size, they recommend further exemptions for limited period after their graduation from tiny or small units category. Had the exemption been time bound in the beginning itself, it would not have created disincentives to grow at all. Same is the case with facilities like supply of capital which targets individual units without time limits.

The approach of the Committee is still atomistic in the sense of being directed to individual units and persists in relying upon government initiative. This will not promote the sector but merely solve the problems of those small units which are fortunate enough to receive those facilities. If the policy is of the type that government takes initiative in providing common facilities like tool rooms and asks private party like associations to share its costs then the latter may not be keen to share or may not manage them well. The initiative should always be encouraged from a group of related units and government can supplement wherever it thinks it appropriate. The Committee also suggests partnership between the private sector and the Government. This is reasonable except that the Committee's policy recommendation still persists in being supply-driven and not for meeting the genuine collective demands as and when they appear.

8. Concluding Observations

In this paper, we addressed ourselves to an evaluation of government policy designed for the modern small scale industrial segment of the small scale sector. We argued that the policy has been and continues to be supply-driven in being paternalistic and atomistic in the sense of individual unit - centred and is dominated by continuous protective and discretionary promotional measures with adverse side-effects for the healthy growth of this segment. We underlined the need to move away from perpetual protection and bureaucratic discretion-based promotion and argued for a radical shift in this policy towards a demand-driven and group-oriented collective effort-based (rather than atomistic) approach with a plea for the abolition of indiscriminate reservation of production lines for exclusive production in the small sector and introducing and strictly enforcing the time bound character of promotional concessions to get out the syndrome of remaining small and inefficient.

Even though wide-ranging changes (atleast at the level of policy statements) have taken place in the general industrial policy since July, 1991, the policies towards the modern small scale industrial segment remain untouched. In fact, all the new policy statements have been at pains to keep the modern small scale units out of their purview. In other words, the policy continues to be dominated by old paternalistic mind set of protecting the small as a goal in itself. This can be interpreted either as the case of incorrigible inertia among the policy makers towards any change or a regulatory capture by this segment or possibly both as they reinforce each other. Needless to add, no major policy change towards structural adjustment is painless. However, if a large number of small units are not availing of assistance and a relatively few larger ones end up cornering supply-driven concessions, the policy is surely not even meeting the test of equity besides continuing to be inefficient and wasteful in the use of resources. Our plea is for a major overhaul of the past policy in order to flexibly adjust to changing circumstances so as to better serve the long-standing and as yet unattained objective of developing a vibrant and self-reliant modern small scale industry.

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