EMERGING TRENDS OF SMALL SCALE INDUSTRIES – PROBLEMS & PROSPECTS

*** Dr.E.Manohar**

Small-Scale Industries play a key role in the industrialisation of developing country. This is because they provide immediate large-scale employment and have a comparatively higher layout capital ratio; they need a shortest gestation period and relatively smaller markets to be economic; they need lower investments, offer a method of ensuring a more equitable distribution of national income and facilitate an effective mobilisation of resources of capital and skill which might otherwise remain unutilised; and they stimulate the growth of industrial entrepreneurship and promote a more diffused pattern of ownership and location. This paper focuses on the role that small firms would play in the Indian economy as it transforms itself. The current policy constraints are reviewed, and the areas that need action are highlighted. It is argued that a better understanding of the process of evolution of the modern small scale sector in the late industrialising economies can help India make appropriate policy choices in the age of liberalisation and globalization.

Introduction

Small-Scale and Cottage Industries have an important role in India's industrial development. It has been estimated that they contribute about fifty percent of gross value of output of the organised manufacturing centres. These industries were established, with an objective to create immediate and permanent employment on a large scale at a relatively low costs; to meet a substantial simple producers goods; to facilitate the mobilisation of resources of capital and skill which might otherwise inadequately utilised; to ensure equitable distribution of the national income; to effect decentralisation of the industries by creating industrial estates; and to raise the standard of living of the people.

* Faculty Member, Dept.of Commerce & Business Management, Savatahana University, Karimnagar – 505001

Small-Scale industries contribute significantly to social and economic development objectives such as labour absorption, income distribution, rural development, poverty eradication, regional balance and promotion of entrepreneurship. In fact they play a vital role in the process of a country's industrial development.

Growth and Transformation of Small Firms in the Context of Late Industrialisation

Small firms in India have a crucial and seminal role to play which arises out of both the late industrialisation context and the particular historical experience of industrialisation thus far that has contributed to the evolution of the industrial structure. Analysing the Indian reality in the context of the experiences of Japan and East Asia and it is argued that macro economic, trade and exchange rate policies do not favour the rapid growth and transformation of small firms, even as they do not favour manufacturing in India, in a situation where Indian manufacturing has to compete with many countries but most notably the dynamic East Asian.

Some General Policy Trends and Issues

A variety of policy issues have been cited for the inadequate performance of the small scale sector in India. Some of these are general, while others relate to fairly specific issues.

The 'Protection' Syndrome

The un-stated but most evident assumption in the policy has been that 'small firms need essentially to be protected". This is a continuing un-examined vestige of the past (perhaps functional then) approach which sought to develop small firms as an integral part of the Mahalanobis strategy. Then it was believed (quite wrongly as the subsequent developments and the historical experience of Japan and elsewhere

in the late industrialisation context would reveal) that the traditional typically handicraft based industries producing a wide variety of consumer products could gradually and through continuous investments and up gradation of technology make the transition to modern medium and small firms. This assumption could at best be right for a minuscule part of the then existing small firms which were largely household. Protection from large was integral to this strategy and this was sought to be built inter alia by the ban on capacity addition in industries like textiles in the mill sector a policy which remained in place until 1984, to the great detriment of the Indian economy. This measure and the overvaluation of the currency that resulted from the pursuit of vanilla import substitution negated the potential that the industry had to ride the post war penetration of manufactured goods markets of the advanced capitalist countries (Morris, 2001).

Losing the Manufactured Export Boom

India among all developing countries had the best endowments and initial conditions to take advantage of falling tariffs over the various GATT rounds not only in textiles, but in a whole host of light engineering, electrical, ceramic and other manufacturing industries that existed in the medium and large industries. With the massive biases against exports (given the strategy and the macro economic policies that compounded the distortions) the only option for manufacturing industries was to get into import substitution. And while the large sector was expected to focus on high tech and long gestation capital and basic material industries, the manufacturing and light industries were to be very much in the small. While the curbs on the Large sector were most effective, the expected flowering of the small firms to produce cheaply the consumer goods did not materialise. During this period up to about the mid-seventies the economy was

woefully short of wage goods not just because of inadequate agricultural surpluses but because the expected larger rise in the consumer goods of the right quality and types from the household industries could not materialise.

Orthogonal Policy

Essentially the policy was orthogonal to the direction of evolution of industrial structure. It is only since the mid-sixties that the modern small firm sector could emerge due to the expansion of the economy (slow up to 1969), and due to the de-facto fragmentation of large firms (given the capacity curbs and the deepening schism in the labour market). Since the plan developments (1956-65) could not ensure the absorption of labour, and neither could agriculture given the slow growth there, small firms could potentially play a more functional role despite the many distortions that continued. In the eighties the modern small scale industries came into their own including through subcontracting and vendor relations (Nagaraj, 1986), and through the exploitation of the schism in the labour market. But the policy continues to assume that small firms need protection. In the process, the major distortions against the small firm sector continued and had deepened. Even the nineties have only led to a partial correction of some of these distortions while others have increased in their intensity.

Political and Social Agenda in Small Industry Policy

In the period of redistribution (1965 to 1980) and continuing until well into eighties, small and medium firms began to be promoted for another additional reason viz. to "diversify the social basis of capitalism." While the positive impact was that many technology based small firms came about, and import substitution was taken deeper, the negative aspect was that small firm policy continued to be focused on the entrepreneur and the surpluses he could make rather than economic benefits to the country. Thus, many sectors where the small firms did hot have any

particular advantage were promoted, reservation was deepened and an inefficient production system put in place. Examples would be chemicals, many textile items, biscuits and confectionery, stationary items etc. Besides reservation government purchase, credit and equity support, and increasing differentials in the taxes paid by small firms vis-à-vis the large were important measures (Desai and Taneja, 1993; Morris, 2001).

The Regional Development Agenda

Regional development ever since the Mahanlaobis Plan was seen as integral to the development of small firms. Small firms were seen as locatable practically anywhere –as long as the basic physical infrastructure could be provided –water electricity roads etc. Thus, simplistic statements such as steel plus electricity, with a policy of regional dispersal equals regional development were articulated. The resulting actions were quite disastrous. Most of the industrial estates that did not have access to reasonably sized central places were failures, others that survived imposed large hardships on the firms, since they had to bear the high cost of inappropriate locations and the denial of the natural agglomeration economies that small firms necessarily demand. Still other like chemicals in being spread out in the name of regional development and backward areas development ended up maximising the externalities of pollution, and making control over pollution virtually beyond the capacity of small firms. States in order to attract industries began to declare areas as backward; some did this more wisely than others by declaring a taluka adjoining a large city as backward, even if the spirit or the purpose of backward area development was vitiated.

Tariff Inversion

Tariffs are not entirely free from inversion that is higher rates on inputs like steel, plastics, energy, and metals semi manufacturer than on finished products. This

inversion which since the reform was at its peak in the late nineties has declined but many still remain, and particularly hurt small firms since they have a comparative advantage in manufacturing in the original sense of the term. Additionally, the very high uncompensated costs of energy especially electricity and petroleum based energy which are not *vatted* even for export industries impose large costs on location of manufacturing in India (Morris, 2001).

Conservative Monetary Policies

Monetary policies have been unduly conservative and amount to targeting money supply. As a result any substantial growth impetus in the second half of the nineties that may have come, have tended to be arrested by this monetary conservatism, since the monetary targets are being adhered to rather rigidly. Once the danger of inflation was over (since 1996 the inflation is almost entirely on the supply-side and caused by rising agricultural and fuel prices) the policy should have shifted to interest rate targeting and supporting fiscal expenditures especially when the fiscal expansion has been on account of (efficiently directed) infrastructural spending. In unnecessarily curtailing demand, therefore, the manufacturing sector has realised poor growth relative to its potential and this hurts the small firm sector

Exchange Rates Not Aggressive Enough

We have already argued earlier that small firms' comparative advantage lies in exports and tradable goods production more generally. Exchange rate policies have been particularly hurtful of small firms especially in areas like textiles which are dominated by small and medium firms. The real effective exchange rate of the rupee has been higher than the value that prevailed at the end of the stabilisation period. If it can move back to those values the small firms' export can rise as can also manufactured goods production that is based in India. It is worth

remembering that the export led growth economies greatly undervalued their currencies (subject them to a structural undervaluation) for long periods to get the export engine running before it could take off on its own steam based on virtuous productivity spiral to become less dependent upon exchange rates. Figure 1 brings out the relative undervaluation of the currency (from its 'purchasing power values') that is policy induced –i.e. when the structural and other determinants of exchange rates have been duly allowed for. It shows that China has since 1979 followed the East Asian economies into export led growth with strategic undervaluation of the currency while India may be said to have made the beginnings of the correction to a more 'equilibrium' value of the currency (Morris, 1999).

"Tight' Credit Situation

The large capital flows both on account of portfolio flows and direct investment have the undesirable effect of imposing tight credit conditions on domestic firms when these capital inflows are sough to be sterilised, to hold on to monetary targets. Such tightening of credit conditions operate asymmetrically as between firms that have access to foreign capital inflows and foreign direct investments firms on the one hand and domestic firms that do not have such access. It is particularly adverse for small firms since these more than other firms are dependent upon intermediated banks for sources of finance. While some part of this effect is inevitable in a situation of bunched capital inflows that is over responsive to Indian growth prospects, a larger part of the same is induced by the inappropriate macro policy of monetary targeting. Additionally, the interest rate being higher than necessary the risks in foreign capital inflows are small leading to excessive flows. Indeed the tendency of the RBI to use (higher) interest rates to stem possible balance of payments (BoP) problems and generally to keep these higher than what is warranted by the closure of the Fischer-open condition is at the

root of the problem. Similarly, the share of financial savings taking the banking route has been steadily declining. The allowed high spread to banks, and the control over deposit rates as also the numerous incentives for so called "small savings", tax deductions allowed on other bonds and funds (infrastructure funds, UTIs schemes, etc) reduce greatly the incentive to save in the form of fixed bank deposits, making for lesser intermediation than what would have been possible otherwise. Since small and medium firms have a comparative advantage to access bank funds (while large firms could go on to markets) there is an implicit discrimination in these distortionary policies. The distortions have not reduced with "reform" of the financial sector, nor have the banks 'need' for large spreads come down.

Conclusion:

Though globalization has opened the doors for small and large scale industries to enter into foreign countries but still the small and medium enterprises have been in the path of struggling constantly. In the light of global recession, if this sector is neglected it would still contribute to the downfall of Indian economy. The appropriate measures are to be taken to strengthen the small scale industries which causes the development of Indian economy. The appropriate choice of technology is to be forced in the small scale units, the environmental forces which are locking the products are to be identified and such pressures are to be removed, the government purchases policies related to small units are to be encouraging, the freedom of innovation and creativity is to be continued with R&D and involvement of Government in marketing of small scale products need to be ensured. The small units are not able to get credit as large firms are getting. In this context some policy measures are to be introduced so that the entrepreneurs are encouraged to establish small units which will be a sign for the development of Indian economy.

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