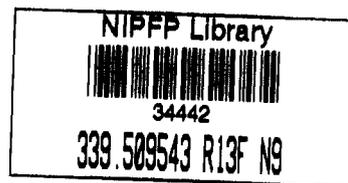# Fiscal Industrial Incentives of the Government of Madhya Pradesh: Costs and Benefits

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PREFACE

The Public Resource Management Programme implemented by the Government of Madhya Pradesh with the assistance of the Asian Development Bank required a review of the industrial incentive schemes of the state government. In particular, the fiscal impact of these schemes, the contribution of the schemes in encouraging investment decisions for setting up industries in the state, the impact in the context of similar schemes operating in neighbouring states, were to be studied. There are two alternative views on industrial incentive schemes of state governments in general and Madhya Pradesh in particular. First, the schemes are wasteful tax expenditure which do not add much to industrial development but only complicate tax administration and breed corruption. Second, these schemes are useful for promoting industrial development and may actually strengthen the revenues of the government by indirect means such as a higher growth of the state economy. Both the Asian Development Bank and the Government of Madhya Pradesh wanted an independent institute of repute to review the industrial incentive schemes of the state government. The study necessarily had to be done in the context of similar schemes operating in neighbouring states.

The findings of the study appear to corroborate the view that tax concessions as industrial incentive schemes in the Indian states did not help industrial development of the states. Without such concessions, the revenues lost in the process could have been gainfully utilised by the states to improve infrastructure. Madhya Pradesh has already announced its plans to implement VAT from 1 April 2001, which will require withdrawal of tax concessions. What is significant is that, following a meeting of the Chief Ministers on 16 November 1999, there has been an announcement that all states will end the scheme of tax concessions from 1 January 2000.

I am happy to forward the study conducted by NIPFP. The study team consists of Indira Rajaraman, Hiranya Mukhopadhya and Namita Bhatia. The Members of the Government Body of the National Institute of Public Finance and Policy are in no way responsible for opinions expressed here by the authors.

New Delhi
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Director

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Madhya Pradesh : Socio-Economic Profile

1.	Date of formation of M.P	November 1, 1956
2.	Location	Central India, bordered by Maharashtra, Gujarat, Rajasthan, U.P, Bihar, Orissa and A.P.
3.	Districts	45
4.	Area	443446 sq.kms (13.5% of India; largest state)
5.	Forested area	155414 sq.kms (20.2% of India)
6.	Population: 1991 census	Total: 66.2 million (India: 846.32 million) Urban : 23.2% (India: 25.7%)
7.	Per capita gross state domestic product (factor cost) at current prices for the year 1996-97	Rs.10783 (India: Rs. 12876)
8.	Sectoral composition of net state domestic product at current prices for the year 1996-97	Primary : 44.9% (India: 27.6%) Secondary : 23.0% (India: 28.8%) Tertiary : 32.1% (India: 43.6%)
9.	No. of telephones per 1000 persons	35 (India: 40)
10.	Road length per 100 sq.km area	48 kms (India: 67 kms)
11.	Electricity (1996-97) % used for industrial consumption (1996-97) consumption per person (1996-97)electrified villages as a % of total villages	 35.7% (India: 35.5%) 313 kwh (India: 247 kwh) 94.2% (India: 85.9%) (as per the 1981 census)
12.	Production of Minerals : 1996-97	(in '000 tons) (%India) Coal : 83283 (28.82) Limestone : 26552 (26.31) Iron ore : 16808 (25.21) Bauxite : 612 (10.32)

Source: Economic Survey of Madhya Pradesh,1997-98; Economic Survey, 1997-98, Government of India; Statistical Abstract of India 1997; Important Statistics for Madhya Pradesh, 1998.

Executive Summary

Madhya Pradesh is well endowed for an industrial future, with rich forest resources and mineral deposits of coal, iron ore, limestone and bauxite, but the sectoral composition of state domestic product shows a secondary sector share in SDP of 23 per cent, below the all-India average of 28.8 per cent.

Madhya Pradesh, like other states, has sought to promote industrial development by offering three types of fiscal incentives: capital investment subsidies; interest subsidies; and exemption/deferment from sales tax. Of these, the last has been slated for removal in a landmark agreement reached between Chief Ministers of states on 16 November 1999. This is a commendable policy agreement, since the econometric exercises performed in this study show that tax concessions have had a statistically insignificant impact on large and medium investment in the state. The econometric results for the capital subsidy are more ambiguous. The slowing of the growth rate of real investment after 1988 cannot be ascribed solely to withdrawal that year of the central subsidy, which was available to large and medium industrial units, and replaced by the state subsidy scheme which (with some minor exceptions) was confined to small-scale units; there was also a sharp concurrent decline in power availability.

Infrastructure indicators point to a general infrastructure deficiency in the state relative to the country average, with the notable exception of electricity availability, which continues to be better than the country average, despite the sharp decline from the power abundant scenario of the eighties. Field interviews with industrialists and industry associations reveal that abundant power in Madhya Pradesh was an important factor attracting investment into the state in the eighties. If power supply is augmented in the short run through better maintenance, and in the long run through expansion of capacity, the advantage the state once enjoyed will be restored, and that alone will attract industrial investment back into the state. Private investment in power generation and transmission will enter, if the prices are right. This in turn calls for examination of the tariff structure for power in the state. Fiscal incentives can at best complement infrastructure availability, but cannot supplant it.

It is important to emphasise that the land-locked situation of Madhya Pradesh does not in and of itself call for an edge in terms of fiscal incentives over other states that are not land-locked. There are examples of land-locked states like Punjab with a better growth record than that of coastal states like Orissa. The confinements of international borders do not apply in the case of land-locked sub-national units within a larger federation.

Total revenue lost from tax exemptions alone (not including deferments) is estimated in this study at approximately Rs 440 crore. No official data are available on expenditure on capital and interest subsidies. The assumption underlying this exercise, that the investments in question would have occurred even without the tax exemption, is justified by the econometric results and field evidence on the insignificant investment-promoting impact of tax concessions. The annual revenue gain from withdrawing tax exemptions alone would fund a minimum of a dozen new growth centres every year at Rs 35 crore per centre. Alternatively, the revenue gained could be used to strengthen growth centres already in existence, which are presently suffering from inadequate funding. Average expenditure per growth centre has been roughly half of that targeted. Industrial policy coherence can be improved by sacrificing tax exemptions for fiscal strengthening of growth centres, in place of the present policy mix whereby subsidies and tax concessions are given as inducements for location at growth centres, which offer poor infrastructure as a consequence of inadequate funding.

The investment function estimated shows a statistically significant positive impact of industrial unrest in West Bengal on investment in Madhya Pradesh. This is an important finding. It confirms the importance of cross-state effects and underlies the importance we give to a common cross-state initiative. It also shows the importance of factors other than fiscal incentives in the competition between states for industrial investment.

The November agreement between states does not include capital subsidies in its ambit. Given the overwhelming importance of infrastructure in attracting industry into a state, the first-best option is surely the redirection of fiscal resources from capital subsidies towards infrastructure provision. It must immediately be added however that to the extent capital subsidies have carried a commitment to an explicit expenditure, there has been greater fiscal discipline observable, with less proliferation of special provisions and clauses as compared to tax concessions .

M.P. is the only state offering both a capital investment subsidy and an interest subsidy (for small-scale units). Even after factoring this in, the present pattern of subsidies within and across states shows M.P. to be relatively disadvantaged vis-a-vis neighbouring states. It is clearly to the advantage of MP therefore to play a catalytic role in forming a cross-State common policy on subsidies. If the first-best alternative, total removal, is not acceptable, there should at the very least be a replacement of the present design of subsidies with a harmonised policy designed to achieve common aims, thus:

i. Redefine the base for determination of the subsidy to fixed investment in infrastructure alone. Such a redefinition carries theoretical justification since infrastructure investment yields externalities for which the private investor can rightfully be subsidised.

ii. Confine the capital subsidy to a set of labour-intensive thrust industries. There is already a thrust sector in every state except Maharashtra, with common labour-intensive constituents.

iii. Combine the above options to define a new investment subsidy confined to a set of labour-intensive thrust industries, where the base for determination of the capital subsidy is confined to investment in infrastructure.

Pending a concerted approach by all states towards a common policy platform, there is considerable scope for unilateral rationalisation without reference to neighbouring states.

i. Limit all schemes to a one-time entitlement at start-up, which is a well-defined and observable event. Extension to subsequent expansion and diversification opens up avenues for misuse.

ii. Eliminate enhanced concessions for special category entrepreneurs (Madhya Pradesh has different sets for each type of concession), which increase the costs of administering any scheme, and constitute a breeding ground for corruption.

iii. The constituents of the thrust sector in M.P. include, in addition to the common core, industries like white goods and petrochemicals, which diffuse the labour-intensive and resource-based character of the grouping. These need to be removed so that the thrust sector becomes more internally coherent.

FISCAL INDUSTRIAL INCENTIVES OF THE GOVERNMENT OF MADHYA PRADESH: COSTS AND BENEFITS

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CHAPTER 1

INTRODUCTION

INDUSTRIAL INCENTIVES

1.1   _Types of fiscal industrial incentives:_ Madhya Pradesh, like other states, has sought to promote industrial development by offering fiscal incentives. There are three types of fiscal industrial incentives offered by state governments to attract industrial investment. These are:

A.   Capital Investment Subsidies

B.   Interest Subsidies

C.   Exemption/Deferment from Sales Tax

Of these, the last has been slated for removal in a remarkable agreement reached on 16 November 1999 between State Chief Ministers and Finance Ministers. In addition to the above, there is expenditure on Growth Centres, a Central Government Scheme, supplemented by State-sponsored Growth Centres. This report does not examine direct tax incentives offered by the Central government.

1.2   _Costs and benefits of industrial incentives:_ Subsidies whether based on capital investment or interest subsidies cause a direct outflow from the exchequer. Tax concessions carry a cost in terms of revenue foregone. The ultimate objectives of attracting industrial investment into a state, which include among them the long term enhancement of the states' taxable capacity, are sought to be achieved by a short-run sacrifice of fiscal resources. This study examines whether fiscal incentives carry benefits commensurate with costs to the state exchequer. While the

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methodology used here for assessing the benefits conferred by incentives is applicable in other states, the findings are specific to the data for Madhya Pradesh and may or may not apply in other states.

1.3   The study comprises four avenues of investigation:

Cross-State Comparisons	(Chapter 2)
Econometric Evidence on Benefits from Industrial Incentives	(Chapter 3)
Costs of Industrial Incentives	(Chapter 4)
Field Interviews	(Chapter 5)

Final recommendations are presented in chapter 6.

MADHYA PRADESH

1.4   *Size*: In terms of area, Madhya Pradesh is the largest state in India (see box on socio-economic profile), subdivided into 45 districts. With 73.8 million people today, it has a population exceeding that of all but twelve nation states.

1.5   *Location*: The location of the state in the centre of the country without access to the coastline may have been somewhat of an obstacle in the development of industrial activity for export. What is important to emphasise, however, is that the land-locked situation of Madhya Pradesh does not in and of itself call for an edge in terms of fiscal incentives over other states that are not land-locked. There are examples of land-locked states like Punjab with a better industrial growth record than that of coastal states like Orissa. The confinements of international borders do not apply in the case of land-locked sub-national units within a larger federation.

1.6   *Mineral endowments*: The rich deposits of coal, iron ore and limestone (a quarter or more of the country total) and bauxite (a tenth of the country total) mark the state as one with a prosperous industrial future. The state also has a rich endowment of forest resources. Thus, the present study on the costs and benefits of industrial incentives is particularly pertinent, since the state is well endowed for an

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industrial future.

1.7 *Per capita income*: Despite its rich forest and mineral endowments, M.P. is unfortunately not at present among the more prosperous or industrialised states in the country. Per capita gross state domestic product at factor cost in 1996-97 at current prices was Rs. 10783, below the country average of Rs. 12876. The sectoral composition shows a secondary sector share of 23 per cent, below the all-India average of 28.8 per cent.

1.8 *Infrastructure*: Infrastructure indicators point to a deficiency of telecommunication and transport infrastructure in the state, relative to the country average. On the other hand, the electricity availability indicators are better than the country average.

1.9 *Composite Infrastructure Index*:

Box 1.1 Relative Composite Infrastructure Index

All India=100

State	1985-86	1993-94
Madhya Pradesh	68.8	75.3
Neighbouring States		
Maharashtra	116.8	107.0
Gujarat	124.8	122.4
Rajasthan	77.4	83.0
Andhra Pradesh	100.4	96.1
Karnataka	97.5	96.9
Orissa	87.8	97.0

CMIE: Profiles of States, March 1997

The composite infrastructure index is lowest for M.P. as compared to neighbouring states. In fact, it is the lowest in the country. However, it has registered a small rise between 1985-86 and 1993-94 along with other infrastructure-poor states (Orissa and Rajasthan). This means there has been some reduction of infrastructure disparity across states, with well-endowed states like Maharashtra and Gujarat seeing a decline in their relative position.

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1.10 *Fiscal health of the state*:

**Box 1.2 Revenue Deficit (-)/surpius (+)
as a percentage of GSDP**

State	1996-97
Madhya Pradesh	-0.02
Neighbouring States	
Maharashtra	-0.01
Gujarat	-0.01
Rajasthan	-0.01
Andhra Pradesh	-0.03
Kamataka	-0.01
Orissa	-0.03

Sources: 1. R.B.I. Bulletin, February 1999.

The Gross Fiscal Deficit (GFD) is not a sufficient indicator of the fiscal position of a state because permissible net borrowing by a state government is subject to control by the Government of India. Therefore, the revenue deficit has been selected as the indicator appropriate for a sub-national unit subject to federal fiscal control. Box 1.2 shows that the revenue deficit in Madhya Pradesh as a percentage of gross state domestic product in 1996-97 was around the same level as in neighbouring states. However, the situation at the time of writing (1999) is far worse. The enhanced salaries after implementation of the Fifth Pay Commission awards have severely inflated the wage/salary bill and plunged the state into a fiscal crisis. Industrial incentives which carry a cost to the exchequer cannot be lightly given away.

CHAPTER 2

INTER-STATE COMPARISONS

INTRODUCTION

2.1 *Inter-state competition in fiscal incentives*: Fiscal incentives are seen as a way by which a short-run sacrifice of fiscal resources can lead to the long term enhancement of a state's taxable capacity by attracting industrial investment into the state. Industrial corridors form around access to raw materials and markets. Where industrial corridors straddle state boundaries, it is clear that between-state competition to attract industrial investment will reach beyond footloose industries into resource-tied industries, and could result in wide-spectrum mutually-beggaring fiscal incentives. In what follows, the fiscal incentives prevailing at the time of writing (1999) in Madhya Pradesh are compared to those offered in competing neighbouring states. The three types of fiscal incentives offered to attract investment at state-level are tabulated as follows:

A.   Capital Investment Subsidies (table 2.1)

B.   Interest Subsidies (table 2.1)

C.   Exemption/Deferment from Sales Tax (table 2.2).

2.2 *Recent Inter-state Multilateral agreement*: A recent Inter-state agreement on 16 November 1999 has slated sales tax incentives for withdrawal by 1 January 2000. A further date for introduction of a VAT has been set at 1 April 2001.

2.3 *Contiguous states*: The tables cover Madhya Pradesh and six of the principal competing states. Other incentives, such as subsidised power/other inputs, are not listed in the tables, but are examined in chapter 5. An industrial corridor on the west

of Madhya Pradesh runs along the border with Maharashtra, Gujarat and Rajasthan. There is an eastern corridor bordering on A.P. and Orissa. Karnataka has also been included in the set of reference states as one of the more industrially aggressive neighbours of M.P., even though it does not share a border with M.P. All comparative statements made are with respect to these seven states alone. Any reference to all states should be understood as referring to these seven states and not to all states of India.

2.4 *Leaders and followers*: In an interesting (and perhaps only) study of competition for international investible resources between nation states, Chia and Whalley, 1992, look at the timing of introduction of incentives to identify leaders and followers. One approach to an across-state effort to co-ordinate such policies and possibly reverse them in case they are found to be unfruitful, could be to place the leadership of such an effort in the hands of the state that led their introduction. In India, however, it was the central government that introduced capital subsidies; indeed, it was to replace the central subsidy which was withdrawn in 1988 that state-level capital subsidies were introduced in the first place. Thus, leader-follower analysis has less political economy significance for subnational units of a federal entity than in a cross-nation context.

2.5 *Thrust sector*: All states, except Maharashtra define a thrust sector, which qualifies for additional incentives. The rationale behind the constitution of the thrust sector is not always explicitly stated, except in Gujarat, which defines the thrust sector by employment potential, and in Rajasthan, which defines the thrust sector on the basis of the state's inherent strengths, growth potential of various sectors and their long term sustainability. Looking at the sectoral constituents of the thrust sector, there is a common core across all states, comprising garments, food processing, agro-based products, leather products and electronics (with exceptions; appendix to table 2.1). EOU's are explicitly included in the thrust sector only in some states (Gujarat, Karnataka and Orissa), but may be given enhanced tax concessions even if not (M.P. and Rajasthan). There is also a long list of sectoral constituents specific to each state. Some of these, such as sericulture in Karnataka or fish canning in MP

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share the labour-intensity characteristic of the common core. Others such as telecommunications and automobiles (Rajasthan) or white goods (MP) clearly diffuse the focus of the thrust sector.

2.6 _The growth centre scheme_: Growth centres in backward areas are funded through a National scheme by GOI started in the nineties. Growth centres are endowed with the basic infrastructure facilities like power, telecommunications and water, as a nodal point for industrial location. The target funding for each growth centre is Rs. 10 crore from GOI and Rs. 5 crore from the relevant state government. Thus the scheme, even though centrally sponsored, carries fiscal implications for state governments. The total target funding for each growth centre under the national scheme is Rs 35 crore. In Madhya Pradesh there is also a state-sponsored scheme, for MPAKVN (Madhya Pradesh Audyogik Kendra Vikas Nigam) growth centres. Table 2.3 shows the status (as on 31 December 1998) of the twelve centrally-sponsored and ten state-sponsored growth centres in M.P. It is clear that the release of central funds for the centrally sponsored scheme has been widely uneven across growth centres, even within a state. The target funding from the central government for each growth centre of Rs 10 crore has been attained in only three centres: Ghirongi, Kheda and Siltara. The target state funding for each centrally-sponsored centre of Rs 5 crore has been exceeded in Ghirongi, Pithampur and Siltara, and not reached in the others. Aggregate state government expenditure amounts to Rs 54 crore across 22 growth centres (approximately Rs 2.5 crore per centre), as compared to the central investment of Rs 53 crore in the 12 centrally-sponsored centres (approximately Rs 4.5 crore per centre). Thus, average expenditure per growth centre has been roughly half of that targeted, in the case of both central and state funding.

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OUTRIGHT SUBSIDIES

A.   Capital Investment Subsidy (ref. table 2.1)

2.7   *The norm*: All the reference states offer capital investment subsidies, except Rajasthan where the capital investment subsidy scheme was replaced by an interest subsidy scheme.[1] Thus the practice of giving capital subsidies is the norm rather than the exception. The November agreement between states does not include capital subsidies in its ambit.

2.8   *Eligibility*: SSI (small-scale industries) are the subset typically eligible for subsidies in all states. Exceptions where subsidies are granted to all industries irrespective of their size are A.P. and Orissa.[2] Other states may carry exceptions at the margin, such as for example in M.P. where eligibility is extended to non-SSI co-operative units with investment exceeding Rs 1 crore located in backward areas, and to pioneer units in growth centres (first entrants with investment exceeding Rs 3 crore). Karnataka offers the only other such case where eligibility is extended to large EOUs (with investment exceeding Rs 75 lakh).

2.9   *Rates and caps*: Capital subsidies are calculated as a percentage of fixed capital investment of the industrial unit subject to absolute caps. In Karnataka, industrial estates in the private and co-operative sectors are given a capital subsidy at the rate of 20 per cent of investment in infrastructure.

2.10   *Rate/Cap pattern within states*: The rates and caps within any state may vary with:

i.   backwardness of location (directly);

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[1]   Hotels and heritage resorts can avail of the capital investment subsidy uptil 31 March 1999. There is also a capital investment subsidy scheme offered through the Rajasthan State Agriculture Marketing Board for agro-based units.

[2]   However, the Orissa eligibility limit of Rs. 5 crore (project cost) is not very much above the latest Rs. 3 crore limit for SSI (revised from 60 lakh in December 1997).

ii.   thrust sector (higher rates); and

iii.   special category entrepreneurs (SCE: higher rates).

These variations are tabulated in table 2.1. In M.P., SCE are defined as those belonging to scheduled castes and tribes and get an additional 10 per cent. Gujarat includes both scheduled castes and tribes and unemployed youth and gives them an additional 5 per cent. Karnataka and Orissa have a very large category of entrepreneurs qualifying as SCE (see table), who are offered an additional 5 per cent. A.P. offers an additional 25 per cent to entrepreneurs from SC/ST and other backward classes.

2.11   *Non-backward (advanced) location*: Rajasthan and A.P. do not discriminate locationally with respect to any kind of concession. In the other states which do, subsidies are denied in general for advanced area location. Orissa is an exception; all units eligible by size are included, even if located in advanced areas (zone C). Two states carry exceptions at the margin. In M.P., small-scale thrust industries in advanced areas are included. In Karnataka, non-polluting, high technology industries located in developed regions of the state are eligible.

2.12   *Rates/Caps across states*: Subsidy rates offered by M.P. are at face value lower than those of contiguous states. The maximum rate is 10 per cent subject to a cap of Rs. 10 lakh in M.P., whereas in all the states the minimum rate is over 15 per cent.[3] In Karnataka, the minimum rate is as high as 25 per cent. But the net disadvantage, is less than it appears because M.P., unlike other states, offers in addition a broad spectrum interest subsidy for all SSI at 2 per cent, with an annual cap of Rs. 25,000,[4] for three years (para 2.25). Even with this, however, M.P. terms are clearly less generous than those of neighbouring states. M.P. therefore stands to gain from a multilateral common platform across states that contains inter-state competition in subsidies.

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[3]   Except for advanced area location in Orissa.

[4]   For SCE, 6 per cent with no cap.

2.13 _Start-up/expansion:_ In M.P., Karnataka and Gujarat, in what appears to be a departure from standard practice, the capital investment subsidy is not confined to start-up but is given also for expansion and diversification provided the unit remains small.

Capital Investment Subsidy: Multilateral Action

2.14 _An Inter-State agreement on capital subsidies:_ Capital subsidies are the norm rather than the exception. There is also a clear common focus across states on SSI and backward location, in conformity with the national effort to encourage SSI and regional dispersal of industry. Thus, there is a sufficient measure of agreement across states on the basis of which to attempt a redefinition of capital subsidies multilaterally across a grouping of contiguous states, along the lines of the November 1999 agreement on tax incentives.

2.15 _A first-best agreement on capital subsidies:_ The econometric evidence on benefits of capital subsidies is somewhat more ambiguous than for tax concessions (chapter 3). However, given the field and other evidence (chapter 5) on the overwhelming importance of infrastructure in attracting industry into a state, the first-best option is surely the redirection of fiscal resources from capital subsidies towards infrastructure provision. It must immediately be added however that to the extent capital subsidies carry a commitment to an explicit expenditure, there is greater fiscal discipline and less proliferation of special provisions and clauses as compared to tax concessions (para 2.33).

2.16 _Defining the objectives of the subsidy:_ If the first-best option is not acceptable, an Inter-State Agreement has to be based on an examination of the objectives underlying capital subsidies to SSIs locating in backward districts. This will provide the underpinning for a possible reconfiguration of the scheme so as to achieve the objectives sought.

2.17 _Infrastructure development:_ If the objective is to compensate units locating in backward districts for infrastructure inadequacy, which is the only reasonable

inference from the rate structure by degree of backwardness, it might be possible to redefine the base for determination of the subsidy in terms of expenditure on fixed investment in infrastructure alone. Expansion of the base for the capital subsidy to include infrastructure increases the fiscal cost of the scheme, and would not be as focused as a subsidy scheme confined to fixed investment in infrastructure alone (as for example for industrial estates in Karnataka, which are offered subsidies at the rate of 20 per cent as a percentage of investment in infrastructure). There is a theoretical justification for this, since infrastructure investment yields externalities for which the private investor can rightfully be subsidised.

2.18 *Employment*: If the objective underlying promotion of SSIs is to promote employment, this is not achieved by a subsidy on fixed investment which, ceteris paribus, encourages capital intensive techniques of production. Two employment promoting alternatives suggest themselves:

i.   The subsidy could be based on labour hired rather than fixed investment. This however carries the difficulty of enforcement, particularly given the reluctance of units to sign on permanent employees (given existing labour laws), and could as a consequence be a breeding ground for corruption.

ii.   The other option is to confine a capital subsidy to a set of labour intensive thrust industries. The advantage of this option is that there is already a thrust sector in every state except Maharashtra, which gets enhanced concessions The thrust sector constituents vary across the states but there is a common core (para 2.5) consisting of labour intensive industries, which is an excellent point of departure for a revised scheme confined to the thrust sector, in place of (as at present) a broader-based scheme with enhancements for the thrust sector.

2.19 *Twin focus on infrastructure and employment:* The suggestions in paras 2.17 and 2.18 are not mutually exclusive. Thus, it is possible to define a new capital subsidy confined to a set of labour-intensive thrust industries, where the base for determination of the capital subsidy is confined to investment in infrastructure.

Capital Investment Subsidy: Unilateral Action

2.20 _Backward area focus_: M.P. and Karnataka are outliers among states which practice locational discrimination in permitting exceptions at the margin for units located in advanced districts, in M.P. for thrust sector SSIs (para 2.11). If the objective of the capital subsidy is compensation for inadequate infrastructure, M.P. can unilaterally rationalise its scheme to exclude advanced districts, which by definition are better provided for in terms of infrastructure. Most of all, exceptions of any kind increase the complexity of administering such schemes.

2.21 _Small-scale focus_: There is an internal inconsistency again between the overall focus on SSI and the subsidy given to cooperative-sector LMI units with more than Rs. 1 crore of investment in a backward location, and to pioneer units in growth centres (first entrants with investment exceeding Rs 3 crore). Karnataka offers the only other such case where eligibility is extended to large EOUs (with investment exceeding Rs 75 lakh). Here again there are gains to disallowing exceptions at the margin.

2.22 _Thrust sector:_ The constituents of the thrust sector in M.P. include, in addition to the common core (para 2.5) industries like white goods and petrochemicals, which diffuse the labour-intensive and resource-based character of the grouping. These need to be removed so that the thrust sector becomes more coherent.

2.23 _Limiting the subsidy to start-up costs_: There are administrative advantages to locating the subsidy to a one-time entitlement at start-up, which is a well-defined and observable event. In M.P., Gujarat and Karnataka, in what appears to be a departure from standard practice, the capital investment subsidy is also given for expansion and diversification provided the unit remains small. Extension to subsequent expansion and diversification opens up avenues for misuse, and adds to the cost of administering the scheme.

2.24 _Growth centres_: Overlaid on the system of state-level subsidies and tax concessions is the growth centre approach. This is clearly an alternative conception

of the manner in which to address infrastructure inadequacy in backward districts. If subsidies serve the purpose of compensating for infrastructure inadequacy at the point of location chosen by the investor (para 2.17), then clearly location at the growth centre, which is a nodal point where infrastructure is publicly provided, should go with a cancellation of the subsidy entitlement. In practice, however, if infrastructure at growth centres is not necessarily better than at other locations, it may not be possible to treat industrial units located at growth centres differently from other locations. M.P. at present offers subsidies to pioneer units in growth centres. Fiscal fortification of the growth centre scheme will be possible with resources gained from scaling back of fiscal incentives.

B. Interest Subsidy (ref: table 2.1)

2.25 The interest subsidy is not a common feature of the concessions landscape. Three of the seven states do not offer an interest subsidy. M.P. alone offers in addition to the capital subsidy a 2 per cent interest subsidy scheme for all SSI[5] subject to an annual cap of Rs.25000, with enhancements for SCE (4 per cent prior to 1994, 6 per cent today). Other states either restrict their offer to Special Category Entrepreneurs (A.P. and Orissa),[6] or have it in place of the capital investment subsidy (as in Rajasthan,[7] where the investment subsidy is now restricted to agro-based units). Only M.P. offers **both** a capital investment subsidy and an interest subsidy for small-scale units. A unilateral phase-out of the interest subsidy should therefore be possible for M.P.

C. Sales Tax Concessions (ref: table 2.2)

2.26 *The norms:* Once again, as in the case of capital subsidies, tax concessions were the norm at the time of the Inter-state Agreement of November 1999. Every state in the reference group granted tax concessions within defined eligibility

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[5]   Not confined to new units; see Motlani and Mahajan, 1998; 15 and 664.
[6]   6 per cent and 2 per cent respectively.
[7]   At the rate of 2 per cent subject to a overall cap of Rs. 1.5 lakh.

parameters. In what follows, the concession schemes in force in 1999 are outlined, although this documentation may be of only historical relevance once the Inter-state Agreement is implemented.

2.27 _Exemption_: A sales tax exemption offers 100 per cent relief from tax liability, usually subject to a cap, on the output of the industrial unit.

2.28 _Deferment_: A deferment defers actual payment until after the holiday period, and is in effect an interest-free loan of an amount equal to the tax liability. It carries an additional advantage that the sales tax is deemed to have been paid and is thus deductible for purposes of assessing corporate tax liability to GOI. All states offer a deferment option for (sold) finished products and the by-products or waste products that might be produced in the course of production of finished goods.

2.29 _Eligibility_:

i. Sectoral - All states except Maharashtra have a list of ineligible or banned industries. The ineligible set consists in general of low-technology agro-based and resource-based industries, but includes others such as iron and steel in A.P. and M.P. for example. Maharashtra has no sectoral exclusions; all units are eligible on first entry into any taluk, with eligibility apparently denied only for subsequent units in the same taluk.

ii. Start-up/other - In addition to new eligible units, existing (eligible) units may also avail of exemption for expansion, diversification and modernisation in M.P. and Orissa; other states are less generous and permit expansion only once (Gujarat); none for modernisation (Rajasthan, A.P. and Karnataka); or none of any kind (Maharashtra).

iii. Inputs/outputs: Exemption extends also to taxes on purchased inputs like raw materials, incidental goods and packing materials (A.P. is an exception). The deferment option is sometimes not extended to inputs (Gujarat), or limited to some inputs or to LMI (Rajasthan, Orissa).

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2.30 *Rates and caps*: In a reversal of the investment subsidy system, which is specified at a fixed rate of investment subject to an absolute cap, tax concessions carry an absolute concession in terms of tax not payable subject to a cap specified at a rate of fixed investment. Thus aside from eligibility, the parameters along which restrictivity or otherwise of concessions can be assessed are as follows:

i.   Cap: Usually specified as a per cent rate of fixed capital investment (para 2.31). The cap is cumulative over the holiday period

ii.   Duration of holiday: In years

The effective concession in terms of quantum, or competitive edge over older units, would be a function of the underlying rate for the product and inputs and cannot be compared across states for within-state sales (for sales outside the state, the CST rate is uniform across states). The cap rate and the duration of the holiday can, however, be readily compared across states, regardless of where the product is sold (within-state or outside). Because the cap is cumulative, the cap rate and holiday duration jointly determine the extent of the concession.

2.31 *Definitions of the fixed capital base:* There is no definitional uniformity across states in respect of which investments qualify for determination of the cap on tax concessions.[8] This flexibility in definition may aid in enhancing the generosity of incentives, and makes cross-state comparisons on the basis of caps and holidays potentially incomplete. There can be definitional flexibility within a state over time and even at a time across units. In M.P, the 1994 scheme defines fixed assets to include, in addition to land, buildings, plant and machinery, electric installations and pollution control equipment, investment on research facilities, railway sidings, godowns and storage tanks.[9] Earlier definitions of the base include just land, buildings, plant and machinery. The base may not even be definitionally uniform within a state, as for example in Gujarat, where project related infrastructure is included in fixed investment for all units, but is enhanced to include public purpose

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8   These are not in general explicitly stated in policy documents.
9   Motlani and Mahajan, 1998; 48-49.

infrastructure also for premier/prestigious units. Premier/prestigious units in Gujarat are very large projects with investment in excess of 100 crores.

2.32 *Concession patterns within states*: All states have a range of rates rather than a single rate. The dimensions along which rates vary are as follows:

i.   Location: All states except Rajasthan and A.P. discriminate on the basis of location with respect to both cap rates and duration of holiday period, with both varying directly with backwardness of location. There is nevertheless extension of the scheme to advanced areas either unconditionally, as in M.P. and Orissa, or conditionally as in Karnataka (specific industries) and Gujarat (thrust sector). Only Maharashtra confines the scheme to backward areas altogether.

ii.   Scale of operations: The base concessions in all states except for Gujarat discriminate on the basis of scale of operations as well, where the scale thresholds are either specified in absolute terms (M.P., Rajasthan) or in terms of the more standard tiny/SSI/LMI categories. The rates in general vary inversely by scale, with the exception of A.P. and M.P. (the scale threshold in M.P. is 10 lakhs, so that there is in effect rate uniformity among units that are not tiny). But there are also rewards for large scale (premier/pioneer/ prestigious units) that run directly counter to the inverse cap rate structure by scale (para 2.33).

iii.   New/expansion: Karnataka and Gujarat also discriminate between new units and (existing) units undertaking expansion and diversification. Gujarat gives an additional 10 per cent to the latter while Karnataka offers them lower rates.

iv.   Other: Rates can also vary between exemption and deferment (a special case: only in M.P.).

v.   Enhancements: The cap rate and/or period of exemption are also enhanced for

      1.   thrust sector;

      2.   special category entrepreneurs (SCE);

      3.   units located in growth centres;

      4.   labour intensive units (a special case: only in Orissa).

2.33 *Subversions of inverse cap rate structure by scale* : Although tax concessions are not in general targeted at small-scale industry, unlike capital subsidies which are in general explicitly so targeted, the special enhancements for large units (variously designated as premier/pioneer/prestigious units across states) show clearly that there has been subversion at the margin by large units able to negotiate special deals for themselves, and are at odds with the inverse rate structure by scale. Perhaps the clearest example of this is the enhanced concession (30 per cent: 20 years) given in Maharashtra to the class of prestigious units, which are defined for a floor investment of Rs. 100 crore for location in a particular district (Gadchiroli). Maharashtra also rewards large size in other categorisations (pioneer; mega). In Gujarat, graded enhancements of holiday durations are given for prestigious units (above 100 crores) and premier units (500 crores and above) even in areas that are not backward (Category III). Rajasthan and Gujarat include an employment requirement for classification as a prestigious units, but these are in general very low. Orissa also rewards size above 100 crores with holidays of increasing duration with size of investment.[10] Thus, reward for large-scale is clearly evident in the pattern of tax concessions in most states where it was not in the case of capital subsidies. The reason is self-evident. Tax concessions carry a cost to the exchequer that is hidden (revenues foregone) in contrast to capital subsidies, which carry a commitment to an explicit expenditure. In MP there are no additional concessions for units at the very large end of the spectrum, but for thrust sector units with investment larger than Rs. 1 crore the cap is lifted altogether.

2.34 *Caps across states*: Since each state has a range of rates rather than a single rate, and since an average cannot easily be extracted from the range, a cross-state comparison is possible only in terms of the range each offers. M.P offers the most generous caps for exemption and deferment in comparison to other states. The minimum cap rate in M.P is 125 per cent for industries located in advanced areas. In the other states, this is the maximum rate applicable to medium and large scale industries located in the most backward of regions. The maximum rate of exemption

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[10] Confined to the thrust sector.

in M.P is as high as 250 per cent, and for the thrust sector there is no cap at all (provided investment in plant and machinery exceeds Rs. 1 crore).

2.35   _Tax holiday duration_: The period of exemption is more or less uniform across states falling within a range of 5-7 years for exemption, and 7-14 years for deferment. Maharashtra and Rajasthan offer relatively longer periods (going up to 20 years for prestigious units in Maharashtra).

Tax Concessions: Multilateral Action

2.36   _Need for multilateral action_: Since move to a VAT by 1 April 2001 is on the cards, and indeed with a partial VAT in Madhya Pradesh already on (para 2.38), the following paragraphs merely outline the nature and implications of a VAT.

2.37   _VAT compatibility_: A VAT implies the following:

i.   Input tax set-off: Under a full-fledged VAT, operated on the tax credit method, input taxes are routinely set off against taxes collected at the time of sale of output. Thus, the input tax exemption that is presently offered to eligible units will be available to all. Likewise, if the output of the unit is used as an input further downstream, the user will get a set-off on tax payable regardless of whether the input is produced by a unit eligible for concessions or not. Thus for producers of intermediate goods, the relative advantage offered by the tax holiday will disappear with the introduction of a VAT.

ii.   MP Sales Tax on within-state sale of final consumer goods: Final consumable goods are akin to intermediate goods in that the final retailer gets a set-off on sales tax paid, thus giving a concessional unit no differential advantage. This is under a VAT operated on the tax credit system. Under the VAT presently in operation in the state on the subtraction principle, it is still possible for the differential advantage conferred by the initial tax holiday to be maintained through subsequent stages of sale (para 2.38).

iii.   Central Sales Tax on out of state sale: A CST may possibly co-exist with a VAT for a period as an add-on. But it is clearly incompatible with a harmonised destination-based VAT. The eventual phase-out of CST will imply a phase-out

of exemption from payment of CST to the source state for eligible units. And in any case it is not legally permissible to grant a CST holiday for new units when a similar relative advantage is not possible for sale within the state.

iv.   MP Sales Tax on within-state sale of final producer goods: The only kind of final product on which concessions can coexist with a VAT operated on the tax credit principle is plant and machinery, and that too only if the type of VAT introduced does not permit offset of tax paid on capital goods.

Thus, it is clear that except for a small class of products, tax holidays are rendered redundant with a comprehensive VAT.

2.38 *VAT in Madhya Pradesh*: A limited Value Added Tax (VAT) was introduced in M.P. with effect from 1 May 1997. The VAT covers only **resellers** of final goods above a turnover threshold, initially specified at Rs 1 crore during the year 1996-97. As a result, out of a total of 1.7 lakh registered dealers, including those not previously liable for payment of sales tax under the First Point Sales Tax Regime in M.P., an additional 4000 dealers became liable, resulting in (additional) revenue during the year 1997-98 of about Rs 13.5 crore. The VAT payments on value addition (sale price minus purchase price inclusive of sales tax) are levied at one of six notified rate slabs (2,4,8,10,12 and 20). Thus, VAT in M.P. is based on the so called 'subtraction principle'. Petrol, diesel, kerosene and LPG are excluded from the VAT ambit. Since only resellers are covered, there is no VAT on first sale of imports and domestic manufactures in M.P. However, manufacturers are given a concessional rate of 4 per cent on inputs, and there is under consideration a further proposal to reduce it to 2 per cent. Goods manufactured by new units, are still permitted the facility of exemption, **but subsequent sales of such goods are subject to VAT**. Similarly, units opting for deferment are allowed to defer the amount of commercial tax as per the old norms but subsequent sales are brought under VAT. Since the VAT operates on the subtraction principle, on value addition in excess of the purchase price inclusive of tax paid, a reseller will clearly prefer goods from concessional units exempt from sales tax. Thus, the concessional advantage offered by exemption is preserved, whether or not differential pricing is preserved down the line at subsequent

resale. Two important changes were introduced in the structure of VAT from 1 April 1999. The threshold limit of Rs 1 crore was reduced to Rs 50 lakh and a single rate of 8 per cent for all commodities liable to VAT was introduced.

2.39 *The Inter-state Agreement of November 1999*: The following decisions were taken in the meeting of the Chief Ministers and the Finance Ministers on domestic trade tax reforms on 16 November 1999:

1. *Implementation of uniform floor rates of sales tax by states and union territories*: It was decided that all the states and union territories will implement uniform floor rates as recommended by the Committee of State Finance Ministers' from 1 January 2000.

2. *Phasing out of sales-tax based incentive schemes including revised definition of backward areas eligible for this scheme*: It was unanimously resolved that the incentives offered for industries shall end on 1 January 2000.

3. *Finalisation of the modalities and time frame for introduction of VAT by state governments*: It was decided that VAT will be implemented by ail the states and union territories from 1 April 2001.

4. *Rationalisation of Central sales tax*: Since CST needs to be studied further linked as it is with broadening of tax base of states like service tax, consignment tax and declared goods, a further study will be done of these issues.

5. Another conference of Chief Ministers' will be called in the middle of January 2000 to review the implementation of these decisions.

6. A Standing Committee of State Finance Ministers' will be constituted to monitor these decisions with secretarial assistance.

2.40 *Immediate revenue implications:* Even if the Inter-state Agreement is implemented in accordance with the time-table, it will take some time for the positive revenue effects to be realised for Madhya Pradesh, since tax exemptions/deferments already granted cannot be withdrawn. The median holiday period for exemption is 6 years, and for deferment it is 10 years.

Outright Subsidies

Capital Investment Subsidies

	M.P. from 6 May 94	Maharashtra Oct.93-Oct.98[1]	Gujarat Aug. 95-Aug.2000	Rajasthan from 1 April 96
I. Eligibility A.	New SSI[2]	New SSI	New SSI	No capital subsidy; replaced by interest subsidy except (till 31/3/99) Hotels: 15% (Cap: 15) Heritage Resorts: 20% (Cap: 20)
B.	LMI cooperative units located in backward areas (FCI > Rs. 1 crore; members > 100)	-	-	
C.	Expansion, diversification & modernization	-	One expansion & all diversification provided unit remains small	
D. (Special eligibility)	Pioneer[3] units in growth centres[4]	-	-	Agri. marketing board scheme for agro-based units 5 lakhs ≤ FCI ≤ 3 crores 20% (Cap: 20)

II. Base Concessions	Areas	Rate[5] SSI	Cap[6] LMI	Areas	Rate[5]	Cap[6]	Areas		Rate[5]	Cap[6]	
	Advanced[2] Backward:	5%	1	-	A	-	-	Backward:				
	A	7.5%	1.5	5	B	15%	7	Category	II	15%	10	
	B	10%	2	7	C	20%	10					
	C	10%	2.5	10	D	25%	15	Category	I	20%	15	
					D+	30%	20					

SSI :   Small-scale Industry;   LMI: Large and medium industry;   FCI: Fixed capital investment.

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[1]   Extended till a new scheme is introduced.
[2]   In advanced areas only small-scale thrust industries eligible.
[3]   FCI > Rs 3 crores (first in growth centres)
[4]   Growth Centres: A national scheme (Government of India). See also footnote 1 in text.
[5]   As a % of fixed capital investment.
[6]   In Rupees lakh.

Capital Investment Subsidies

	M.P.	Maharashtra	Gujarat	Rajasthan
III. Additional Concessions				
1. Thrust industries	Cap[5]: + 0.5 (SSI) + 2 (for LMI; A&B) + 5 (for LMI; C)	-	Rate: + 5%	-
2. Special category entrepreneurs (SCE)	Rate: + 10%	-	Rate: + 5%[7]	-
Includes:	SC/ST's	-	SC/ST's & Backward Women Unemployed Youth	-
			-	
3. Other	Pioneer Cap: 30	-		-

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[7]   For most groups; some get less. Extra concession to tiny units set up by SCE (@ 40%; Rs. 2 Lakhs).

Capital Investment Subsidies

		A.P. current	Karnataka 1996-2001			Orissa from 1 April 96		
I. Eligibility	A.	All new[8]	New SSI			All new (project cost ≤ Rs. 5 crore)		
	B.	-	-			-		
	C.	-	Expansion & diversification			-		
	D. (Special eligibility)	Captive power plants, including cogeneration units	1. EOU's (FCI ≥ Rs. 75 lakh) 2. Industrial Estates in private/cooperative sector (project cost ≤ Rs. 5 crore): 20% of Infra. inv. (Cap: 20)			-		
II. Base Concessions		20% Cap[6]: 20	Areas	Rate[5]	Cap[6]	Areas	Rate[5]	Cap[6]
			Developed[9]	25%	25	Zone C	10	10
			Developing	25%	25	Zone B	15	15
			Growth Centres	30%	30	Zone A	20	20

8   Except for units in ineligible sectors or banned areas. Eligible units should go into commercial production on or after November 15, 1995.

9   Only non-polluting high technology industries eligible.

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	A.P. current	Karnataka	Orissa
III. Additional Concessions 1. Thrust industries		Rate : + 5% Cap[6] : + 5	
2. Special category entrepreneurs (SCE)	Rate: 25% Cap[6]: 50	Rate : + 5% Cap[6] : + 1	Rate: +5% Cap[n]: +5
Includes:	SC/ST's Other backward classes	SC/ST's Women Minority communities Physically handicapped Ex-servicemen Technocrat entrepreneurs	SC/ST's Woman technical entrepreneur Women's cooperative Artisan's cooperative Certified physically handicapped
3. Other		New/existing SSI/tiny units installing equipment for utilization of renewable sources of energy: Rate : + 10% Cap[6] : 5	

Interest Subsidies

	M.P.	Maharashtra	Gujarat	Rajasthan 1 April 98 - 31 March 03	A.P.	Karnataka	Orissa
I. Eligibility bn/	SSI	No int. subsidy	No int. subsidy	FCI ≤ Rs. 60 lakh	SCE	No int. subsidy	SCE with project cost ≤ Rs. 1 crore
Rate	2% (cap Rs. 25000/yr.) SCE: 6% (no cap)			2% (overall cap of Rs. 1.5 lakh)	6% (cap Rs. 5 lakh/yr)		2% (only on term loans)
Period	3 yrs.				5 yrs.		

Appendix to Table 2.1

Thrust Sector*

	M.P	**Gujarat**	**Rajasthan**
Common: Garments Food processing[10] Agro-based prod.[10] Leather prod[11]. Electronics[12] E.O.U's	Additional: Agricultural implements/inputs Mineral resource based Fish canning Automobile components White goods Petro-chemicals based Sport goods Excluded	Additional: Gems & jewellery Ancillary engineering Included	Additional: Knitwear Gems & Jewellery Textiles Telecommunications Information technology Automobiles & components Dimensional stones Cement Class & ceramics Excluded
	A.P.	**Karnataka**	**Orissa**
                      E.O.U's.	Additional: Mineral sector Drugs & chemicals Software & hardware Precision engineering Steel & metal based industries Sugar & allied industries Paper Cement Jewellery Excluded	Additional: Informatics [Software] Energy conservation equip. Pollution control & water recycling plants Sericulture based Textile processing Included	(Called Priority Indus.) Additional: Aluminium based Synthetic yam, spinning & weaving mills Gems & jewellery Precision engineering Automobile & automobile components Basic drugs & pharmaceuticals Petrochemicals Ship breaking Stainless steel & downstream inds. Flyash based inds. Products relating to generation and/or use of non-conventional energy & relating to pollution control Included

Maharashtra does not define a thrust sector.

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[10] Not classified as thrust in Rajasthan.

[11] Not common to A.P.

[12] Though not explicitly categorized as thrust in Gujarat, it gets the same additional concessions as thrust industries.

Table 2.2

Sales Tax Exemption/Deferment

	M.P. from 6 May 94	Maharashtra Oct.93-Oct.98	Gujarat Aug.95-Aug.2000	Rajasthan from1 April 98 - 31 March 03
I. Eligibility A.	All new except ineligible list	First entrant in any taluka[2]	All new except banned list	All new except ineligible list[4]
B.	Expansion,[1] diversification & modernization	-	Expansion only once All diversification[3]	Expansion, diversification[5] but not modernisation
C.	-	-	-	Sick industrial units
D.	-	-	Except banned areas	Except banned areas[6]
E.	-	-	-	-
II. In respect of: Inputs	Exempted/Deferred	Exempted[7]/Deferred	Exempted/Not deferred	Exempted[7]/Deferred[8]
Outputs	Exempted/Deferred	Exempted[7]/Deferred	Exempted/Deferred	Exempted[7]/Deferred

[1] Available only for production in excess of installed capacity, and for FCI ≥ Rs. 10 lakh. There are minimum qualifying floors, which vary by the initial size of the unit.

[2] Where there is no such existing unit, whether private/public/joint/cooperative sector.

[3] Rates different from those applying to new units.

[4] Only if employment is provided to bonafide residents of Rajasthan to the extent of at least 70% of work force, in a phased manner.

[5] Capacity utilization ≥ 80% of existing installed capacity.

[6] Eligible industries should not be located in banned areas. However, sick units may be located in banned areas.

[7] Switching over from exemption to deferment or vice-versa allowed once during the period of the scheme.

[8] Only packing materials.

Sales Tax Exemption/Deferment

III. Base Concessions

M.P.

Area	Exemption (Ex.) Cap[9]	Yrs	Deferment (Df.) Cap[9]	Yrs
FCI ≤ Rs. 10 lakh	100%	-[11]	150%	-[11]
FCI > Rs. 10 lakh				
Adv.	125%	3	175%	4
Bwrd				
A	150%	5	200%	7
B	200%	6	250%	8
C[10]	250%	7	300%	9

New units in Adarsh Audyogik Nagar & Laghu Vikas Kendra & diamond cutting & polishing units:
FCI ≤ Rs. 10 lakh: 100% - 9 yrs.
FCI > Rs. 10 lakh: 250% - 9 yrs.

Maharashtra

Area	Cap[9]	Yrs.
SSI		
A	-	-
B[12]	100%	6
C	110%	8
D	120%	10
D+	130%	12
LMI		
A	-	-
B[12]	60%	5
C	75%	7
D	90%	9
D+	125%	12

Gujarat

Area	(Ex.) Cap[9]	Yrs.	(Df.) Cap[9]	Yrs.
Backward				
II	80%	5	100%	7
I	100%	7	125%	9

Rajasthan

No differentiation based on location

FCI	Cap[9]	Yrs.
Upto 150 lakhs	125%	11
Exceeding 150 lakhs	100%	11

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[9] As a % of fixed capital investment.

[10] Category C concessions in M.P. are extended also to units set up in 'no industry blocks' in any district.

[11] Same periods as for units with FCI > Rs. 10 lakh.

[12] Category B concessions in Maharashtra are available also for eligible electronic industrial units & 100% EOU's located in Mumbai Metropolitan Region (with some exceptions) and Pune Metropolitan Region.

Sales Tax Exemption/Deferment

	M.P.	Maharashtra	Gujarat	Rajasthan
IV. Additional Concessions				
A. Thrust industries	FCI ≥ Rs 1 crore No Cap	-	Cap: + 10% Category III areas[13]: Ex. 60%, 5 yrs. Df. 75%, 7 yrs.	Cap: 125%[15] + 2 yrs.
B. Expanding & diversifying units	-	-	Expansion only once & all diversification + 10%	-
C. Special category entrepreneurs	SC-ST's + 1 yr. Women + 1 yr. Backward classes + 1 yr.	-	-	-
D. Growth centres	MPAKVN growth centres + 2 yrs. 'No industry blocks' in category C districts + 1 yr.	-	-	Cap: + 20 % + 1 yr.
E. Prestigious units	-	FCI > Rs 100 crore (only Gadchiroli district) Cap:130% 20 yrs.	Project cost > Rs. 100 crore,[14] emp. ≥ 100 Ex. + 5 yrs. Df. + 4 yrs. Category III areas: Ex: 60%, 9 yrs. Df: 75%, 10 yrs.	FCI ≥ Rs 25 crore, emp. ≥ 250 Cap: 100% 13 yrs. Very Prestigious Units: FCI ≥ Rs. 50 crore; emp. ≥ 250 Cap: 125% 13 yrs.

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[13]   Category III is the residual area of the state that is not banned.

[14]   Any no. of units in category I & II areas but only first five in category III areas; none in banned areas.

[15]   Following thrust industries are excluded: Automobiles & components; Dimensional stones; Agro processing; Cement - All plants incl. pioneering/prestigious/very prestigious/premier units (except mini cement plants; Cap 100%; 11 yrs).

Sales Tax Exemption/Deferment

	M.P.	Maharashtra	Gujarat	Rajasthan

F. Premier/pioneer units		Pioneer[17]
		LMI[18] +20%
		+2 yrs.
		FCI ≥ Rs. 300 crore in
		B, C, D areas: 14 yrs.
			Premier[19] A B
			Ex. +7 yrs. +9 yrs.
			Df. +6 yrs. +8 yrs.
			Category III areas:
			Ex: 60% 60%
			           11 yrs. 13 yrs.
			Df: 70% 75%
			           12 yrs. 14 yrs.
			A: 500-1000 cr; emp. ≥ 100
			B: >100 crores; emp. ≥ 100
				Pioneer
				Cap: 100%[20]
				13 yrs.

G. Other	100% EOU's + 2 yrs. NRI's[16] + 2 yrs.	Mega projects: units in B/C/D/D+ areas with FCI ≥ Rs. 1000 crore: 17 yrs. Rs. 2000 crore: 20 yrs.		a. Grassroot[21] automobile units purchase tax 7 yrs. & sales tax 12 yrs. without cap. b. Manufacturing facilities for bricks, building materials & other fly-ash & stone slurry based products: 100%, 10 yrs. c. EOU's exporting ≥ 50% of their production: sales tax 13 yrs; purchase tax on machinery 5 yrs.

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[16] Investment should be atleast Rs. 2 crore.

[17] A new, first unit with FCI threshold greater than:-
100 crores (B) ; 30 crores (C); 15 crores (D); 5 crores in (D +) area;
A new unit or an existing unit in the same taluka with FCI threshold: 300 crores (B); 60 crores (C);
30 crores (D); 10 crores (D +).

[18] In D+ areas: an additional +5%, +3 Yrs.

[19] Only one unit per taluka is given the status of premier unit.

[20] Exporting units with a minimum of 15% of their production exported given the same benefits.

[21] FCI ≥ Rs. 10 crore and regular employment ≥ 200 persons.

Sales Tax Exemption/Deferment

		A.P. current	Karnataka 1996-2001	Orissa from 1 April 1996
I. Eligibility				
	A.	All new except ineligible list	All new except ineligible list	All new except ineligible list[25]
	B.	Expansion-capacity enhancement of at least 25% Diversification-enhancement of FCI & turnover by at least 25%	Expansion, diversification[23,24]: developing areas - all growth centres - all developed areas - specf. categories	Expansion, modernization & diversification
	C.	-	-	-
	D.	Except banned areas[22]	-	-
	E.		Khadi village units exempted completely	All new khadi, village, cottage & handicraft units.
II. In respect of:	Inputs	-	Exempted/Deferred	Exempted/Deferred[26]
	Outputs	Exempted/Deferred	Exempted/Deferred	Exempted[27]/Deferred[28]

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[22]   Municipal corporation areas of Hyderabad, Vijayawada & Vishakapatnam.

[23]   Different rates than those applying to new units.

[24]   Modernizing units are given grants-in-aid of 10% of capital cost subject to a ceiling of Rs. 10 lakh. However, no subsidies or exemption/deferment benefits are given.

[25]   'Industrial unit' is defined to include PSU's of the state Government and their subsidiaries.

[26]   No deferment option for khadi, village, cottage & handicraft indus.

[27]   Extends to all existing khadi units at authorised outlets.

[28]   Only new LMI, not new SSI, will have the option of deferment in respect of finished goods.

Sales Tax Exemption/Deferment

III. Base Concessions	A.P.			Karnataka				Orissa		
	Area	Cap[9]	Years	Area	Cap[9]	(Ex.) (Df.) Years		Area	Cap[9]	Years
	SSI:			New units (Expanding/ Diversifying units)				FCI ≤ Rs. 10 lakh	200%	+ 1
	Ex.	100%	7	Tiny:						
	LMI:			Devd.[29]	150%	4	6	FCI > Rs 10 lakh Zone C	100%	7
	Ex.	135%	7	Devg.	(60%)[30]	6	8	Zone B	100%	6
	Df.	135%	14	Growth	150% (80%)	7	8	Zone A	100%	5
				Centres	150% (80%)					
				SSI:						
				Devd.[29]						
				Devg.	100% (60%)	4	6			
				Growth	100% (80%)	6	8			
				Centres	100% (80%)	7	8			
				LMI:						
				Devd.[29]						
				Devg.	100% (60%)	4	6			
				Growth	100% (80%)	5	7			
				Centres	100% (80%)	6	8			

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[29]   Only non-polluting high technology industries eligible.
[30]   The cap rates given in the brackets are for expanding/diversifying units.

Sales Tax Exemption/Deferment

	A.P.	Karnataka	Orissa
IV. Additional concessions A. Thrust industries	-	+ 1 yr.[31]	Cap:[32] 200%[33] + 2 yrs. Project cost 100- 500 crores: +1 yr. 500-1000 crores + 2 yrs. > 1000 crores + 3 yrs.
B. Expanding, diversifying/ modernizing units	-	-	-
C. Special category entrepreneurs	-	SC-ST's + 1 yr. Women + 1 yr. Minority communities + 1 yr. Physically handicapped + 1 yr. Ex-servicemen + 1 yr. Technocrat entrepreneurs + 1 yr.	-
D. Growth centres	-	-	-
E. Prestigious units	-	-	-
F. Premier/pioneer units	-	-	Project cost ≥ Rs. 5 crore + 2 yrs.[34]
G. Other	-	-	a. Labour intensive units which are not priority.[35] b. New industrial units having more than 30% women and/or handicapped and/or belonging to SC/ST among regular employees + 2 yrs.[36]

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[31]   Only in developing areas and growth centres.

[32]   The thrust sector is termed the "priority" sector in Orissa.

[33]   In respect of electronic/telecommunication (hardware & software) industrial units, the cap is 250%.

[34]   First two LMI in a panchayat samiti area.

[35]   FCI per employee: Ex/Df Cap
    Rs. 10,000-25,000: 175%; Rs. 25,001-50,000: 150%; Rs. 50,001-75,000: 125%

[36]   Provided the unit has regular employment of not less than 20 persons.

Appendix to Table 2.2

Ineligible Industries

M.P.	Gujarat	Rajasthan
<u>Agro-based</u>:[37] Refining of Oil Blending/manf.: liquor/tea/spices/gur Decorticating: nuts Dehusking Ice & ice-cream	<u>Agro-based</u>: Oil seed processing (except in cooperative sector) Solvent extraction Milk products	<u>Agro-based</u>: Flour, cereals, pulses, rice, sugar & spice mills[38] Ice candy, ice fruits, kulfi, sweetmeats. Decorticating, roasting, parching, frying oil seeds & colouring, decolouring & scenting of oil Khandsari units Liquor/alcohol excluding ind. alcohol Preparation of bread, biscuits and bakery products Hydrogenated vegetable oil or vanaspati ghee Oil extraction excluding solvent extraction plant
<u>Resource-based</u>:[37] Saw mills Veneering & plywood ind. Boxes of plywood & timber Wooden windows/doors/ frames Firewood Extraction, collection of gum, tendu leaves Bricks Repairing of bardana and hessian Preparation of sutli & rope Kavelu and ridge Lac and chapri Coke & coal briquettes Charcoal Powdering of minerals Stone crushing Stone cutting & polishing	<u>Resource-based</u>: Firewood and charcoal Mining	<u>Resource-based</u>: Production of firewood & charcoal Saw mills & wood & furniture items Stone crushers Lime kilns Candles & chlorinated paraffin wax Cotton ginning & pressing ind.

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[37] The following industries were ineligible prior to 1994:
Oil mills; Solvent extraction plants; Cotton ginning & pressing factories; Manf. of lime & surkhi.

[38] These mills are eligible if established at places having a population < 25,000 as per 1991 census.

Appendix to Table 2.2

M.P.	Gujarat	Rajasthan
Other:	Other:	Other:
Paper bags	Thinner & French polish, kakab	Photographic studio
Pressing of iron/steel scrap into	& gadaku	Laundry
blocks	Electricity Generation	Tailoring
Repacking	Cottage & village ind.	Re-packing of goods[39]
Printing processes	State & Central public sector	Ordinary bricks
Colour laboratories	Such other items for which	Hotel, motel, restaurants & catering or
Ornaments and articles of gold &	registration is to be restricted	eating places
silver		Induction & arc furnace ind.
Utensil manf. ind.		Thinner manf. ind.
Manf. of wooden & steel		Iron & steel rerolling mills
Galvanizing of iron & steel		Jalies, water tanks, electric poles
Processing of iron & steel		made of cement
Refining of crude oil		Fabricating units (eg. trunks, buckets)
Public sector undertakings of Govt.		Steel furniture ind.
of India		Mini cement plants[40]
Industrial undertakings of Govt. of		
India		
A closed industrial unit revived by		
an entrepreneur		
A new industrial unit set up by		
transferring, shifting or dismantling		
or closing of existing unit within the		
state of MP.		
Such other industries notified by the		
State Govt.		

A.P.	Karnataka	Orissa
Agro-based:	Agro-based:	Agro-based:
Edible oil seeds/cakes	Roller flour mills	Rice hullers and rice mills
Rice, dal & flour mills coffee	Pop-corn & ice candy units	Flour, besan, pulse & chuda mills
roasting, grinding	Coffee roasting & grinding	Spices, papad etc.
Ice creams, chocolates &	Jaggery making units	Confectionery
confectionery	Khandsari units	Preparation of sweets and numkeens
Aerated water & soft drinks	Breweries & Distilleries	Bread-making
Nut powder	Units using molasses/rectified	Mixture, Bhujia & Chenachur
Khandsari sugar & sugar mills	spirit/denatured spirit as main	preparation units
Spices, pickles & chutneys	raw material for manufacturing	Ice candy & ice fruits
Sweets	of potable alcohol	Processing of betelnuts
Alcoholic drinks & alcohol based		Hatcheries, Piggeries, Rabbit or Broiler
inds. (other than drugs &		farming
pharmaceutical)		
Poultry & related activities		
Manure mixing inds.		
Tobacco products, cigarettes &		
bidis		

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[39] Goods incl. medicines, toiletries, pesticides, herbicides, edible products.
[40] Manf. capacity upto 2,000 tonnes per day.

Appendix to Table 2.2

A.P.	Karnataka	Orissa
<u>Resource-based:</u> Cotton ginning mills Cotton/jute/iron scrap bailing presses Saw mills, wooden furniture	<u>Resource-based:</u> All types of saw mills	<u>Resource-based:</u> Coal/Coke screening units Coal/Coke briquetting Prod. of firewood & charcoal Units for physical mixing of fertilizers Brick-making units Tarpaulin out of canvas cloth Oil mills Saw mill, sawing of timber Carpentry joinery & wooden furniture making Units for mixing or blending of tea Repacking & stitching of woven sacks out of woven fabrics
<u>Other:</u> Soap Slab polishing Chloral hydrate Naphthalene balls Shampoos, tooth powder & paste Distilleries & Breweries Varnishes & thinners Lime Kilns · Printing presses Power laundries Drinking straws Road metal, stone crushing Cinematography, video parlours Book binding Tailoring Steel structural & fabrication works Aluminium & stainless steel utensils other steel products Tiles & asbestos products Hotels X-ray clinics Photo studios Alloy steel castings Ferro-alloys manuf. Calcium carbide & silicon carbide	<u>Other:</u> Photo studios & colour processing centres Photo copying & Xerox machines Power laundries Clock & watch repair shops Cassette recording (audio & video) Fertilizer mixing Repacking of drugs/ medicines/chem. etc. without any processing and value addition, excl. formulation units.	<u>Other:</u> Iron & Steel Processors Chrome ore beneficiation Cracker-making Tyre retreading Stone crushing Painting & spray painting Drilling rigs, Bore-wells & Tube-wells Units for bottling of medicines Book-binding Rubber stamp making Note books, exercise note books & envelopes Printing press Photo copying Stencilling Distilled water Distillery Tailoring Laundry/Dry cleaning Photographic studios & laboratories Clinical/Pathological laboratories Beauty parlours Guest Houses/Restaurants Goods & passenger carriers

Table 2.3

Growth Centres in Madhya Pradesh

(Rs crore)

Growth centres		Investment by	
		State government	Centre government
Centrally sponsored			
1.	Pillukhedi	1.60	2.00
2.	Satlapur	4.63	4.35
3.	Malanpur	-	2.00
4.	Ghirongi	8.77	10.00
5.	Chainpura	1.60	1.00
6.	Pithampur	13.63	2.00
7.	Kheda	1.67	10.00
8.	Meghnagar	3.84	2.00
9.	Maneri	1.47	2.00
10.	Siltara	5.32	10.00
11.	Borai	2.68	6.68
12.	Purena	0.62	1.00
	Total	45.83	53.03
State sponsored			
1.	Mandideep	1.73	-
2.	Pratappura	-	-
3.	Banmore	2.02	-
4.	Maksi	0.15	-
5.	Dewas	0.12	-
6.	Boregaon	2.01	-
7.	Sidgawan	-	-
8.	Sirgitti	0.92	-
9.	Urla	0.73	-
10.	Waidhan	0.53	-
	Total	8.22	-

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Source: Madhya Pradesh State Industrial Development Corporation Limited, AVN Towers, Bhopal. Information updated to 31 December 1998.

Notes: The state government is committed to contributing funds from centrally-sponsored growth centres; the target funding for these is Rs 10 crore from the Centre, and Rs 5 crore from the relevant state government.

CHAPTER 3

BENEFITS FROM INDUSTRIAL INCENTIVES:
ECONOMETRIC EVIDENCE

INTRODUCTION

3.1   *Incentive regimes*: Fiscal incentives have already been seen to fall in two categories: outright subsidies and tax concessions. The final impact of these on investment is additive, and it is extremely difficult to disentangle the incremental impact of each. The first of the two methods employed in this chapter examines each incentive for policy changes over time along dimensions specific to it to mark transition points to more (or less) generous regimes. These are then superimposed on each other to obtain an identification of regimes jointly unchanging in respect of both subsidies and concessions. Three regimes are so identified for the period since 1971, broken at 1981 and 1988 (Box 3.1).

3.2   *Regime-specific growth rates:*   Having demarcated the regimes, the growth rate of investment in the different regimes is econometrically estimated from a data base on large and medium industries supplied by the Industries Department, and the differences if any examined for statistical significance. Details on the data set are in para 3.12. Time-series data on SSI units were not available. The non-availability of data on SSI is a nationwide problem. In particular, there are no data with which to test whether, as is commonly reported, tax holidays lead to planned mortality of small-scale units at the conclusion of the holiday period.

3.3   *Investment function:* The second formal exercise attempted is an investment function. A full-fledged investment function is at all times difficult for a sub-national

unit of a large federation, where even non-export demand can be generated outside the home state. A simple specification which includes SDP growth in the home state, interacted with slope dummies for the two periods D1 (1981-88) and D2 (1989-96, truncated at 1996 by availability of SDP data); and a continuous variable for the impact of industrial unrest in West Bengal, measured in million mandays lost in that state, which the field interviews suggested was an important factor explanatory of investment in Madhya Pradesh after 1979, yielded a reasonably good fit.

3.4 *Central incentives*: Central subsidies and other concessions are clearly overlaid on the state incentives, so that any identification of regimes must carry no change in respect of those as well. Central investment subsidies are already incorporated in any time-trend of state-level subsidies, since the latter were introduced as a substitute when central subsidies were withdrawn in 1988. Indeed that accounts for one of the transitions (1988; Box 3.1). Central interest subsidies are dealt with in Appendix B to the Report. The sector-specific rates in force during the period under review in this chapter do not bear on large and medium industries, which are the focus of analysis in this chapter.

OUTRIGHT SUBSIDIES

3.5 *Transitions*: The Central government investment subsidy scheme for backward districts introduced in 1971 was discontinued on 30 September 1988 (table 3.1). The Government of Madhya Pradesh introduced its own scheme on 1 October 1988 as a replacement for the central scheme, and this is the scheme in place until today (table 3.1). The MP scheme covered only SSIs (although some medium and large scale (LMI) co-operative units and pioneer units located in growth centres were also eligible). This immediately marks greater restrictivity as compared to the central scheme which covered all industrial units, large and small. It is also clear from table 3.1 that the state scheme offered lower rates as well as lower ceilings (with the lone exception of the enhanced thrust sector cap for LMI located in category C districts). However, whereas the central scheme was confined to backward districts, the state scheme was available, in addition, for small scale thrust industries located in

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advanced districts. These minor extensions notwithstanding, 1988 marks a decisive transition from a more generous (central) subsidy regime to a less generous (state) subsidy regime.

3.6   *Rate pattern*: From the rate structure of the central scheme (table 3.1), the alphabetical coding of districts seems to have been in descending order by degree of backwardness, unlike the state scheme.

TAX CONCESSIONS

3.7   *Tax concession regimes*: The regime of formal tax holidays began in MP with the introduction of the 1981 scheme (table 3.2). Prior to 1981, there was a sales tax subsidy scheme operated by the industries department. The 1981 scheme was followed by the 1986 scheme, the 1992 scheme and finally by the 1994 scheme which is what stands today (table 3.2). In addition to the general schemes mentioned above, there are some specific schemes. These are as follows:

i.   1991 Scheme for units with capital investment in fixed assets of Rs.100 crore or more.
ii.   1992 Scheme for units manufacturing cement, vanaspati, ghee, paints, colours and tiles.
iii.   1993 Scheme for integrated steel plants with capital investment in fixed assets of Rs. 100 crore or more.
iv.   1995 Scheme for new hotels, non-conventional power generating units, NRIs and 100 per cent EOUs.
v.   1997 Scheme for units having capital investment of Rs. 10 crore plus, 100 crores plus and 500 crores plus, for units in earth quake affected areas of Jabalpur with capital investment of more than Rs. 10 crore, and for Fly Ash Brick units.

3.8   *The 1981 scheme*: This scheme allowed full exemption for all industries other than a prescribed set of ineligible industries which started commercial production or took prescribed steps after 1 April 1981 but before 1 April 1992. Complete information about the sales tax subsidy scheme before 1981 is not available, but given that the

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tax subsidy has to have been less than complete, the 1981 scheme can be taken to mark a transition from a less generous to a more generous regime.

3.9   *The 1986 scheme*: This scheme was available to units which commenced commercial production or took prescribed steps on or after 1 August 1986 but before 1 April 1992. The 1986 scheme introduced a cap for the first time for SSIs, although SSIs with investment upto Rs. 10 lakh were free to opt for the 1981 scheme. This greater restrictiveness towards SSIs is not a transition that would have an impact on our data set which is confined to LMIs alone. The 1986 scheme also raised the maximum holiday period to 11 years from 9 years, and offered a deferment option for the first time. These changes do mark some relaxation in the terms of offer, but are not sufficient to mark a move to a distinctly new regime overall.

3.10   *The 1992 scheme*: This scheme was available to units that started production on or after 1 April 1992 but before 6 May 1994.[11] It introduced caps on all industries varying by location and clubbed together CST and State Sales Tax. The eligibility net was restricted with the expansion of the ineligible set to include an additional 30 industries during the early nineties, and the maximum period of tax holiday was brought down to 9 years. Thus, 1992 does mark a decisive transition to a tighter regime, the first such move after 1981.

3.11   *The 1994 scheme*: This scheme is currently in operation and effective from 6 May, 1994. The scheme introduced, for the first time, higher caps for units with higher investment in fixed assets, and variations in caps and holiday periods between exemption and deferment options. Four industries from the list of ineligible industries became eligible under the 1994 scheme. These are: oil mills, solvent extraction plants, cotton ginning and lime and surkhi. Of these, solvent extraction plants and lime and surkhi were eligible for tax concessions before 1990 and became briefly ineligible only between 1990 and 1994. Oil mills and cotton ginning had always been

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[11]   Or which took prescribed effective steps before 6 May 1994 and commenced commercial production before 1 April, 1995.

ineligible till 1994. The impact of these changes at the margin on the overall characterisation of the concession regime is not clear. Clearly larger units and newly included industries faced a less restrictive regime as a result of these changes, and the extension of concessions for expansion/diversification/modernisation again marks a change towards less restrictivity. On the other hand, the reduction of the holiday period below 9 years for the first time since the inception of the practice in 1981, marks a tightening of the scheme. Certainly, the direction of change is not as clear as it was in 1992.

TRANSITION OVERVIEW

3.12 *Three regimes*: After the 1971 introduction of the central government investment subsidy scheme, the major break occurred in 1988 when the central subsidy scheme was withdrawn in September, and replaced by the state subsidy scheme, which was not available to large and medium industries (with a few exceptions; para 3.5). Within the period 1971-88 the introduction of the 1981 state government scheme offering 100 per cent tax exemption for eligible industries further added to the industrial incentives for investment in MP. Superimposed on the central subsidy, this made 1981-88 a more generous regime than 1971-81. Thus, three incentive regimes resulted, as listed in Box 3.1.

Box 3.1 Incentive Regimes

Regime number	Duration	Regime identifiers
I.	1971 to 1981	Central : Investment Subsidy State : Tax Subsidy (< 100%)
II.	1981 to 1988	Central : Investment Subsidy (unaltered) State : Tax Holiday (100% for eligible sectors)
III.	1988 to 1997	State : Investment Subsidy (< Central) State : Tax Holiday Progressively More Restrictive

A pair-wise ranking of incentive regimes is possible thus; the > sign implies a more generous regime:

I < II

II > III

I > III

REGIME-SPECIFIC INVESTMENT GROWTH RATES

3.13   *Data set*: A data set of all large and medium industries (LMI) with their year of production, product specification and capacity, investment and employment as on March 1997 was provided by the Industries Department. An annual data set going from 1971-1997 with 27 observations was constructed from the raw data, aggregated across 718 industrial units newly set up during those years.

3.14   *Nominal and real investment trends*: The chart of nominal and real investment in Madhya Pradesh, aggregated across all sectors, starting from the year 1965, is shown in Chart 3.1. Both variables are shown in logs; real investment is aggregate nominal investment deflated by the national gross domestic capital formation deflator (base 1980-81=100). Starting from 1965 investment declines steadily until the year 1971, when it bottoms out and starts rising again. The post-1965 slowdown in industrial investment was a phenomenon that extended to the country as a whole, and generated a huge explosion of literature as to possible causes and correctives (for example Ahluwalia, 1991). It is unquestionably true that the central investment subsidy was a response to the lack of other macroeconomic incentives for investment at the time. The issue of whether that was the best response is beyond the scope of this exercise here. Certainly the investment pick-up starting-1971 is co-terminous with the introduction of the central subsidy in 1971. There is a distinct flattening out after the late 1980's, more decisive in the case of real than in the case of nominal investment.

3.15   *Employment per lakh of nominal investment*: Chart 3.2 shows employment per lakh of nominal investment from the information in the data set. This has to be formal

employment as reported at the time of installation of capacity. Keeping in mind that the entire period would show the employment-discouraging impact of labour laws in the country, what is startlingly evident is that after a period where employment per lakh of investment fluctuated largely between 1 and 2, after 1987 it has remained low and flat at between 0.1 and 0.2 per lakh of investment. Ancillary employment generated in the small-scale sector clearly would not appear in the graph, but the low direct employment generated in LMI must be kept in mind when evaluating capital subsidy schemes, which of their very nature encourage capital-intensive techniques.

3.16 *Econometric methodology:* The first of the two exercises attempted quite simply estimates the growth rate of aggregate investment across all sectors for each of the three regimes, and tests for whether there was a statistically significant difference in the (overall) investment growth rate between regimes. The conventional method of estimating the growth rates of a variable in different sub-periods by OLS fitting of separate exponential curves to each sub-period or a single curve with intercept and slope dummies for each sub period has not been adopted because it can lead to strange results, e.g., all sub-period growth rates simultaneously exceeding or falling short of the growth rate for the period as a whole (Boyce, 1986). This problem can be eliminated by introducing certain linear restrictions (Poirier, 1976). A kinked exponential function can be estimated in log linear form with such restrictions using OLS. The estimated equation with one kink is as follows, where Y_t is the value of the dependent variable in period t:

$$\ln Y_t = a_1 + b_1(D_1t + D_2k) + b_2(D_2t - D_2k) + U_t \qquad \qquad .....(3.1)$$

The time series is broken at k, and D_i (i=1,2) is a dummy variable taking the value 1 in the ith sub-period and zero otherwise. The OLS estimates of b_1 and b_2 give the exponential growth rates in the two sub-periods. There is a kink between the two trend lines whenever b_1 and b_2 are significantly different. Similarly the equation with two kinks is,

$$\ln Y_t = a_1 + b_1(D_1t + D_2k_1 + D_3k_1) + b_2(D_2t - D_2k_1 - D_3k_1 + D_3k_2) + b_3(D_3t - D_3k_2) + U_t \quad .....(3.2)$$

3.17 *Regime-specific growth rates: All industries*: The dependent variable is the log of real investment (para 3.13). It is important to stress that, since the dependent variable is in real, i.e. inflation-adjusted form, a zero growth rate merely implies that the rate of growth of nominal investment did not exceed the rate of inflation. The results shown in Box 3.2 for all industries show that the growth rates of 14.09 per cent and 20.03 per cent per annum in regimes I and II respectively are significantly higher than zero; the negative growth rate of (-) 2.16 per cent in regime III however is not significantly lower than zero. Clearly, we have positive growth rates of investment upto 1988, and a flattening to zero growth thereafter. This is merely a factual description of investment in the state, as revealed by the database on large and medium industrial investment alone. **There are a number of factors that could bear upon the growth time-profile by incentive regime outlined in Box 3.2. In particular, the zero growth after 1988 cannot be ascribed to withdrawal of the central subsidy alone.** The field interviews with industrialists reported in chapter 5 highlight the crucial impact of electric power inadequacy in the nineties on industrial investment in a state where power abundance had been a major attraction in the eighties.

**Box 3.2 Kinked Exponential Growth Rates of Real
Investment in Madhya Pradesh: All Sectors
(Large and Medium Industries)**

No. obs = 27

Regime number		All industries
	Constant	7.3412
I.	1971-1981	0.1409 (2.12)
II.	1981-1988	0.2003 (2.41)
III.	1988-1997	-0.0216 (-0.29)*
	R^2	0.6319
	$\bar{R}^2$	0.5838

* Not statistically different from zero.

Notes: Estimated function is equation 3.2 (see text) with k_1 = 11; k_2 = 18 (t-values in parentheses).

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3.18 *Incentive Regimes I and II: All Industries*: While the lowering of the investment growth rate after 1988 is immediately apparent from the table, what is not immediately apparent is whether the growth rate is higher in regime II as compared to regime I. The value of the t-statistic for the difference between the coefficients for the two regimes had a value of 0.442, which is not significantly different from zero. These results show that the growth rate of real investment in regime II was no greater than the growth rate of real investment in regime I, even though regime II had tax concessions along with continuation of the central capital subsidy. It is difficult however to conclude from this that tax concessions have had no incremental impact on industrial investment in the state without further investigations.

3.19 *Eligibility for tax concessions*: Tax concessions were and are available only for those industries that are sectorally eligible. The ineligibility list currently numbers 52 industries. The list of eligible industries got squeezed during the early nineties when 30 industries were added to the ineligibility list with retrospective effect. However, these 30 industries belonged to the set of low technology SSI products. In our LMI data set, these industries do not have much of a presence. Thereafter, four industries (oil mills; solvent extraction plants; cotton ginning; and lime and surkhi) were released from the list of ineligible industries in the 1994 scheme. Of these, two (solvent extraction and lime and surkhi) were eligible until 1990 and were therefore briefly ineligible only during 1990-94. These have therefore been included in the eligible set.

3.20 *Results for concession-eligible industries*: The estimation of growth rates for eligible industries was confined to the first two regimes, since the attempt here is to identify the incremental impact of tax concessions after 1981 on the central subsidy available starting 1971. Since close to zero investment in the eligible set was recorded in the year 1971, the data set covers the years 1972-88 (seventeen observations) aggregated over a total of 244 eligible industrial units. The results are displayed in Box 3.3. For the eligible set, the growth rate in the period 1972-81 is not significantly different from zero. This result is very different from that for all industries, and is possibly the reason for introduction of tax concessions for the eligible set in 1981. What is of interest is that, even for this set taken in isolation, the growth rate

for the period 1981-88 is also not significantly different from that before 1981. Thus this result appears to support the result for all industries that tax concessions have not had an incremental impact on the growth rate of industrial investment beyond that observed before the introduction of tax concessions in 1981.

**Box 3.3   Kinked Exponential Growth Rates of Real Investment
in Madhya Pradesh: Concession-eligible Sectors
(Large and Medium Industries)**

No. obs = 18

Regime number		Eligible (tax relief) industries
	Constant	7.4234
I.	1972-1981	0.1108 (1.11)
II.	1981-1988	0.1824 (1.38)
	R^2	0.3525
	$\bar{R}^2$	0.2600

Note: For eligible industries, the second regime starts from 1972. The estimated function is equation 3.2 (see text) with $k_1 = 10$.

AN INVESTMENT FUNCTION

3.21   *The specification:* A very preliminary attempt to explain the rate of real (para 3.13) investment (as a per cent of SDP) was made with the specification given below:

Inv/SDP =   Constant + ßGRSDP + δ_1 GRSDP * D1 + δ_2 GRSDP * D2 + γWB .... (3.3)

where

GRSDP   :   growth rate of SDP in Madhya Pradesh

GRSDP*D1 :   interacted with slope dummies for the two periods D1 (1981-88)
GRSDP*D2   and D2 (1989-96, truncated at 1996 by availability of SDP data).

WB   :   Million mandays lost due to industrial unrest in West Bengal.

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There is also an intercept dummy D3 (=1 for 1986 and 1993), which is essentially an outlier-remover for unexplained investment spikes in those years. For the concession configuration of the periods of coverage of D1 and D2, see Box 3.1. Inclusion of industrial unrest in West Bengal resulted from the field evidence which suggested that it was an important factor explanatory of investment in Madhya Pradesh after 1979.

3.22 *The findings:* The estimated investment function is reported in table 3.3. The explanatory power of the equation, at 42.22 per cent (adjusted R^2) is reasonable, and the diagnostics reveal no serial correlation. The t-values of the coefficients show that the growth rate of SDP has a statistically significant positive impact on the investment rate. The slope dummies show no change in this impact with the introduction of tax concessions (D1) or with the replacement of the central subsidy by the state subsidy (D2).This result bears out the previous result on the insignificant impact of tax concessions on investment. The negative coefficient of the D2 dummy is consistent with the previous exercise which showed a distinct flattening of the growth rate of real investment after 1988, but the coefficient is statistically insignificant. What is of immense interest is the statistical validation of the positive impact of industrial unrest in West Bengal on investment in Madhya Pradesh. This last result serves to underline once again the immense importance of developments, whether policy-induced or otherwise, in adjoining states within a larger federation.

THE COUNTERFACTUAL

3.23 What would the time profile of industrial investment in large and medium industries have been in the absence of the tax concessions introduced in 1981? What is the counterfactual, in other words? Since the exercises performed consistently show that tax concessions did not have a significant impact on either the growth rate of real investment, or on the rate of investment (as a per cent of SDP), the counterfactual is in effect no different from what is observed. To drive home this point, however, table 3.4 presents the mean investment rate (as a per cent of SDP) predicted for the period 1971-96, and for the regime sub-periods within it, using the model of equation 3.3, and re-estimates these means without the D1 dummy for

1981-88 (cofact 1); without the D2 dummy for 1988-96 (cofact 2); and without both D1 and D2 (cofact 3). These predictions and counterfactuals use the reported coefficients of table 3.3 without reference to their statistical significance.

3.24 It can be seen that only cofact 2 (and hence cofact 3) depart at all from the predicted investment rate, for the period of operation of the D2 dummy (i.e. after 1989). Because the D_2 dummy carried a negative coefficient the counterfactual shows a higher investment rate. Great care must be taken in the interpretation of cofact 2. This shows the counterfactual after removal of the D2 dummy covering the period 1988-96 when a number of adverse developments occurred:

1.   The central subsidy was replaced by the state subsidy which was not available to large and medium industries.
2.   Sharp deterioration in power supply in the state.
3.   Strict enforcement of Conservation of Forests Act (chapter 5).

Therefore the higher investment rate in cofact 2 (and hence cofact 3) after 1989 cannot be attributed to withdrawal of the central subsidy alone.

Table 3.1

Investment Subsidy Scheme (Backward Districts)

| Backward Districts | Central Scheme All | | State Scheme | | | |
| | | | Small Scale | | Medium/Large (Co-operative) | |
	Rate	Ceiling (Rs. lakh)	Rate	Ceiling (Rs. lakh)	Rate	Ceiling (Rs. lakh)
Category A	25%	25	7.5%	1.50 (general) 2.00 (thrust)	7.5%	5.00 (general) 7.00 (thrust)
Category B	15%	15	10%	2.00 (general) 2.50 (thrust)	10%	7.00 (general) 9.00 (thrust)
Category C	10%	10	10%	2.50 (general) 3.00 (thrust)	10%	10.00 (general) 15.00 (thrust)

Source: Mahajan and Motlani, 1998; Annual Report of Ministry of Industries, 1998-99.

Notes: 1. The Central Investment Subsidy Scheme started in 1971 was discontinued on 30 September 88; the State Investment Subsidy Scheme was effective from 1 October 88.

2. The State Investment Subsidy Scheme additionally covers small scale thrust industries in advanced districts at the rate of 5 per cent (ceiling: Rs. 1 lakh); and units in Growth Centres at the rate of 15 per cent (ceiling: Rs. 5 lakh for SSI, Rs. 15 lakh for Medium/Large co-operative industries).

3. For the coverage of backward and advanced districts, see Annexe 1.

Table 3.2

Tax Concessions: Madhya Pradesh

	1981	1986	1992	1994
Sectoral Eligibility	All but 26	All but 26	All but 56 (additions* applicable retrospectively to earlier schemes)	All but 52 (oil mills, solvent extraction plants, cotton ginning, lime and surkhi newly eligible)
Coverage	All new units only	All new units only	All new units only	All new units All expanding, diversifying modernizing (existing) unit
Cap (% capital investment)	No cap	90% (SSI only)	100% to 150% (according to location) CST & State Sales Tax added together	Ex: 125% to 250% (by location/size) Def: 175% to 300% (by location/size)
Period	Max. 9 yrs.	Max. 11 yrs.	Max. 9 yrs.	Ex: Max. 7 yrs. Def: Max. 9 yrs.
Options	Only ex.	Ex: 81 scheme option for SSI (inv ≤ Rs. 10 lakh) Def: Newly introduced	Ex/Def: 81, 86 options (effective steps before 1 April 92)	Ex/Def: 81, 86, 92 options (effective steps before 6 May 94)

Source: Mahajan and Motlani, 1998.

Notes: *   Introduced in stages in the early nineties. Two of these became eligible again in 1994 (solvent extraction and lime and surkhi)

1.   Ex: Exemption; Def: Deferment

2.   There are schemes for exemptions to certain specific industries, e.g., 1991 scheme for units with capital investment in fixed assets of Rs. 100 crore or more, 1995 schemes for NRIs & 100% EOU etc.

3.   Prior to 1981, there was a sales tax subsidy scheme operated by the industries department, details of which are not known. But on the assumption that the subsidy was fractional (< 100%), the uncapped 1981 scheme marked a change to a more generous (100%) regime; see text.

Table 3.3

Investment Function for Madhya Pradesh
Dependent Variable: Investment Rate
(Real Investment/Real SDP)

No. of obs=26

	Coefficient	t-value
Intercept	0.75	1.61
D (86, 93 = 1)	3.48	3.95
Growth rate real SDP (X)	0.03	1.63
X * D1(81-88)	-0.002	-0.04
X * D2(89-96)	-0.05	-0.84
Mandays lost in West Bengal (10^6)	0.05	1.73
R^2	53.78	F:4.65
$\bar{R}^2$	42.22	
DW	1.57	

Note: The critical values of t for a one-tailed test with df=20 is 1.32 at P=0.10, and 1.72 at P=.05.

Table 3.4

Predictions and Counterfactuals

	Predicted	Cofact 1	Cofact 2	Cofact 3
1971-96 Mean (Coeff. of var.)	1.84% (0.54)	1.84% (0.54)	1.92% (0.55)	1.92% (0.55)
1971-80 Mean (Coeff. of var.)	1.38% (0.38)	1.38% (0.38)	1.38% (0.38)	1.38% (0.38)
1981-88 Mean (Coeff. of var.)	2.25% (0.46)	2.25% (0.45)	2.25% (0.46)	2.26% (0.45)
1989-96 Mean (Coeff. of var.)	2.02% (0.63)	2.02% (0.63)	2.26% (0.61)	2.26% (0.61)

Notes: Predicted : Predicted investment/SDP using equation 3.3, and reported coefficients in table 3.3.

Cofact 1 : Predicted investment/SDP using equation 3.3 after excluding X*D(81-88) (table 3.3).

Cofact 2 : Predicted investment/SDP after excluding X*D(89-96).

Cofact 3 : Predicted investment/SDP after excluding X*D(81-88) and X*(89-96).

Chart 3.1:Nominal and Real Investment

Year

—■— Log Nominal Investment —◆— Log Real Investment
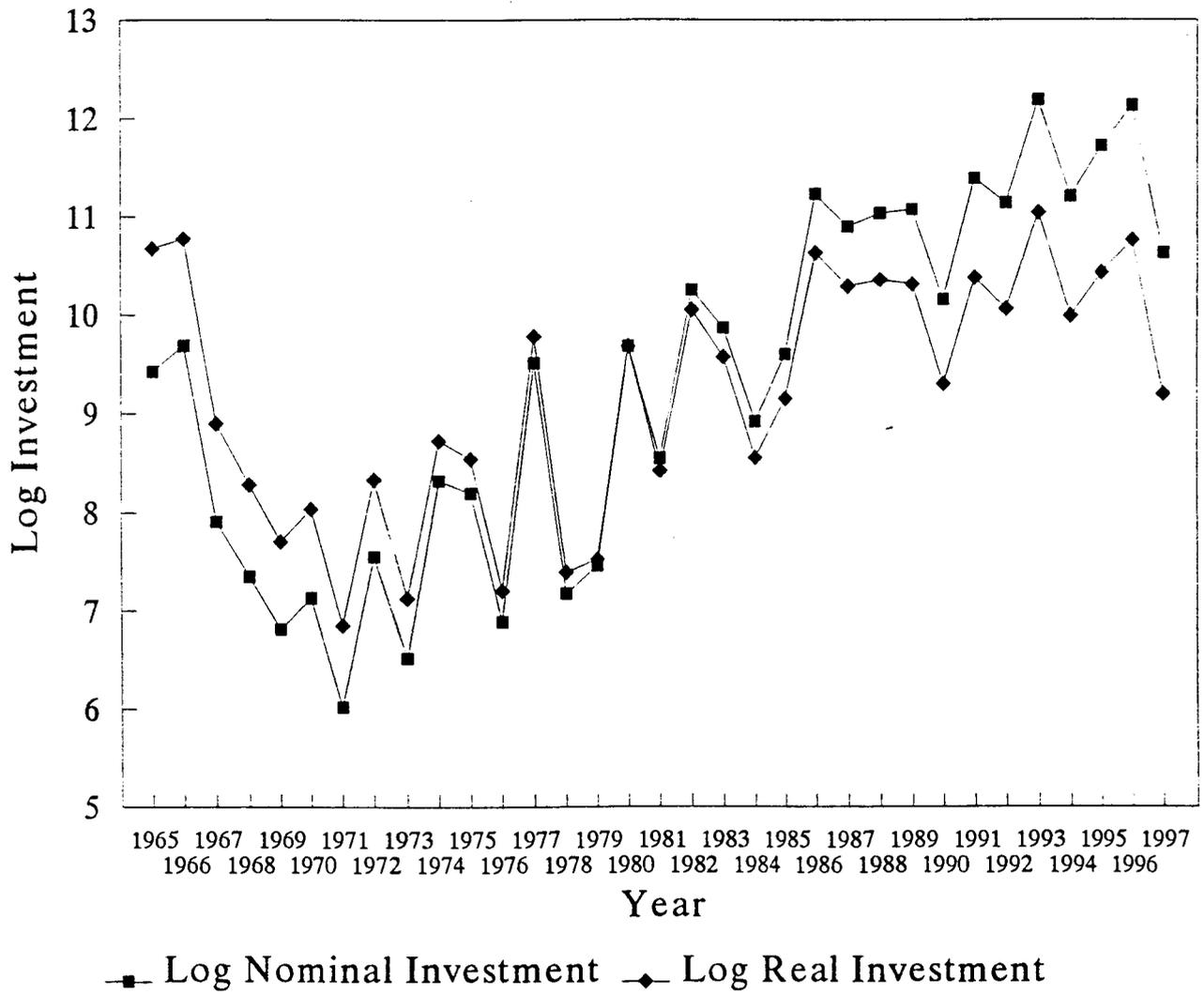
Chart 3.2: Employment Per Lakh Nominal Investment
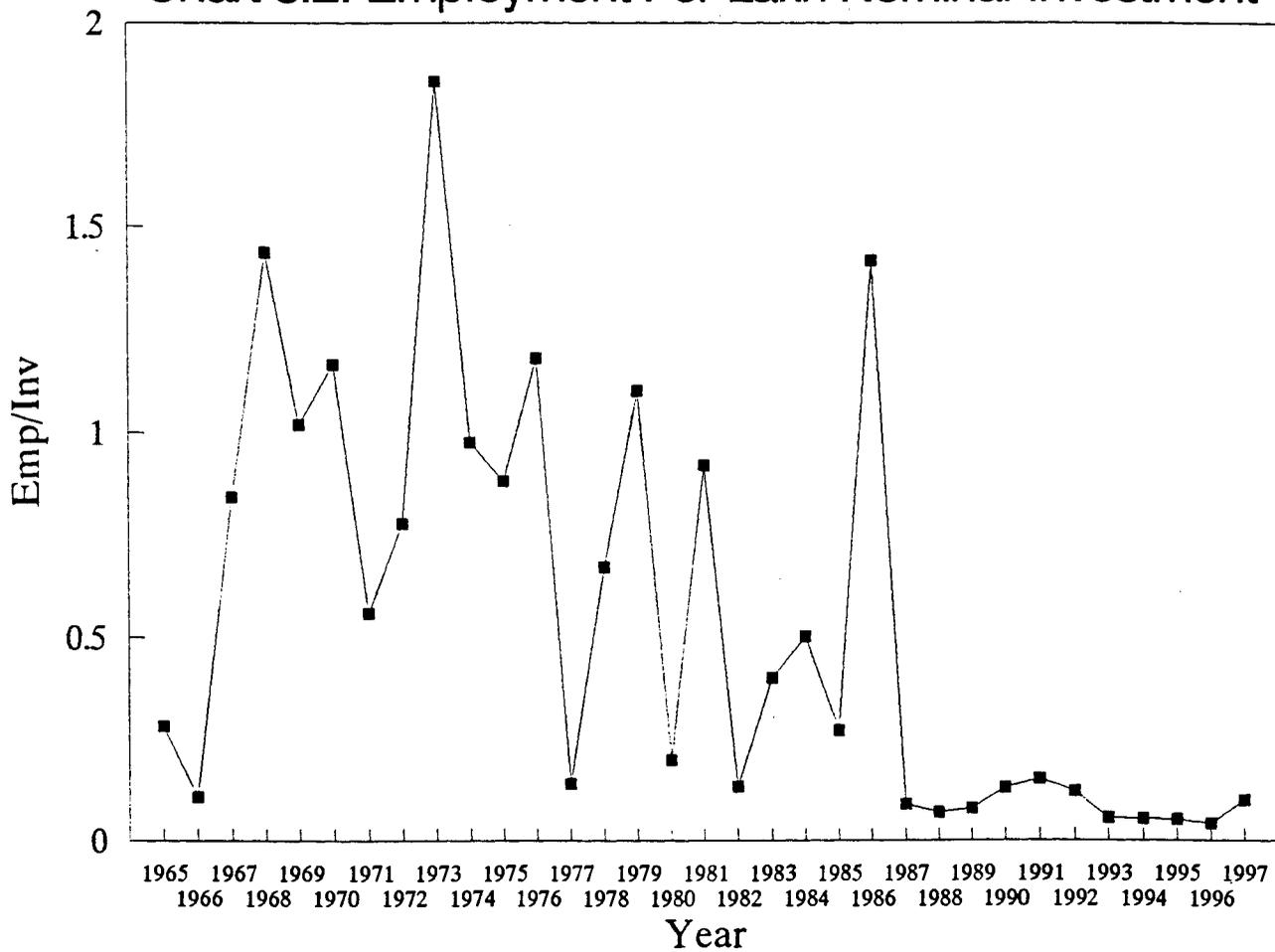
CHAPTER 4

COSTS OF INDUSTRIAL INCENTIVES

SALES TAX REVENUE: COLLECTIONS

4.1   _Collections_: The total tax revenue for the year 1997-98, from general sales tax (GST) and central sales tax (CST) was Rs. 2065 crore (table 4.1). Of this, Rs. 1360 crore (65.87 per cent) was collected from the advanced districts, and the remainder from backward districts (11.47 per cent from category A, 2.42 per cent from category B, and 20.24 per cent from category C). The constituent districts in each backwardness group (A, B, C) are listed in appendix A. Entry tax yielded another 319 crore.

4.2   _Share of GST_: General sales tax (GST) on sales within the state as a percentage of total sales tax (GST + CST on sales outside the state) lies between 76 to 79 per cent during the five-year period from 1993-94 to 1997-98. In 1997-98 its share was 79.03 per cent (table 4.1).

4.3   _Growth rate of collections_: The trend growth rate of sales tax was 13.88 per cent per year over the period 1993-98.

4.4   _Performance by backward district grouping_: The disaggregated trend growth rates over the period 1993-94 to 1997-98 are as follows: 15.67 per cent for the advanced districts; (-)1.61 per cent for category A districts; 25.57 per cent for category B districts; 21.04 per cent for category C districts. There is no clear pattern in terms of GST shares by backwardness grouping. For example, GST shares were the highest in category B districts in all years except in 1997-98, when category B had the lowest share.

TAX HOLIDAYS: REVENUES FOREGONE

4.5 *Tax exemptions/deferment*: Data supplied by the Department of Commercial Taxes, Government of Madhya Pradesh, listing the LMI units that have been granted tax concessions under all schemes starting from the 1981 scheme, show that at the start of 1998 a total of 232 units carried exemption/deferment status. Of these, 59 (25.43 per cent) had opted for deferment, and 173 units for exemption. Since some units produce more than one product, our revenue foregone exercise is based on a total of 193 tax-exempt products.

4.6 *Revenue deferred*: Under the deferment scheme, revenues are not surrendered but merely postponed. To that extent, revenue from tax-deferred units should not be treated as a loss to the exchequer in the same way as revenue from tax-exempt units (disregarding the opportunity cost of the interim interest-free loan that the government is in effect giving on deferred revenue). Paradoxically, data on tax deferred is in principle available where data on tax exempted are not, because units opting for deferment are assessed for tax dues, and an administrative order is passed on the amount deferred; this exercise is not performed for tax-exempt units. This indeed offers the second of the two advantages of the deferment option to the opting unit; the amount of sales tax deferred can be deemed to have been paid and is therefore deductible for payment of corporate income tax. However, data on total revenues deferred were not made available to us.

4.7 *Departmental estimates of revenues lost from tax exemption*: The Department of Commercial Taxes arrives at an approximate estimate of the revenue foregone with the help of a restricted sample of industrial units within the jurisdiction of Commercial Tax Division III, Indore. Estimated revenue foregone from this sample was blown up to arrive at an aggregate state-wide figure of Rs 500 crore. Their methodology is not known to us. However, the percentages of total sample turnover subject to within-state sales tax, and the further breakdown of this by GST and CST, have been used in our calculations.

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4.8   *Available data on tax exempt units:* The data supplied to us on tax-exempt units did not have information on annual turnover for any year. Thus estimation of revenue lost required the imputation of turnover for 1997-98 from figures of installed capacity figures in physical units, which were available to us.

4.9   *Product categories:* The products produced by the set of tax exempt units were classified in nine categories as follows:

1.   agro-based products.
2.   paper and related products
3.   yarn and related products
4.   metal and related products.
5.   construction materials
6.   chemical and related products
7.   vehicles and related products
8.   electrical instruments
9.   miscellaneous

4.10   *Prices for 1997-98:* Data on ex-factory prices were not available. Therefore, prices were primarily obtained from two sources. Wholesale prices (absolutes rather than an index) for some important categories of products are available in published form for 1993-94. These were updated using product-specific (the closest approximation) wholesale price indices. There is an important drawback with using wholesale prices to generate sales tax revenue losses, since wholesale prices are inclusive of (first-point) sales tax levies. In order to provide a cross-check on the margin of error from the use of wholesale prices, an alternative set of prices for 1993-94 were computed from Central Excise Statistics on value and quantum of clearance for levy of excise.[12] The Excise source surprisingly yielded a set of prices higher in general than the set obtained from wholesale prices. Although this indicates that the data from one or both sources may be in error, the exercise served at least to establish that our estimates based on wholesale price data may not necessarily be biased upwards. The second source of price information which we have used in our

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[12]   Government of India, Statistical Year Book of Central Excise 1993-94,

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estimate of revenue lost were market surveys in Indore and Bhopal. There were a few products on which no price data were obtainable from any source (on account of unclear or too wide product specification).

1. Some categories of cotton yarn
2. Immunological reagents
3. Ampicillic trihydrate
4. Cabine and baliesses
5. Tyre bead wire
6. Video cassette tape
7. Polyurethane foam
8. Rubber and plastic products
9. Reciprocating P.

4.11 _Turnover._ The turnover from these nine categories at an assumed 75 per cent of installed capacity is Rs 19751 crore. At a lower capacity utilisation factor of 50 per cent, the estimated turnover turns out to be Rs 13289 crore. The sector-wise breakdown is as follows:

Sectoral Turnover (1997-98)

(Rs. crore)

	75 per cent capacity	50 per cent capacity
Agro	8313	5542
Paper	10	7
Yarn	2905	1937
Metal	2182	1455
Construction	411	274
Chemical	336	224
Vehicle	750	626
Electrical	4052	2702
Miscellaneous	792	528
Total	_19751_	_13289_

4.12 *Revenue lost from tax exemption:* Of total turnover at 75 percent of installed capacity, taxable turnover is taken to be 52 percent of the total, the remainder being accounted for by exports (29 per cent) and consignments (19 per cent) out of the state which are not subject to CST. Of this 52 percent, 23 percent constitutes within-state sales subject to GST and 29 percent sales outside the state subject to CST. These assumed shares were obtained from figures for industrial units located within one of the jurisdictions of the Commercial Tax Department, for the year 1997-98. The appropriate product-specific tax rates inclusive of surcharge[13] have been applied to the shares of within-state and out-of-state sales given above, to obtain an estimate of the revenue foregone due to sales tax exemptions. The revenue loss so estimated works out to approximately Rs. 440 crore, of which the GST loss is Rs 271 crore, and the CST loss is Rs. 169 crore. This figure underestimates total revenue foregone because it excludes nine tax-exempt products for which we do not have price data, and does not include revenue lost due to tax payable on inputs purchased by the tax-exempt units from non-exempt units.

4.13 *Total revenue lost:* It must be kept in mind that any exercise of the kind performed here assumes that the investments in question would have occurred even in the absence of the tax exemption. **It is only on the basis of the finding in chapter 3 that tax exemptions did not have a statistically significant impact on investment in Madhya Pradesh, that the revenue estimates of this chapter are predicated.** That is why this chapter follows the presentation of the econometric findings in chapter 3. The information gathered from what were admittedly unstructured field interviews with industrialists and associations in Madhya Pradesh bear out the econometric evidence on tax concessions not having been a major inducement, especially till the early nineties. Since the revenue lost today is on account of units which entered into the state largely prior to the early nineties, we believe that the assumptions underlying the revenue loss exercise are justified.

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[13]   A 15 per cent surcharge was imposed on GST for all taxable commodities with effect from August 28, 1997.

4.14 _Comparison with departmental exercise:_ The estimate obtained here of Rs 441 crore is well below the official estimate of Rs 500 crore approximately. Thus, it is clear that our estimate do not overstate the revenue loss from tax exemptions. It is possible that the departmental estimate includes revenue lost due to tax payable on inputs purchased by the tax-exempt units from non-exempt units, which our estimate does not.

CAPITAL AND INTEREST SUBSIDIES

4.15 _Expenditure:_ No data were available on expenditure by the state government on capital and interest subsidies.

Table 4.1

Sales Tax Collections

(In Rs. Crore)

Districts	Tax Collection 1997-98		
	GST	CST	Total
Advanced	1207	153	1360 (65.87%)

Backward:
        Category 'A'
        Category 'B'
        Category 'C'
	
	122
	26
	277
		
		115
		24
		141
			
			237 (11.47%)
			50 (2.42%)
			418 (20.25%)

Total	_1632_ _(79.03%)_	_433_ _(20.97%)_	_2065_ _(100%)_

Source: Department of Commercial Taxes, Government of Madhya Pradesh, Indore.

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Table 4.2

Revenue Loss from Sales Tax Exemption

(Rs. crore)

Products	No. of producing units	Revenue lost (at 1997-98 prices)		
		GST	CST	Total
Agro-based:				
Soya solvent ext./refined oil	16	42.22	29.12	65.83
Flour	4	0.84	1.16	1.90
Soya nuggets/meal	3	0.64	0.45	1.01
Soya milk	4	0.01	0.01	0.02
Refined veg. oil	13	9.86	6.79	15.36
Deoiled cake	2	1.64	1.14	2.57
Wheat products	2	0.79	1.09	1.78
Fruit beverages/juices	2	0.10	0.21	0.30
Potato chips/snacks	4	0.23	0.31	0.51
Macaroni	1	0.00	0.00	0.00
Cereal food	1	0.00	0.00	0.00
Aerated water	1	0.03	0.04	0.07
Corn starch	1	0.48	0.33	0.75
Vanaspati	2	1.32	0.91	2.06
Total		*58.18*	*41.56*	*99.74*
Paper and related products:				
Coated paper	1	0.06	0.07	0.12
Duplex boards	1	0.05	0.05	0.09
Total		*0.10*	*0.12*	*0.22*
Yarn and related products:				
Cotton seed	2	1.91	2.09	3.74
Cotton rui	1	0.91	1.00	1.79
Lint cotton	1	0.10	0.11	0.20

Products	No. of producing units	Revenue lost (at 1997-98 prices)		
		GST	CST	Total
Cotton yarn	9	1.02	1.13	2.02
Cotton yarn cellular spun	1	0.14	0.15	0.26
Blended yarn	7	1.90	2.06	3.71
Manmade fibre yarn	6	2.14	2.35	4.21
Wool fabric	2	0.23	0.25	0.46
Worsted yarn	1	0.06	0.07	0.12
Synthetic yarn	3	0.94	1.03	1.85
Nylon	2	5.57	6.10	10.94
Cast polyester	1	0.15	0.17	0.30
Spun silk yarn	1	0.01	0.01	0.02
Textiles	1	0.48	0.53	0.94
Mixed blended yarn	1	0.15	0.17	0.30
Polyester child cloth	1	0.05	0.05	0.09
Reg. cap	1	0.07	0.08	0.14
Total		*15.82*	*17.35*	*33.17*
Metals and related products:				
Tungsten filament wire	1	0.46	0.64	1.05
Sponge iron	2	1.51	1.04	2.34
Pig iron	1	8.57	5.91	13.36
Flat rolled products of iron	1	0.06	0.04	0.10
Steel cords and wires	2	1.46	1.01	2.28
M.S casted blooms	1	0.05	0.03	0.07
Steel round bars	1	1.51	1.04	2.34
M.S slabs	1	1.39	0.96	2.17
Steel castings	2	1.86	1.29	2.91
Strips and coils	4	4.11	2.83	6.41
Ingots and billets	3	1.83	1.26	2.85
Steel pipes	1	0.67	0.46	1.05

Products	No. of producing units	Revenue lost (at 1997-98 prices)		
		GST	CST	Total
Silicon	1	0.00	0.00	0.00
Alum. extruded product	1	0.43	0.30	0.67
Zinc	1	0.21	0.15	0.33
Smokeless coke	1	0.05	0.04	0.08
Galvanized steel pipes	1	0.67	0.46	1.04
Ferro-manganese, ferro-silicon	1	0.43	0.29	0.66
Ferro-chrome	2	1.41	0.97	2.20
Other ferro alloys	2	0.43	0.29	0.66
Re-rolled products of iron	1	0.28	0.19	0.43
Cold-rolled coils	1	1.30	0.90	2.03
M.S welded tub. profiles	1	0.01	0.01	0.02
Total		*28.66*	*20.10*	*48.76*
Construction materials:				
Portland cement	9	4.78	9.89	14.05
Clinker	2	2.35	4.84	6.88
Ceramic tiles	1	0.20	0.39	0.56
Total		*7.33*	*15.13*	*22.46*
Chemical and related products:				
Sulphuric phosphate	1	0.37	0.40	0.72
Cyoctra cylene sodium	1	Neg.	Neg.	Neg.
Borax	1	0.06	0.06	0.11
Industrial alcohol	1	0.06	0.06	0.11
Pigments	1	0.29	0.31	0.56
Sulphuric acid	1	0.14	0.15	0.27
Linear alkyl benzene sulpho	2	0.10	0.12	0.21
Synth. detergent powder	1	0.32	0.35	0.62
Detergent cake	1	0.24	0.26	0.47
Oleum	1	0.01	0.01	0.02

Products	No. of producing units	Revenue lost (at 1997-98 prices)		
		GST	CST	Total
Sorbitol	1	0.09	0.10	0.19
Rifampicin	1	0.87	0.96	1.72
Acrylonitrile	1	0.08	0.09	0.17
Photographic chemical	1	0.00	Neg.	Neg.
Formaldehyde	1	0.08	0.08	0.15
Polyprocen bottle/dextrose	1	0.70	0.77	1.39
Resins	1	0.43	0.16	0.53
Total		*3.84*	*3.90*	*7.74*
Vehicles and related products:				
Vehicles	1	1.43	9.51	10.75
Wheeled tractors	1	0.06	0.06	0.11
Automobile tyres	1	13.57	4.96	16.76
Automobile tubes	1	0.71	0.26	0.88
Scooter tyres and tubes	1	0.16	0.06	0.21
Taped leaf/autoparabolic	1	0.05	0.05	0.09
Chassis frame	1	0.17	0.19	0.34
Total		*16.15*	*15.09*	*31.24*
Electrical instruments:				
Fluorescent lamps and tube	2	46.71	20.49	61.11
Dry cells	1	7.14	2.61	8.82
T.V. receivers	3	0.72	0.27	0.90
T.V. picture tubes	2	19.42	7.10	23.99
Video cassettes and tapes	1	0.24	0.09	0.29
Elec. copy machine	1	0.71	0.26	0.88
Microwave ovens	1	0.58	0.21	0.71
Computer monitor	1	0.60	0.22	0.74
Cold telerecording set	1	0.06	0.02	0.07
Telephone instrument	1	0.24	0.09	0.30

Products	No. of producing units	Revenue lost (at 1997-98 prices)		
		GST	CST	Total
Electrolytic capacitors	1	42.85	15.66	52.92
Total		*119.28*	*47.00*	*166.28*
Miscellaneous products:				
Finished leather	1	14.88	6.53	19.46
HDPE/PP bags and fabrics	3	0.08	0.08	0.15
HDPE/PP woven sacks	1	0.06	0.06	0.10
HDPE/PP/LDPE film tapes	1	0.06	0.02	0.07
PVC sheeting	1	1.78	0.65	2.21
PVC pipes and fittings	1	3.16	1.15	3.90
Rigid PVC films	1	1.67	0.61	2.06
Disposable syringe needles	2	0.05	0.09	0.12
Film (biaxily poly film)	1	Neg.	Neg.	**Neg.**
Total		*21.74*	*9.19*	*30.93*
Grand total		**271.09**	**169.43**	**440.52**

Source: Government of Madhya Pradesh, 1998 Exemption/Deferment Report; Government of India, Ministry of Industry Index Numbers of Wholesale Prices in India (Monthly Bulletin for September 1994); market surveys in Bhopal and Indore.

CHAPTER 5

FIELD INTERVIEWS

OBJECTIVE

5.1 _Opinion of industrialists:_ Field interviews were conducted keeping in mind two broad objectives. The first was to obtain from entrepreneurs who have invested in M.P. their opinion on factors favourable to investment in the state, and factors adverse to investment. There could be three such sets of factors. First, those that affect industries across the board; second, industry-specific factors; and finally, those that impact on industries in a particular region. Needless, to say, some of these factors may complement each other. As we have discussed later, tax concessions seem to have gained in importance during the nineties. Therefore, the second objective of our field interviews was to assess the importance of tax concessions on the decision to invest in recent years. To this end we selected some industrialists who had signed Industries Entrepreneurial Memoranda (IEMs) between January 1996 and March 1999 to set-up plants in M.P. Some of these units have already begun production. They were asked in a questionnaire to rank the following reasons in terms of importance to their decision to investment in M.P.[14]

A.   Availability of raw materials.

B1.   Availability of uninterrupted power.

B2.   Availability of land.

C.   Familiarity with business environment (unit already exists in M.P.)

D.   Generous tax incentives (sales tax exemption or deferment) as compared to

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[14]   It may be noted that these units are not included in our econometric exercise in chapter 3. Since these entrepreneurs already have a stake in the state, there may be an (unquantifiable) bias in their response on policy variables, like tax incentives, vis-a-vis immutable characteristics of the state, like raw material availability.

Maharashtra, Karnataka, Andhra Pradesh and Gujarat.

5.2 *Area covered*: Field interviews were conducted extensively in five areas: (i) The industrial belt near Raipur including Urla Growth Centre and Siltara Growth Centre; (ii) Bhilai industrial area and Borai Growth Centre (Durg district); (iii) Jagdalpur industrial area (Bastar district); (iv) Indore including Pithampur Growth Centre and Dewas; and (v) Gwalior including Malanpur and Banmore growth centres. Moreover, we have interviewed many entrepreneurs in Delhi and Calcutta. These entrepreneurs have signed IEMs to set-up their plants in M.P.

FACTORS INFLUENCING INVESTMENT: COMMON ACROSS SECTORS/REGIONS

5.3 *Favourable factors*: The stated attractions of M.P. during the eighties for industries not based on local resources(minerals or timber), were principally three: (i) abundant land; (ii) no labour problem, and (iii) uninterrupted supply of power. Tax concessions did not seem to have been a major factor for attracting investment into M.P. until the early nineties.

5.4 *Importance of tax concessions*: The situation appears to have changed since the eighties. Favourable supply-side factors are absent today. The neighbouring states of M.P. have also been offering various incentives. Moreover, industries throughout the country have been passing through a phase of deep recession for some years. As a result, inter-state competition in incentives has intensified, and the advantages of incentives offered by M.P. have been neutralised by those offered by competing states.

5.5 *Power problem*: Today, the attraction of abundant power in M.P. no longer exists. Industries in MP, cutting across all regions and all sectors, suffer from irregular power supply and high industrial power tariffs. Moreover, the system of billing a unit on the basis of minimum demand rather than actual consumption along with Fuel Cost Adjustment Charges leads to much higher effective rates per unit of consumption in many industrial units. Table 5.1 shows that M.P. does indeed have

among the lowest shares of industry in total sale of power, but the average industrial tariff is only marginally higher in M.P. than in Maharashtra (table 5.2). Therefore, the allegation by various industry associations that the average industrial tariff is much higher in M.P. because the electricity charges are not based on actual consumption is not adequately supported by the figures in table 5.2. However, two points must be noted in this connection. Power tariffs have gone up significantly since the 1996-97 rates shown in the table (at present, the industrial power tariff is around Rs. 5 per unit including all charges except for low-end users), and there are wide variations in the power tariff as well on account of load factor penalty, electricity duty on energy charges, meter rent etc. Madhya Pradesh Electricity Board (MPSEB) also charges heavily for electricity connections (line cost). Finally, erratic power supply in M.P. is indeed a serious problem. Most of the power intensive Ferro Alloys industries in M.P. (with a total demand of 130 MW) and many mini cement plants are closed presently due to these problems. Furthermore, industries which get power through rural/ domestic feeders have to face power cuts during the agricultural season and during system-peak hours. Lack of power has forced many units to run on diesel generator sets, but because diesel has been shifted to schedule III recently, it does not qualify for input tax concessions. The current sales tax rate on HSD is 20 per cent. As a result, industries are incurring huge additional costs on purchase of HSD (some units like S.R.F. Limited in Malanpur have decided to take legal action against this decision; many units in Malanpur and Banmore prefer to pay 4 per cent CST and procure HSD from Mathura in U.P.).

5.6   _Tax exemption/deferment_: Often, the selection between tax exemption or deferment by a new unit is not something over which the unit itself has any control. We highlight three cases.

i.   Perfect competition in the Product Market: If each seller faces a horizontal demand curve, price competition among sellers compels all new units producing the same product to select the exemption option if that is what other units have opted for.

ii.   Monopolistic Competition: We assume that products confront segmented markets, because of either product differentiation, transport costs, or

information asymmetry. As a result, each new unit faces a negatively sloped demand curve. When demand is price-inelastic entrepreneurs prefer the exemption option because they can raise their prices upto the tax-inclusive price of older units. However, well informed buyers invariably can prevent new units from doing this. Under these circumstances, new units may choose deferment, which gives them an interest-free loan. On the other hand, they may stay with exemption and lower prices if demand is price-elastic, i.e. the more market conditions approach perfect competition.

iii.   Monopsony: When the number of buyers is very small, suppliers may be forced into opting for exemption, even though they themselves may prefer the deferment option.

5.7   _Expiry of tax exemption:_   Once the period of tax exemption is over, industries find it very difficult to compete with new units who still get the exemption. It was reported that Raipur Flour Mill was forced to shut down because Jagdamba Flour Mill in Raipur could sell its product at a lower price because of sales tax exemption. This has also been reported to us by many units in Malanpur and Banmore. An old unit can only compete with other exempted units in the industry if it has achieved lower unit costs of production owing to the lower interest burden. The competitive edge offered by a tax holiday is also clearly a function of sales tax rates. For example, a recent notification (A3-63-98-ST-V(32) dated 17-06-98) reduced the sales tax rate for rolling mills to two percent, thus effectively reducing the competitive edge of tax exemption for rolling mills.

5.8   _Default on deferment:_ The deferment option, although preferred by many, is not free from troubles. Many units that have opted for determent but do not charge sales tax or impose a reduced rate to retain the competitive edge during the deferment period are sure to default after the deferment period is over.

5.9   _Industry preferences_: Industrial units and industries associations interviewed expressed four preferences during our meetings with them.

i.   The exemption option should be abolished.

ii. If tax exemptions are retained, they should be extended to cover the revival phase of a closed/sick unit.

iii. While giving tax exemptions to large industries, it should be ensured that more than 50 per cent of their purchases are made from industrial units situated within the state (this will mean buyers being forced to buy from possibly inefficient high-cost producers in MP).

iv. At present tax exemptions are not available to Iron & Steel plants with an investment in plant and machinery below Rs.1 crore. The industry associations want this condition to be waived. Since M.P. enjoys a comparative advantage for steel plants, the acceptance of this demand may promote setting up of mini steel plants in the state.

5.10 _Labour laws_: Various industries and their associations have conveyed their displeasure with the Minimum Wage law. They wish it to be delinked from the price index; and an exemption for small scale industries employing upto 30 employees from the Minimum Wage Law. This demand is surprising in view of the fact that many uneducated and unskilled labourers are often paid less than the minimum wage anyway, despite labour laws.

5.11 _Procedural delays and harassments_: Most industrial units and associations spoke of the adverse impact of procedures of multi-window clearance, and harassment by various inspectors.

5.12 _Interest rate subsidy_: Many small scale units feel that the provision of interest rate subsidy (maximum Rs 25,000) is grossly insufficient considering their loan requirements (see also para 2.13).

FACTORS INFLUENCING INVESTMENT: SECTOR-SPECIFIC

5.13 _Ferro alloys_: The ferro alloys industry made its debut in M.P. in 1989. The number of units rose to 22 by 1995. The steep hike after 1995 in the power tariff and Fuel Cost Adjustment charges imposed by MPEB has led to the closure of all 22

units. Total investment on these plants was about Rs.200 crore and 20,000 workers were involved directly or indirectly. The ferro alloys industry association had already submitted a proposal for power tariffs in line with West Bengal with incentive/penalty upto 25 per cent depending on the load factor:

a. Less than 20% load factor   25 % penalty

b. 20 - 30 % load factor   20 % penalty

c. 30 - 40% load factor   10 % penalty

d. 40 - 60% load factor   Nil

e. 60 - 70% load factor   10 % incentive

f. 70 - 80% load factor   20 % incentive

g. above 80% load factor   25 % incentive

The National Thermal Power Corporation (NTPC) power has also been a controversial issue for these units. The Central Electricity Authority sanction of 35 MW power to the ferro alloys industry out of the unallocated NTPC quota at subsidised rates was not made available to them, although it was available to ferro alloy units in other states (eg. Orissa, Maharashtra and Andhra Pradesh). Setting up of captive power plants can be a feasible solution. However, each ferro alloys unit requires massive investment for captive power, and currently there is no concession/subsidy for investment in captive power plants.

5.14 *Mini steel plants*: The secondary steel industry faces high competition from East Asian countries, and inadequacy of demand arising out of recession in all industries.

5.15 *Bhilai ancillary industries*: Problems specific to the ancillary industries in the Bhilai Industrial Area, currently passing through a bad phase, are as follows:

a. Lack of demand due to recession in steel industry;

b. Competition from West Bengal;

c. Delay in payments from Bhilai Steel Plant;

d. Squeeze in the market share of the existing units due to the emergence of new units; and

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e. High sales tax rate leading to conflict between old and new units

5.16 *Mini cement plants*: Mini cement plants are suffering owing to a sharp hike in the price of coke breeze (plants with vertical shaft kiln process), and non-availability of limestone. Two plants in the Jagdalpur industrial area are denied limestone quarrying access under the Conservation of Forest Act (1980) even while they are in possession of quarrying leases from the Government of Madhya Pradesh.[15]

5.17 *Saw mills*: All saw mills in the Bastar district are faced with acute shortage of their principal raw material, namely, timber. Environmental issues, especially the Conservation of Forest Act are believed to be the cause of this hardship.

5.18 *Edible oil extraction*: Most of the oil extraction plants are operating with high unutilized capacity. Plant owners attribute this to lack of demand due to the central government's liberal import policy. Soyabean extraction plants are also facing shortages of soyabean.

5.19 *Granite products*: A unit in Jagdalpur engaged in the manufacture and export of granite monuments, dining tables etc. is almost on the verge of collapse owing to the lack of export demand. Moreover, these units are not eligible for sales tax exemption on sales to the domestic market because their production process does not qualify as a manufacturing process.

FACTORS INFLUENCING INVESTMENT: REGION-SPECIFIC

5.20 *Jagdalpur industrial area (Bastar district)*: The sector-specific factors earlier enumerated assume the character of regional factors when there is a concentration of industries in a particular region. Bastar district is endowed with minerals including

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15. With a view to checking deforestation the President promulgated on 25 October 1980, the Forest (Conservation) Ordinance, 1980. The ordinance made the prior approval of the Central Government necessary for dereservation of forests and for use of forest land for non-forest purposes.

iron ore, limestone, and bauxite. Bastar district is also especially rich in forest resources. Thus, the mini steel plants, cement, paper, timber products, saw mills, plywood and various items based on bauxite and granite which have located in this region suffer from the sectoral obstacles applying in these particular sectors. Environmental regulations are depriving entrepreneurs of mining and besides adversely affecting the supply of wood. There is a second problem in that Jagdalpur is not connected to Durg (the location of Bhilai steel plant) by railway. There is, however, a proposal to extend the railway track from Dalli-Rajhara (which is connected to Durg) to Jagdalpur, via Rowghat. The estimated cost of the track from Dalli-Rajhara to Jagdalpur via Rowghat Mine has been estimated at Rs.381 crore. Steel Authority of India Limited (SAIL) is committed to contributing Rs.134.96 crore towards this.

5.21 _Dewas industrial area_: Non-availability of water and poor roads are two important factors that are obstructing industrial growth in this area.

5.22 _Growth centres_: All growth centres are not equipped with adequate infrastructural facilities. Roads, water, street lights and drainage are not adequately provided. Though the development charges are being taken, industries feel that there should be more transparency as far as the uses of funds are concerned.

SUMMARY OF SURVEY RESULTS

5.23 _Survey responses:_ The responses of the entrepreneurs interviewed are summarized in table 5.3. These are entrepreneurs who have signed IEMs. Familiarity with the business environment was reported to be a major determinant of the decision to invest in M.P., followed by raw material availability. The ranks clearly show that availability of power is no more a major attraction for M.P. Forty per cent of respondents ranked tax concessions among the top two (of five) reasons for investing in M.P.; forty per cent ranked tax concessions either last or irrelevant to the decision to invest in M.P.

5.24 _Conclusion_: The overall impression from both the interviews of functioning industrial units and industry associations, and the questionnaire-based survey of potential entrants, is that sustained growth can only be achieved if power supply and other basic facilities such as good roads and water are improved. Incentive schemes can at best complement these factors, but cannot supplant them.

Table 5.1

Share of Industry in Total Sale of Power
1996-97

Madhya Pradesh	35.7
Maharashtra	36.6
Gujarat	38.4
Rajasthan	39.7
Andhra Pradesh	39.0
Karnataka	23.2
Orissa	50.1

Source: Planning Commission, 1997, Annual Report of
the Working of SEBs,

Table 5.2

Average Tariff: 1996-97

(Paise/Kwh)

	Domestic	Industrial
Madhya Pradesh	66.73	267.65
Maharashtra	125.00	263.60
Gujarat	130.00	245.42
Rajasthan	106.89	242.52
Andhra Pradesh	112.30	248.41
Karnataka	86.71	229.79
Orissa	98.00	209.30

Source: See table 5.1

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Table 5.3

A Numerical Assessment of Investment Determinants
(Total Respondents:20)

(per cent)

Determinants of investment	Rank					Not rele-vant	Total
	First	Second	Third	Fourth	Fifth		
Availability of raw materials	25	15	5	25	10	20	100
Availability of power	10	15	15	40	5	15	100
Availability of land	20	25	35	5	0	15	100
Familiarity with business environment	30	5	10	15	15	25	100
Tax concessions	10	30	20	0	30	10	100

CHAPTER 6

CONCLUSIONS AND SUMMARY OF RECOMMENDATIONS

6.1 *Industrial incentives:* Like other states, Madhya Pradesh has sought to promote industrial development by offering fiscal incentives. The ultimate objectives of attracting industrial investment into a state, which include among them the long term enhancement of the state's taxable capacity, were sought to be achieved by a short-run sacrifice of fiscal resources through incentives of three types:

A. Capital Investment Subsidies

B. Interest Subsidies

C. Exemption/Deferment from Sales Tax

A recent Inter-state agreement on 16 November 1999 has slated sales tax incentives for withdrawal by 1 January 2000. A further date for introduction of a VAT has been set at 1 April 2001. This agreement does not include capital subsidies within its ambit. Capital subsidies are the norm; every state bordering M.P. offers them barring Rajasthan, which has an interest subsidy instead. M.P. is the only state offering both a capital subsidy and an interest subsidy.

6.2 *Growth centres:* Overlaid on the system of state-level subsidies and tax concessions is the growth centre approach, whereby basic infrastructure facilities like power, telecommunications and water are provided at nodal points in backward areas to attract private industry. This is clearly an alternative conception of industrial incentives, and is in consonance with field evidence on the importance of infrastructure as an inducement for industrial entry.

6.3 *Attractions of better infrastructure:* Field interviews with a wide range of industrialists and sectoral industrial groups overwhelmingly point to the importance

of power abundance in Madhya Pradesh in the eighties as the chief attraction of the state at that time. There has been severe erosion in the relative standing of the state since then. A survey of potential investors shows that power availability is no longer the major attraction it once was. If infrastructure investment in the power sector restores the advantage the state once enjoyed, that alone will attract industrial investment back into the state. This investment need not necessarily be publicly funded; private investment in power generation and transmission will enter, if the prices are right. This in turn calls for examination of the tariff structure for power in the state. What is important to emphasise is that the land-locked situation of Madhya Pradesh does not in and of itself call for an edge in terms of fiscal incentives over other states that are not land-locked. The excessive significance attached to land-locked geographical locations derives from recent work by Gallup and Sachs (1999) highlighting the development retarding role of unfavourable geographical attributes. It is important to recognise that the confinements of international borders do not apply in the case of land-locked sub-national units within a larger federation, and that even within India, there are examples of land-locked states like Punjab with a better growth record than that of coastal states like Orissa. Further, as pointed out by Krugman (1999), geographical factors that have been obstructive in the past may cease to matter with improvements in transport and telecommunications.

A.   Main Findings of This Study

6.4   _Costs of industrial incentives:_   Subsidies whether for capital investment or interest cause a direct outflow from the exchequer. Tax concessions carry a cost in terms of revenue foregone. Although M.P. is not uniquely under fiscal stress, relative to its neighbouring states, it is not in a comfortable fiscal situation. Industrial incentives which carry a cost to the exchequer cannot be lightly given away. The official estimate of revenues lost due to tax concessions, at approximately Rs. 500 crore, appears to be just about right. The exercise performed in chapter 4 yielded an estimate of revenues lost from tax concessions of **Rs 440 crore**, on the basis of 193 tax-exempt products, and excluding 9 classes of products on which price data were not obtainable. **No official data are available on expenditure on capital and**

interest subsidies. The fiscal resources lost through industrial incentives carry a heavy opportunity cost. They could have been used instead to build up infrastructure which is an overriding attraction for industrial investment. Madhya Pradesh is in particular need of investment in roads and telecommunications, which are underprovided in the state relative to the national average. Recent contributions to the development literature, such as Krugman (1999), stress the importance of infrastructure facilitation in terms of better transport and telecommunications, in driving the growth dynamic. **Even if the limited estimate obtained here of the fiscal cost in a single year of industrial incentives, limited to taxes foregone alone, had been spent on providing growth centres instead, there could have been, using the target expenditure for each centrally-sponsored growth centre of Rs 35 crore (rather than actual expenditures which exhibit evidence of having been fiscally constrained) a minimum of a dozen new growth centres fully developed every year.** This is the cost the state has surrendered by opting for fiscal incentives in terms of sacrificed infrastructure. Alternatively, this sum could be used to build up growth centres already in existence, which are presently suffering from inadequate funding. The Dewas growth centre, for example, was discovered on field visits to suffer from water shortage and poor roads, not surprising in view of the low investment so far of only Rs 12 lakh by the state government. Shoring up infrastructure in growth centres already in existence will reverse the slump in investment in recent years in the state.

6.5 *Explicit versus hidden costs:* Tax concessions carry a cost to the exchequer that is hidden (revenues foregone) in contrast to capital subsidies, which carry a commitment to an explicit expenditure. The impact of this is clearly visible in the enhanced tax concessions for large units (variously designated as premier/pioneer/ prestigious/mega units across states) which are at odds with the inverse concession rate structure by scale. These demonstrate clearly the scope for fiscal subversion where fiscal costs are hidden and not explicit. There is also a far greater proliferation of special provisions and clauses in respect of each dimension along which enhancements are offered, than in the case of capital subsidies.

6.6   *Benefits of industrial incentives:* This study has attempted an econometric estimation of whether subsidies/tax concessions in the state have conferred benefits commensurate with their cost to the state exchequer. In a scenario where different types of industrial incentives are superimposed on each other, the overall impact on investment is additive. The disentangling of the incremental impact of each has been attempted in two ways. The first of the two methods examines each incentive for policy changes over time along dimensions specific to each to mark transition points to more (or less) generous regimes. There are then superimposed on each other to obtain an identification of regimes jointly unchanging in respect of both subsidies and concessions. Three regimes are so identified for the period since 1971, broken at 1981 and 1988. Having demarcated the regimes, the growth rate of investment in the different regimes is econometrically estimated from a data base on large and medium industries supplied by the Industries Department, and the differences if any examined for statistical significance. The second formal exercise attempted with the same data is an investment function for real investment as a per cent of SDP over the period 1971-96. No data were available on SSI; the lack of data on investment in SSI is a nationwide problem and is not by any means limited to M.P. alone.

6.7   *Econometric results:* Both econometric exercises show that tax concessions have had a statistically insignificant impact on large and medium investment in the state. The results on the capital subsidy are more ambiguous. The slowing of the growth rate of real investment after 1988 cannot be ascribed solely to withdrawal of the central subsidy, which was available to large and medium units, and its replacement by the state subsidy scheme which (with some minor exceptions) was not available to large and medium units. There was a sharp decline in the nineties in power availability which added its unfavourable impact in a state where, as the field interviews revealed, power abundance had been a major attraction in the eighties. The investment function estimated shows a statistically significant positive impact of industrial unrest in West Bengal on investment in Madhya Pradesh. This is an important finding. It confirms the importance of cross-state effects and underlies the importance we give to a common cross-state initiative. It also shows the importance of factors other than fiscal incentives in the competition between states for industrial

investment.

6.8   *The counterfactual:* Since the formal econometric exercises performed on the data base in large and medium industries shows that tax concessions had no impact on either the growth rate of real investment or on the rate of investment (as a per cent of SDP), the counterfactual predictions for what might have obtained in the absence of tax concessions are no different from those actually observed. But had the adverse conditions which reduced investment after 1988 not occurred, investment might have been higher. One of these adverse conditions was the withdrawal of the central subsidy for large and medium industries, but there were other adverse concurrent developments as well, such as the sharp deterioration in power availability. Field interviews affirmed the importance of power abundance in the eighties as a factor attracting investment into Madhya Pradesh. The loss of this relative advantage would have been a major contributor towards slowing investment in the nineties in the state.

B.   Restructuring the Capital Subsidy

6.9   *Need for a common cross-state policy on industrial incentives:*   Madhya Pradesh cannot possibly formulate a unilateral policy on an issue where it is the inter-state balance of advantage which matters. Since both the western and eastern industrial corridors straddle state boundaries, there is an imperative need for a united approach to capital subsidies along the lines of the inter-state Agreement on tax incentives. The chief advantage accruing from such a cross-state platform is that it imposes external discipline and reduces the scope for subversion at the margin by large units able to negotiate special eligibility for themselves, or by other special interest groups. An inter-state agreement strengthens the hands of individual state governments in enforcing rule-based policy regimes. The scope for unilateral action, as listed in Section C of the recommendations that follow is confined to pointing out internal inconsistencies, if any, and the scope for rationalisation within and across schemes as they are presently structured.

6.10 _A first-best agreement on capital subsidies:_ The econometric evidence on benefits of capital subsidies is somewhat more ambiguous than for tax concessions (chapter 3). However, given the field evidence (chapter 5) on the overwhelming importance of infrastructure in attracting industry into a state, the first-best option is surely the redirection of fiscal resources from capital subsidies towards infrastructure provision. It must immediately be added that to the extent capital subsidies carry a commitment to explicit expenditure, there is greater fiscal discipline and less proliferation of special provisions and clauses as compared to tax concessions.

6.11 _Objectives of industrial incentives:_ If the first-best option is not acceptable, an Inter-State Agreement has to rethink the objectives underlying capital subsidies, and examine whether a redesigned scheme might better promote those objectives. The revealed pattern of capital subsidies across states suggests a commonality of objectives with exceptions in each case: promotion of SSI with enhancements; and promotion of backward area location with a rate structure that varies directly with degree of backwardness. M.P. and neighbouring states (except Maharashtra) also have a thrust sector group of industries which get enhanced concessions. The thrust sector constituents vary across the states but there is a common core (para 2.4) consisting of labour intensive industries which is an excellent point of departure for a revised scheme confined to the thrust sector, in place of (as at present) a broader-based scheme with enhancements for the thrust sector.

6.12 _Objective 1: Infrastructure development:_ If the objective is to compensate units locating in backward districts for infrastructure inadequacy, which is the only reasonable inference from the rate structure by degree of backwardness, it might be possible to redefine the base for determination of the subsidy in terms of fixed investment in infrastructure alone. Expansion of the base for the capital subsidy to include infrastructure increases the fiscal cost of the scheme, and would not be as focused as a subsidy scheme confined to fixed investment in infrastructure alone (as for example for industrial estates in Karnataka, which are offered subsidies at the rate of 20 per cent as a percentage of investment in infrastructure). There is a theoretical justification for this, since infrastructure investment yields externalities for which the

private investor can rightfully be subsidised.

6.13 _Objective 2: Employment promotion_: If the objective underlying promotion of SSIs is to promote employment, this is not achieved by a subsidy on fixed investment which, ceteris paribus, encourages capital intensive techniques of production. The need for an employment thrust to industrial policy is paramount in view of evidence (chart 3.2) that employment per lakh of investment in large and medium industries has fallen to negligible levels in the nineties (see also Ghose, 1999, for the nationwide problem of poor growth in organised sector employment). Data on labour intensity in the small-scale sector over the long-term are unfortunately not available so as to assess the employment impact of capital subsidies, which after 1988 have been confined to SSI (except for cooperative sector units in backward locations, and pioneer units in growth centres).

6.14 _Employment-promoting subsidies_: Two employment-promoting alternatives for redesign of the investment subsidy suggest themselves:

i. The subsidy could be based on labour hired rather than fixed investment. Orissa already has in its tax exemption scheme, though not in its subsidy scheme, a provision for enhanced rates for labour intensive industries, where the rates are slabbed by fixed investment per employee. This however carries an enforcement difficulty, particularly given the reluctance of units to sign on permanent employees (given existing labour laws), and could as a consequence be a breeding ground for corruption.

ii. The other option is to confine a capital subsidy to a set of labour intensive thrust industries. There is already a thrust sector concept in place in every state except Maharashtra, with a common set of constituent industries across states which are clearly labour-intensive in character. The common constituents of the thrust sector across states are: garments, food processing, agro-based products, leather products, and electronics. This common core to the thrust sector (which may have additional constituents varying across states) is an excellent point of departure for a revised scheme confined to the thrust sector, in place of (as at present) a broader-based scheme with

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enhancements for the thrust sector.

6.15   The suggestions in paras 6.12 and 6.14 are not mutually exclusive. Thus, it is possible to define a new investment subsidy confined to a set of labour-intensive thrust industries, where the base for determination of the capital subsidy is confined to investment in infrastructure. These provisions could further serve the objective of regional dispersal of industry by being made applicable to location in backward areas alone.

C.   Unilateral Policy Options for Madhya Pradesh

6.16   _Interest subsidy_: A unilateral phase-out of the interest subsidy should be possible for M.P., since it is the only state which offers small-scale units both a capital investment subsidy and an interest subsidy. Other states either restrict their offer to Special Category Entrepreneurs (A.P. and Orissa), or have it in place of the capital investment subsidy (as in Rajasthan, where the investment subsidy is now restricted to agro-based units). Clearly, any interest subsidy maps onto a capital subsidy equivalent. What is certain is that the case for having both schemes in operation is very weak, because it fragments the total subsidy given, and increases transactions costs with no corresponding benefit, since the same target level of subsidy can be achieved with a single (either) scheme. Between the two, the interest subsidy, with its recurring payment requirement, is less preferable on grounds of higher transaction costs.

6.17   _Coherence across schemes:_

i.   If capital investment subsidies serve the purpose of compensating for infrastructure inadequacy at the point of location chosen by the investor, then location at a growth centre, which is a nodal point where infrastructure is better than in other locations, should not qualify the unit for the subsidy entitlement.

ii.   If on the other hand, capital investment subsidies and enhanced concessions are found to be necessary for attracting investment to growth centres, then the growth centre scheme itself, and the location of the centres, call for re-

examination.

iii.   If the capital subsidy scheme is confined to backward areas (with marginal exceptions, para 6.20) there is no case for extending tax concessions to advanced areas, as is presently the case.

6.18   *Rationalising capital subsidies:*   Pending redesign of the capital subsidy through a cross-state platform, there is considerable room for rationalisation of the capital subsidy scheme as it is presently structured.

6.19   *SSI focus of capital subsidy:*   The present focus of capital subsidies in M.P. on SSI, as in other states, is blurred in M.P. by the extension of the subsidy to LMI cooperatives (inv. > 1 crore) in backward areas, and to pioneer units in growth centres (first entrants with investment exceeding Rs. 3 crore). These kinds of relaxations at the margin can make the distribution of capital subsidies very skewed across units, with one or a few large units getting the largest share because of their overwhelmingly larger base relative to small units. The need is not so much for preservation of the focus on small-scale as for a coherent internally consistent and rule-based scheme that is predicated on clearly articulated objectives.

6.20   *Backward area focus of capital subsidy:*   The present focus of capital subsidies, in M.P., as in other states on backward areas is blurred by extension of the scheme to advanced districts, for thrust sector SSIs. If the objective is compensation for inadequate infrastructure, M.P. can unilaterally rationalise its scheme to exclude advanced districts, which by definition are better provided for in terms of infrastructure. This is only to retain internal consistency within the scheme as it is presently structured. There are on the other hand states like Rajasthan and A.P., which do not practise locational exclusion at all. What is at issue here is partial, discriminatory, exclusion, and the damaging effects this has on policy coherence and costs of administration.

6.21 _Elimination of Special Categories of Entrepreneurs (SCE)_: In the case of the investment subsidy, SCE (SC/ST) get an additional 10 per cent. These features increase the costs of administering any scheme, and constitute a breeding ground for corruption. All states do not have SCE's, and even where they do, the categories are not uniform across states. Thus, this is a feature calling for unilateral correction rather than a cross-state agreement.

6.22 _Limitation to start-up_: In MP and Gujarat, in what appears to be a departure from standard practice, the capital investment subsidy is also given for expansion and diversification provided the unit remains small. There are administrative advantages to limiting both schemes to a one-time entitlement at start-up, which is a well-defined and observable event. Extending it to subsequent expansion and diversification opens up avenues to misuse.

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APPENDIX A

BACKWARD DISTRICTS

Category 'A'

1.	Bilaspur	7.	Raipur
2.	Dewas	8.	Ratlam
3.	Hoshangabad	9.	Satna
4.	Khandwa	10.	Shahdol
5.	Mandsaur	11.	Ujjain
6.	Morena	12.	Vidisha

Category 'B'

1.	Betul	3.	Rajnandgaon
2.	Raigarh	4.	Sehore

Category 'C'

1.	Balaghat	13.	Narsinghpur
2.	Bastar	14.	Panna
3.	Bhind	15.	Raisen
4.	Chhatarpur	16.	Rajgarh
5.	Chindwara	17.	Rewa
6.	Damoh	18.	Seoni
7.	Datia	19.	Shajapur
8.	Dhar	20.	Shivpuri
9.	Guna	21.	Sidhi
10.	Jhabua	22.	Surguja
11.	Khargone	23.	Tikamgarh
12.	Mandla	24.	Sagar

APPENDIX B

CENTRAL INTEREST SUBSIDIES

Interest rates fall in the national rather than State-level policy sphere. In 1990-91 the structure of interest rates was linked to the size of loans rather than as previously to their purpose. With this, all sector-specific and program-specific lending rate prescriptions, except for the differential rate of interest (DRI) scheme and export credit, were discontinued.

The sector and program-specific lending rates in force prior to 1990 are tabulated in table B.1 (information on rates for the period prior to 1980 is awaited from the RBI). It can be seen from the table that rates on term loan for SSIs remained unchanged overtime. The rate on composite loans was reduced in 1983 by 1/4 percentage point for backward areas and by 1/2 percentage point for areas other than backward areas. There was no change in these rates thereafter. The rates for the other sectors (retail trade; transport operators; agriculture) also exhibit constancy over time.

It is important to note that, even had these rates not been constant over time, there is no change in the interest rate regime confronted by the data set of large and medium industries used for the econometric exercise of chapter 3. The regime demarcation of that chapter remains unaffected by these perturbations.

The Differential Rate of Interest (DRI) scheme was introduced in March, 1972, whereby the public sector banks were asked to lend at the rate of 4 percent (2 per cent below the then bank rate) to specified borrowers (SC/ST, indigent students, physically handicapped persons, etc.). This rate remained fixed at 4 percent over the year. The DRI scheme was to be implemented initially in selected, relatively backward areas of the country. In May 1977 the scheme was revised to cover the entire country. The minimum percentage of the aggregate advances that the banks were required to lend under the DRI scheme was increased from 1/2 to 1 in November

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1978. There were upward revisions in loan limits and income eligibility criteria from time to time. The DRI scheme thus essentially remained unaltered over time except for a slight expansion in provision and coverage in the period 1977-78. Once again, as in the case of priority sector lending, the target beneficiaries of the DRI scheme make it not relevant for interest rates confronted by large and medium industries.

Export credit is subjected to an entirely different regime of lending rates. Until August 6, 1991, there was the Export Credit (interest subsidy) scheme, introduced in 1968 and funded through the Market Development Assistance fund of the Government of India (Table B.2). It provided an interest subsidy at the rate of 1.5 percent on all export credit. This rate was doubled in August 1986 to 3 percent. In October 1989, different rates were introduced for pre-shipment and post-shipment export credit. Interest subsidy was given at the rate of 3.85 percent for pre-shipment export credit and 5 percent for post-shipment export credit.

Another special subsidy was introduced in 1974, funded by the Ministry of External Affairs. This subsidy was extended at the rate of 3 percent to IDBI, the United Commercial Bank of India and the United Bank of India on a special bank credit of Rs. 25 lakh extended to certain financial institutions in Bangladesh for their imports from India. This special subsidy was terminated in 1989.

The Export Credit (Interest Subsidy) scheme was withdrawn in August 1991. Even so, rates on export (pre- and post-shipment) are prescribed (either flat, or a floor/ceiling).

The issue of whether the increase in subsidy rates on export credit during 1986-89 affects the regime demarcation of chapter 3 remains. Since our second regime transition occurs in 1988, our judgement is that it does not. In regime III after 1988, the lower rates on export credit till 1991 may have provided an interlude of relaxation in what was in all other respects a less concessionary regime than regime II (1981-88).

Table B.1

Priority Sector Lending Rates

	1981 (Eff. 2 March)	1982	1983 (Eff. 1 April)	1984

1. SSI
a. Composite loan upto 25000
   i. backward areas
   ii. other
b. term loans
   i. backward areas
   ii. other
	
	10.25
	12.5
	
	12.5
	13.5
		
		10.25
		12.5
		
		12.5
		13.5
			
			10
			12
			
			12.5
			13.5
				
				10
				12
				
				12.5
				13.5

2. Retail trade a. upto 5000 b. 5000 < x ≤ 25000 c. 25000 < x d. 1 lakh ≤ x	 12.5 not > 15 not > 19.5 -	 12.5 not > 15 not > 19.5 -	 12.5 not > 15 not > 18 -	 12.5 not > 15 not > 18 -
3. Educational a. indigent students for higher edu. in India b. other	 Not < bank rate 15-17.5	 Not < bank rate 15-17.5	 Not < bank rate 14-16.5	 Not < bank rate 14-16.5
4. Road transport operators a. Single vehicle b. 2 or more	 12.5 15	 12.5 15	 12.5 15	 12.5 15
5. Professional & self employed belonging to SC-ST & SE women: a. term loans b. other than term loans	 - -	 13.5 14-16.5	 13.5 14	 13.5 14
6. Other priority (other than agr.)	not > 17.5	not > 17.5	not > 16.5	not > 16.5

Priority Sector Lending Rates (Contd..)
(Eff. April 1)

	1985	1986	1987	1988	1989	1990
1. SSI a. Composite loan upto 25000 i. backward areas ii. other b. term loans i. backward areas ii. other	10 12 12.5 13.5	10 12 12.5 13.5	10 12 12.5 13.5	10 12 12.5 13.5	10 12 12.5 13.5	10 12 12.5 13.5
2. Retail trade a. upto 5000 b. 5000 < x ≤ 25000 c. 25000 < x d. 1 lakh ≤ x	12.5 not > 15 not > 17.5 -	12.5 not > 15 not > 17.5 -	12.5 12.5-15 15-16.5 -	12.5 12.5-15 15-16.5 -	12.5 12.5-15 15-16 16 (min.)	12.5 12.5-15 15-16 16 (min.)
3. Educational a. indigent students for higher edu. in India b. other edu. advs.	not < bank rate 14-16.5	not < bank rate 14-16.5	not < bank rate 14-15.5	not < bank rate 14-15.5	not < bank rate 14-15	not < bank rate 14-15
4. Road transport operators a. Single vehicle b. 2 or more	12.5 15	12.5 15	12.5 15	12.5 15	12.5 15	12.5 15
5. Professional & self employed belonging to SC-ST & SE women: a. term loans b. other than term loans	13.5 14	13.5 14	13.5 14	13.5 14	13.5 14	13.5 14
6. Other priority (other than agr.)	not > 16.5	not >16.5	14-15.5	14-15.5	14-15	14-15

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Table B.2

Export Credit (Interest Subsidy) Scheme, 1968

	1972	1974	1986 (Aug. 1)	1989 (Oct.)	1991 (Aug. 6)
Participant banks	3 State and 12 Central co-operative banks	Same	Same	Same	Same
General subsidy	@ 1.5% out of the market dev. assistance fund of the GOI	@ 1.5%	@ 3%	Pre-shipment: @ 5% Post shipment: @ 3.85%	Scheme withdrawn
Special subsidy (for imports from Bangladesh	None	@ 3% out of funds allotted by the commerce ministry	Special subsidy continues	Special subsidy terminated	

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APPENDIX C

List of Persons Interviewed:

1. G.S. Mishra (M.D, AKVN, Raipur)
2. K.K. Ganguli (G.M, AKVN, Raipur)
3. D.K. Mishra (G.M, AKVN, Raipur)
4. P.K. Shukla (G.M, AKVN, Raipur)
5. D.K.Kulshreshtra (Executive Engineer, AKVN, Raipur)
6. M.P. Awasthi (Jt. Director, Industries, Durg)
7. Pravin Shukla (Asst. Director, DIC, Durg)
8. G.K. Sinha (G.M, DIC, Jagdalpur)
9. Shyam Kabra (President, Urla Industries Association)
10. Pukhraj Bothra (President, Bastar Chamber of Commerce)
11. R.N. Pandey (President, Nagpur Engineering Co..Limited)
12. K.K. Jha (President, B.S.P Ancillary Industries Association)
13. Suresh Ahuja (Bhilai Auxiliary Industries)
14. S.K. Jhamb (System India Casting)
15. Sandeep Tiwari (Shri Bajrang Alloys LTD., Urla)
16. Pradeep Kasliwal (Dhar Cement, Indore)
17. A.K. Bhat (AKVN, Indore)
18. M.C. Ranka (Senior General Manager, AKVN, Indore)
19. Gautam Kothari (President, Pithampur Audhyogik Sangathan)
20. Gobind Jethmalani (President, Association of Industries MP)
21. V.D. Pandit (Executive Secretary, Dewas Industries Association)
22. C.S. Nigam (Advisor, Dewas Industries Association)
23. S.N. Menia (Chief General Manager, D.T.I.C., Gwalior)
24. Arun Shrivastava (General Manager, M.P.A.KVN, Gwalior)
25. G.K. Tiwari (General Manager, D.T.I.C., Gwalior)
26. S.C. Jain (Managing Director, M.P.AKVN, Gwalior)
27. P.K. Shrivastav (Addl. Director, Director of Industries)
28. Adesh Birla (Sriniwas Synthetic Packers (P) Limited, Malanpur)

29. Sunil Gandhi (Sun Ultra Technologies (P) Limited, Gwalior)

30. M.S. Bhaduria (Manager, J.K. Tyre, Banmore)

31. Y.C. Mital (Banmore Foam Pvt. Limited)

32. Laxmi Kant Gupta (Manager Account, Surya Tubes, Malanpur)

33. Neeraj Vijay (Manager, M.P. State Industrial Development Corporation Limited, Bhopal)

34. V.N. Masaldan (Managing Director, Hotline Teletube and Components Ltd.)

35. Alok Saboo (Director, Midland Plastics Limited, Gwalior).

List of Industries or Associations Interviewed:

1. Woolworth and Fabworth, Urla Growth Centre

2. Paras Oil Extraction, Urla Growth Centre

3. NECO Engineering, Siltara Growth Centre

4. Bajrang Alloys, Urla Growth Centre

5. Bhilai Ancillary Industries Association

6. Bastar Chamber of Commerce

7. Bimal Stone Associates, Jagdalpur

8. Pithampur Audyogik Sangathan, Indore

9. Association of Industries, Dewas

10. Association of Industries M.P., Pologround, Indore