WP - IX

STRUCTURE OF THE INDIAN ECONOMY AND THE RELEVANCE OF THE ECONOMIC REFORMS

by

R. Vaidyanathan *

March 1992

Indian Institute of Management
Bangalore

*Professor, Indian Institute of Management, Bangalore

STRUCTURE OF THE INDIAN ECONOMY AND THE RELEVANCE OF THE ECONOMIC REFORMS

R Vaidyanathan *

Abstract

An attempt has been made in this monograph to highlight the role of unincorporated enterprises in the Indian Economy and the relevance of the economic reforms currently underway. The share of the unincorporated sector in national income, in manufacturing and in activities like transport, trade, construction etc. is analysed. Savings and capital formation in the unincorporated sector are detailed. Finally the implications of the recent economic reforms in the context of this sector, are discussed.

Between the holy-cow of Agriculture and white elephant of corporate sector, the galloping horse of unincorporated sector is un-noticed and un-analysed. It marches on.

The objective of the paper is to highlight the role of unincorporated enterprises in the Indian economy and the relevance of the economic reforms currently underway in the context of the structure of the economy. Most of the discussions

----

*Professor of Finance and Control at I.I.M. Bangalore

regarding economic reforms concentrate on the Private Corporate Sector or on Government Sector. Similarly discussions on savings, taxation, capital formaion etc. also to a large extent pertains to the corporate sector (consisting of both government companies and private sector companies which are incorporated under the 1956 companies act). But the other sector namely unincorporated enterprises has not been studied in detail in respect of its share in our economy as well as the implication for this sector for the economic reforms.

In our context by unincorporated sector we mean, the forms of organisations like proprietorship, partnership, HUFs, etc. forms of organisations. That is all types of organisations in the non-government, non-corporate sector of the economy that are engaged in non-agricultural activities. The first section highlights some of the available indicators to establish the importance of the unincorporated sector and briefly discusses terminological issues. The second section deals with the share of the sector in national income, and in manufacturing, as well as in activities like transport, trade, construction etc. This section also discusses savings and capital formation in unincorporated sector. The third section deals with major economic reforms undertaken and contemplated and looks at the implication for this sector and provides conclusion based upon the earlier data and analysis. We have provided all the relevant tables in the appendix.

SECTION I

Importance of the Unincorporated Sector: There does not seem to be a single source of time series data on the characteristics of unincorporated enterprises. The importance of this sector can be gleaned from income-tax data and credit data of commercial banks.

Table-1 gives income tax statistics on the number of units assessed income assessed and tax payable for different categories of assesses for the years 1960-61 and 1986-87. In the case of non-company forms of organisation, the number of units assessed has increased nearly seven times between 1960-61 to 1986-87 (from 113.5 thousand to 764.6 thousand) whereas in the case of companies, it has gone up from 10,400 to 17,100.

This is surprising since according to the Department of Company Affairs, the total number of companies in existence increased from 27,000 in 1960-61 went to 1,34,000 in 1986-87. If the number of companies assessed is much smaller than the total number of existing companies, then, in the case of non-company forms of enterprises, the actual number, could be much larger than what is shown as assessed.

The income assessed of the company sector (for tax purposes) went up from Rs.248 crores to Rs.6894 crores (ie by 28 times) while that of the unincorporated sector went up by 19 times (from Rs.248 crores to Rs.4552 crores). The average tax rate is substantially lower for the unincorporated sector as compared to companies. (13% compared to 42%). It is to be noted that in the case of partners of a firm, the income derived from the firm is liable to be taxed coupled with their other income and hence the category 'individuals' includes partners and proprietors as 'individuals'. This has been changed in the 1992-93 budget proposals. The non-company sector whose average rate of taxation is lower seems to play a significant role in the saving of the 'household' sector (to which we will revert later).

Table-2 gives the share of credit obtained by the unincorporated enterprises from commercial banks as given by the R.B.I working group on savings (Dr Raj Committee, RBI-1982). It shows that the percentage share of unincorporated enterprises in the outstanding bank credit to the private sector has gone up from 35% in 1975 to 41.5% in 1980. This does not include accounts with a limit of less than Rs.10,000, and to that extent, the share could have been understated. Unfortunately, this type of data is not available for later years.

<u>These two aspects bring out the significant role played by the unincorporated sector in our economy.</u>

<u>Terminological issues</u>: Before we proceed, it is pertinent, to distinguish between the 'unincorporated' sector and the 'unorganised' sector. 'Unorganised forms of activities would fall under the category of unincorporated sector since by definition these activities are carried out by non-company forms of organisations.

But as per National Accounts Statistics (NAS 1980,89), it is possible for a partnership firm (non-company form of organisation) to belong to the 'organised sector', if it is covered by the Factories Act of 1948. Or if a wholesale dealer in cigaretees is covered by Sales Tax Act then he belongs to the 'organised' sector etc . In other words, NAS defines".... all unincorporated enterprises and household industries which are not regulated by any of the Acts of the above type and which do not maintain any annual reports presenting profit and loss accounts and balance sheets are classfied as unorganised". Hence it is to be noted that the 'unorganised' sector is a sub-set of the unincorporated sector.

Similarly, in estimating saving NAS (1980,1989) uses the category "household sector which comprises apart from individuals, all non-government non-corporate enterprises like sole proprietorships and partnerships owned and/or controlled by individuals and non-profit institutions which furnish educational, health, cultural, recreational and other social and community service to households".

Hence, the larger savings of the household sector is due to the inclusion of millions of partnership/proprietorship firms which are involved in activities like manufacturing, trade, construction and transport etc. Unfortunately, the 'savings statistics' of the Indian economy does not differentiate between 'consuming' households, and 'producing' households both in the farm and non-farm sectors.

In the case of <u>manufacturing</u> activity, the Annual Survey of Industries (ASI) has started publishing data on some major indicators separately for the (corporate) company sector and partnership/proprietorship firms. But these data are only for the registered factory sector which is covered by ASI. In the case of 'unregistered' manufacturing (since they are not even covered by the Factories Act in terms of at least 20 persons employed without power and 10 with power) we can infer <u>that all of them would be unincorporated forms of organisations</u>.

SECTION II

The Share of the Unincorporated Sector in the National Economy:

In order to estimate the share of the unincorporated enterprises (which are spread over both 'organised' and 'unorganised' sectors) in the net domestic product (n.d.p.) we first arrive at the n.d.p. of these enterprises in the unorganised sector and then in the organised sector and then add them together. Details of the mechanics of estimation are given in an earlier paper by the author (1988).

Table-3 gives the percentage share of various sectors in the n.d.p. during selected points of 1970-71 to 1988-89. We find that the share of Agriculture and allied activities (like fishing, forestry etc.) has declined from 47% to 33% and that of

Government has increased from 15% to 25%. The share of Private corporate sector has stagnated around 7 to 8%. The unincorporated sector has a share of around one third of our national income (actually it has shown an increase from 30% in 70-71 to 35% in 88-89).

But the economic reform package focusses only on the corporate (particularly big company) sector which has no relevance to 35% of our economy.

Share in the Manufacturing Sector:

Partnership-Proprietorship forms of organisation has nearly 50% of net value addition even in the manufacturing sector as shown in Table-4. We have constructed this using the Annual Survey of Industries (summary results) and the National Accounts Statistics of CSO. We have essentially considered unregistered manufacturing (all of which are unincorporated) which itself constitutes more than 40% of all manufacturing value addition and added the unincorporated share of registered manufacturing (which is roughly 15% of registered manufacturing).

We find that the share of the unincorporated sector is around 50% of value addition in manufacturing with the government share having improved from 6% to 17% (between 73-74 to 88-89) and the share of the private corporate sector declining from 39% to 34%.

Any economic reform not concerned with the millions of partnerships and proprietorship firms in the manufacturing activity is not facing the real nature of our non-agricultural economy. In 1985-86 the unincorporated sector had 30% of employment in <u>registered manufacturing</u> and in unregistered manufacturing it will run into millions, and hence in total manufacturing the share in employment could be as high as 70% to 75%.

<u>Share of the unincorporated Sector in the Major Service Activities</u>

If we consider service activities like (i) construction, (ii) transport other than railways and storage (iii) trade, hotels, restaurants (iv) real estate, ownership of dwellings, and business services and (v) other services (educational, medical, legal, religious etc), we find ours is truly an economy of proprietorship and partnership firms. <u>Our 'friendly' neighbourhood contractor, tailor, doctor, lawyer, hotelier, truck operator, cinema hall owner, barber, actor, architect, professor, xerox operator, wholesale and retail trader (in provisions, vegetables, TV's, ceiling fans, motorcars, petrol, chemicals etc) arrack merchant, school business barons, hospital promotors and religious saints - all of them constitute not only the largest chunk of our economy they are also the fastest growing segment of our economy.</u> We have provided in Table-5, the share of partnership and proprietorship forms of organisations in these activities. We find their share was between 75 to 80% during 1970-71 to 88-89. This shows the dominance of the unincorporated sector in these 'service' activities. We can conclude from this that the unincorporated sector can be identified with the following activities: (i) unregistered manufacturing (ii) construction (iii) transport (by other than railways) and storage (iv) trade, hotels and restaurant (v) real estate and business services and (vi) other services in the private sector. Besides even in registered manufacturing, the unincorporated sector has about 15% share in terms of value addition.

It is also to be noted that the compounded rate of growth of these activities during 80-81 to 88-89 (at current prices) was of the order of 14.3%,(while it was 13.9% for the whole economy and nearly 12% each for Agriculture and manufacturing). If we consider the growth rate at constant prices (1980-81 as base), then the compounded growth rate for these activities works out to 5.3% as compared to a growth rate of 3.6% for agriculture and 5.4% for the economy as a whole. During the eighties (80-81 to 88-89), unregistered manufacturing grew at 6% (real terms) while registered manufacturing grew at 8.6%.

For the above mentioned 'service sector' activities unfortunately reliable figures are not available regarding employment. Table-6 gives the figures as provided by the Economic Survey (90-91) which speak volumes about our data base. It is scandalous, to say the least, that our governemnt should state that in the whole country there are only 64000 people employed in the private construction industry. Even more scandalous is the statement that the figure dropped from 73000 in 1980 to 64000 in 1989.

Similarly in transport (both goods and passenger) industry (if you believe the government) there were only 51000 people employed in the private sector as of 1989 and this had also come down from 71000 in 1980. It is ridiculous to say that in the entire country, only 2,86,000 people are employed in wholesale and retail trade. And data for hotels and restaurants is not separately provided at all.

It is interesting to note that, these data as given in the Economic Survey have not been questioned in the Parliament.

Savings and Capital Formation

As earlier mentioned, savings data is available from NAS for the household sector which includes agriculture households, unincorporated enterprises and purely consuming households. We know that 'household' sector savings constitute more than 75% of gross domestic savings and also that the 'household' sector is a net lender in the flow of funds account prepared by the RBI (see

Table-7). We find that roughly 25% of the financial surplus of the 'household' sector is used to finance private corporate businesses and 74% to government (through banks, PF, small savings etc).

The savings of the unincorproated sector is adequate to sustain its rate of capital formation instead of it being a beneficiary of the net borrowings from farm households and consuming households. This surmise is based on the survey results of RBI on traders and transport operators. RBI (1981,82,83) has published the results of its massive surveys on traders and transport operators which show that post-tax return on net-worth was as high as 41% for transport operators and 40% for the retail trade. In these activities (where the unincorporated sector is predominant) the post-tax returns are higher than that of the corporate sector and the larger savings thus generated are able to maintain capital formation. Also, as we will elaborate later, the unincorporated sector has labour cost advantage in these activities, which is another reason for its' larger return.

If we consider the gross domestic capital formation (g.d.c.f) in unregistered manufacturing, construction, transport (other than railways) and storage, trade, hotels and restaurants, real estate, ownership of dwellings, business and other services, we find that in the eighties around 35% of the total g.d.c.f. was due to the unincorporated sector. Since in these activities, more than 80% of value addition is by the unincorporated sector, we can take these activities to represent the unincorporated sector.

In other words more than one third of our g.d.c.f. is unregulated and unplanned from the government's point of view. We also find that the g.d.c.f of the unincorporated sector was nearly 25% of it's g.d.p. in the eighties. This is higher than the rate of gross domestic capital formation in the whole economy.

SECTION III

Economic Reforms 1991

Some of the aspects of the recent economic reforms announced by the government are:

- De-licensing of industries except those in the restricted list
- Automatic clearance for import of capital goods if foreign exchange is ensured through equity.
- Removal of convertibility clause in the case of loans from term lending institutions.
- Enchancing the foreign equity limits to 51% and even to 100% in some situations.
- Foreign equity proposal need not be accompanied by foreign technology agreement.

- Removing threshold limits of assets in respect of MRTP companies and dominant companies.
- Inclusion of the Public Sector within the ambit of Restrictive Trade Practices Act.
- Introduction of EXIM scripts
- Removal of ceiling in lending rates by banks.

From the above we find that the economic reforms package accounced by the government focusses primarily on the private corporate sector of the economy whose share in national income is as low as 7 to 8% and which does not play even a minor role in the service sectors (with a share of 3 to 4%) and whose share in manufacturing, is only of the order of 33%. Private corporate sector has consistently been a net spender and its investments have been sustained by the funds of the household sector channelled through financial institutions.

<u>On the issue of Government regulations:</u> At this juncture it is pertinent to point out that many of the fiscal and regulatory instruments pertaining to the unincorporated sector are in the realm of state governments. The major sources of revenue for the state governments are sales tax (covering wholesale and retail trade and restaurants most of which are in the unincorporated sector), road and motor vehicle tax (contributed by transport operators - predominantly in the unincorporated sector) entertainment tax etc. Also the regulations regarding construction and real estate activities are vested more with

state governments than the central government. Hospitals, educational and religious institutions are also regulated by state governments.

The children-rolling matchsticks in Sivakasi (Tamil Nadu) or preparing slates/pencils in Mandsul (MP) or doing quarry work in Haryana or washing in the tenneries of Ambur (Tamil Nadu) or rolling beedies in Belgaum and Mangalore (Karnataka) or working in the powerlooms of Bhiwandi (Maharastra) or helping the diamond industry in Surat (Gujarat) or constructing buildings in semi urban and urban areas or washing plates and serving customers in restaurants spread over the length and breadth of the country or working as cleaners and helpers in the private transport sector or working for the retail and wholesale trade, - are all contributing to the larger 'cause' of the unincorporated sector.

The state governments resource generation through commercial taxes, road tax, entertainment tax or liquor excise is far from satisfactory in terms of coverage as well as realisation. That is existing instruments are not being used optimally by state governments.

In sum, the state governments have been hijacked by the powerful combination of local trader-transport operator-construction contractor-cinema hall owner-real estate developer - arrack bottler-education and health business trusts and societies. This combination is the controlling interest at the state level. Hence the "inability" of the state governments to generate more resources from commercial taxes, road taxes, liquor excise and entertainment taxes.

The economic reform package aims at integrating our economy into the global economy. But the real challenge before our economy lies in integrating the unincorporated sector into the national markets- namely, product, capital and labour. In this context the role of state governments and Centre-State economic relationships acquire a sharper focus.

In the area of finances provided by commercial banks, most of these activities (of unincorporated sector) it fall under the category of "non-priority" sector and hence these enterprises rely on 'open' market borrowings which is an euphemism for unaccounted funds flow.

Hence we can notice that the tertiary activities like construction, wholesale and retail trade, real estate ownership of dwellings, hotels, restaurants and services like medical, educational, entertainment etc. are major contributors to black money generation. Large portions of these activities are not adequately covered by our taxation efforts and even by the National Accounts Statistics.

Hence, some of the reasons for the larger financial returns enjoyed by the unincorporated enterprises could be lower average tax rates, non-compliance with labour laws regarding child-labour, PF etc. and avoidance/evasion of tax.

Any structural reform which does not focus on the unincorporated sector is not relevant, considering the nature of our economy. The coverage of individuals, proprietorships and partnerships by a Central income tax authority will not provide optimal results since administratively it is not a feasible proposition. The Centre perhaps should think in terms of new instruments and regional level (more than one state participating) councils, for adequate coverage of these activities.

Within manufacturing, the substantial portion of value addition emanating from unregistered manufacturing (all unincorporated) and the unincorporated in registered manufacturing -to the extent of nearly 50% suggests significant problems associated with standardisation (classic for example of household switches not having proper screws and threads) and quality improvement. If we go in for massive import programme under the liberalised trade regime, the possibility of quality improvement is much less as dual markets will only be created. Even our private corporate sector with its small share of national income is not at a stage where it can face international competition within India. In such a situation, foreign equity/technology-based companies providing high quality products will push the existing private corporate sector to become ancialliary suppliers or at worst, lower order product producers.

This type of situation will also create a dual economic system or a two-channel economy where we have ceiling fans, mixies and micro-processors of international standards and power supply by electricity boards of fourth world standard; cars, scooters and bicycles of international standards and roads full of pot-holes and water-logging.

Roads, water, telecommunication, electricity etc. are not tradeable and unless these primary services are made efficient, product and economic improvements may become a mirage.

Labour cost advantage is available to the unincorporated sector even though the capital cost is much higher for them. Neither process efficiency nor product improvements are feasible in the unincorporated sector, since, given our 'reserved goods' categories and demand requirements it is advantageous for them to be at existing levels of efficiency so that larger margins are maintained.

Conclusion

Given this economic structure, we find the reforms suggested by the governemnt and various economists do not address themselves to the following important issues.

- Ability of the Indian state to integrate the unincorporated sector with the national market, both product markets and capital markets.

If the proposition that the Indian State is in search of a nation is true then one of the basis of such a nation state is the recognition of the role of the unincorporated sector which has become a dominant player in the national economy and the need to integrate it in an orderly fashion, into the regulatory system.

- It is worth mentioning that in a way the unincorporated sector is a strength for our economy since it has created a large middle class (EEC size market in terms of purchasing power and life styles) but it is also a weakness because it has grown based on labour (child) exploitation, black money generation and there is inefficiency due to economy of scale.

- The entry of foreign companies will further accentuate the dual economy (channel one and channel two economy) wherein Japanese scooters are to be repaired by by untrained child labour in mofussil towns and German washing machines are to be run with the poor quality electricity supplied by the state boards and the French cars are to be run on roads full of pot-holes. The reforms have to start from the other end. Logic on its head not on its, crawling feet!

- Another aspect to bear in mind is that the major export earnings in gems, diamonds, leather, textiles, garments etc. comes from partnership activities. The entry of MNC's as large export houses will accentuate 'sweat shop' economy, wherein the (child) labour cost advantage will be used to further exports.

- The exit policy pertaining to entities as well as labour need not be endlessly debated since it is practised regularly in more than 60% of the non-agricultural economy.

- The context of debate on Centre-State economic relationships should explicitly recognise the role of the unincorporated sector and inability of state governments to generate revenues from them.

- Additional resource mobilisation (ARM) is often discussed at the central level but more important is the ARM at the state level and for this purpose, entirely different economic instruments and efforts are needed at the state level.

- Black money generation is estimated to take place in such of those activities where the unincorporated sector is predominant. In such a situation, administratively is it feasible for the centre to monitor and regulate millions of enterprises spread over the length and breadth of the country, in terms of its direct tax efforts?

- What type of instruments can be shifted to the state governments or to groups of states (regional levels), after reforming the current regulatory system of state governments?

- A large proportion of investment and savings takes place in this sector which is outside the governmental regulatory framework. When we combine the unincorporated sector with Agriculture (which is largely in the private sector) we find that larger areas of our economic decision making are not decided or influenced by governemntal policies, particularly in the areas of savings, investment, and national income.

These are issues of far-reaching significance at the current juncture, than tinkering with the four percent economy, in terms of 'corporate' reforms or calling it as economic reforms.

References

1. CSO; Government of India - "Annual Survey of Industries" Various issues.

2. CSO; Government of India -"National Accounts Statistics": "Sources and methods" - (1980; 1989)

3. Economic Survey 1990-91, Government of India, Ministry of Finance, Economic Division.

4. Reserve Bank of India 1982; "Report of the Working Group on Savings " (known as Dr KN Raj Committee report)

5. Reserve Bank of India Bulletin March 1980, May 1981, Sept.1982, February 1983, August 1983.

6. Vaidyanathan R. "The role of Unincorporated enterprises in the Indian Economy" I.I.M.B Management Review, Vol.3 No.2, July-Dec. 1988.

****

TABLE - 1

Number of units, total income assessed/returned and tax payable in 1960-61 and 1986-87

(Rs.crores)

	1960-61			1986-87		
	(no.in 000)	Total income assessed	Tax payable	(no in 000)	Total income returned	Tax payable
a) Individuals	828.3	777.8	98.1	2307.6	8267	1355
b) Companies	10.4	248.9	122.7	17.1	6894	2914
c) Partnership firms/HUF AOP etc.	113.5	248.1	22.3	764.6	4552	576
Total	952.2	1274.9	243.2	3089.3	19713	4845

Source: Various Issues of "All India Income-Tax" Statistics: Directorate of Income Tax" (New Delhi)

Note: From 1984-85 onwards the figures are for returned income instead of assessed income for earlier years.

TABLE 2

Percentge share of unincorporated enterprises* in outstanding Bank Credit to the Private sector under major industrial categories (scheduled commercial banks)

Industrial Category	June 1975	June 1980
1. Industry (mining, manufacturing and electricity)	24.4%	34.4%
2. Large and medium industry	10.1%	13.3%
3. Small scale industry	72.4%	76.9%
4. Total bank credit excluding food procurement credit	34.6%	41.5%

*Unincorporated enterprises taken to cover category of "Partnership, proprietory concens, joint families, trusts, societies etc" and exclude individuals. Accounts with limits of Rs.10,000 and less have not been considered due to lack of data.

Source: RBI (1982)"Report of the working group on Savings" (known as Dr.K.N.Raj Committee report)

TABLE 3

Percentage share in net domestic product of various sectors (at current prices)

	70-71	80-81	88-89
1. Private Agriculture and allied activities	47	37	33
2. Government	15	21	25
3. Private Corporate	8	8	7
4. Unincorporated sector	30	34	35
5. All n.d.p.	100	100	100

Note: Computed from various issues of National Accounts Statistics (NAS).

TABLE 4

Net Value added by unincorporated sector in Manufacturing (Percentage share)

	73-74	79-80	85-86	88-89
1. Unincorporated Sector (partnership, proprietorship etc)	55	55	49	49
2. Private Corporate Sector	39	37	37	34
3. Government Sector	6	8	14	17
Total	100	100	100	100

Source: Computed from various issues of Annual Survey of Industry (Summary results) and National Accounts Statistics (CSO).

TABLE 5

Percentage Share of Value added of Unincorporated sector in Non-manufacturing non-Agriculture activities

	70-71	80-81	88-89
1. Value added by unincorporated sector	75%	75%	80%
2. Value added by government sector	21%	22%	16%
3. Value added by private corporate sector	4%	3%	4%
Total	100%	100%	100%

Note: The activities considered are (i) construction (ii) trade, hotels and restaurant (iii) transport (other than railways) and storage (iv) real estate ownership of dwellings and business services (v) other services (like medical, education, religious, legal etc.)

TABLE 6

Employment in the Private Sector

(in lakhs)

		1980	1985	1989
1.	Construction	0.73	0.70	0.64
2.	Wholesale and retail trade	2.74	2.77	2.86
3.	Transport, storage and communication	0.71	0.54	0.51
4.	Finance, insurance, real estate etc.	2.06	2.19	2.43
5.	Community, social & personal services	11.67	13.09	14.29

Source: Economic Survey (1990-91) (table 3.2 page S.51)

TABLE 7

Draft on Financial Savings of the Household Sector

Item	1980-81 to 1985-86	
	Amount (Rs crores)	Percentage
1. Direct Financing		
a) Private Corporate Business	7,738	9.6
b) Government	19,446	24.1
2. Indirect Financing to		
a) Private Corproate Business through	12,656	15.7
i) Banking	5,560	6.9
ii) Other Financial Institutions	7,096	8.8
b) Government through	40,043	49.6
i) Banking	27,373	33.9
ii) Other Financial Institutions	12,670	15.7
3. Total Financing	80,721	100.0
a) Private Corporate Business (1a+2.a)	20,394	25.3
b) Government (1.b + 2.b)	59,489	73.7
c) Others (including discrepancy)	838	1.0

Percentages are with respect to financial surplus of household sector.

Source: "Flow of Funds Accounts of the Indian Economy 1980-81 to 1985-86. RBI Bulletin Jan. 1991.