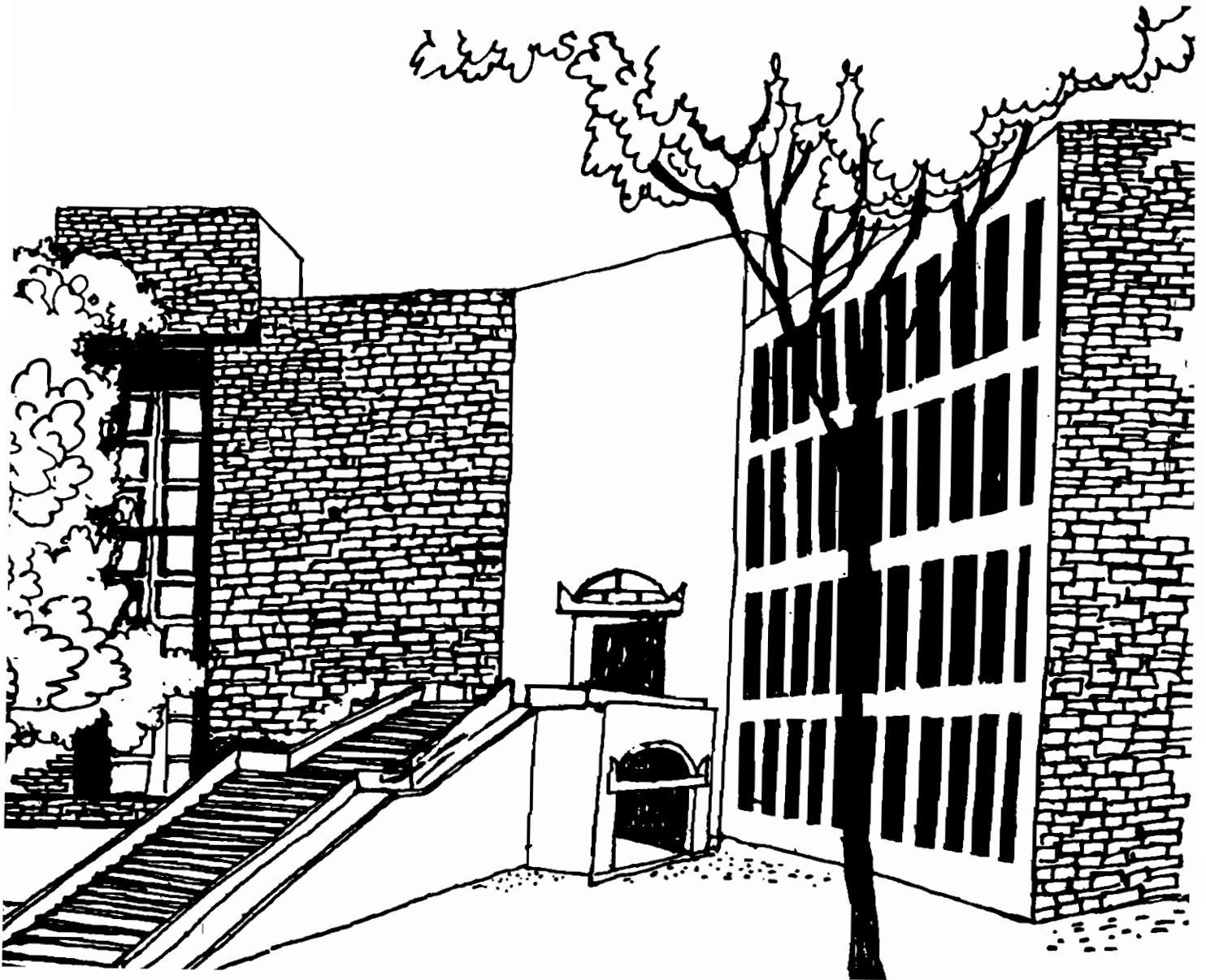





Working Paper



**ISO 9000 LINKED TAX INCENTIVE:
A BETTER LEVERAGE POINT FOR GROWTH**

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ISO 9000 Linked Tax Incentive:
A Better leverage Point for Growth

By

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Abstract:

The efficiency and efficacy of government instruments in implementing policy have been particularly problematic in India. For instance, the incentives, mostly fiscal, to boost industrialization and exports from time to time, have frequently been linked to investments, e.g., development rebate and later investment rebate; others have been linked to depreciation like higher depreciation rates for certain categories of plant and machinery; and yet a host of other incentives have been in the form of various subsidies pertaining to backward areas and free trade zones; and various duty drawbacks and value based export licencing and so forth. Many of these systems of incentives have long since become dysfunctional, while others are still in force, but surprisingly there has never been any incentive linked to quality, when it is quality which may be regarded as the single most important and fundamental hindrance to our exports and industrial growth. Given the image of shoddiness usually associated with Indian products, for international buyers, the ISO 9000 series becomes vitally necessary in lowering the perceived risk in dealing with a newcomer in the international market. In this context, we suggest linking tax incentives to quality via ISO 9000. Such an incentive system, we argue, among other benefits will strike at a pivotal leverage point for change given the present situation and the overall thrust of economic policy in opening up the economy to speed up exports.

1. The authors are members of Economics and Finance Faculty respectively at the Indian Institute of Management, Ahmedabad. The latter would like to acknowledge partial support by a research grant from IIM, Ahmedabad.

ISD 9000 Linked Tax Incentives:
A Better leverage Point for Growth

By

S. Morris and V. Raghunathan

Globalization of Indian economy is as yet a nebulous concept even among our policy makers within the Government. If history is any guide and the experience of the dynamic East Asian newly industrialized countries (NICs) is of any relevance, it ought to mean increased competitiveness of Indian industry, and following from it, enhanced exports of manufactured products. Freedom to import technology, freedom in technology choice and freedom in entry and exit choices are aspects of the liberalization effort. Opening up makes sense only if growth can be speeded up, and a firm basis for this entails relaxing the foreign exchange constraint through increasing exports. This of course has been the thrust of the 1993-94 budget as well.

Even if the immediate increase in exports is in natural resources and in natural resource based products, in the medium term and certainly in the long term it is only on the trade account of manufactured items that India can show surpluses. The ratio of manufactured exports to their imports is a fairly stable one that depends upon the stage of development, and the endowment of natural resources, for which useful proxies are per capita GDP and land-man ratios. Countries with large land-man ratios even when highly industrialized (for example, Australia, New Zealand,

Canada, and even the USA) do show deficits on manufactured exports and surpluses on natural resource products. On the other hand, those that are land scarce, like Korea, Japan, Germany, and Italy, do show the reverse pattern. India with land-man ratios closer to the latter set would therefore have to show large surpluses in manufactured goods to match the deficits in natural resources and products, if it develops (and for it to develop).

In a regime of controlled conversion of rupee till recently, our export policy was more or less synonymous with devaluation of the rupee. One can easily trace each major devaluation of the rupee to a precarious balance of payments (BOP) situation in the country. Devaluation of the rupee was thought of as the trigger that would fire exports and correct the adverse BOP. While one may hardly quarrel with the aphorism that devaluation helps exports, it would be a grave error to consider devaluation by itself as a long term export boosting measure. Shorn of all technicalities, devaluation in the international market is akin to a price cut in the domestic market. That price cut helps the selling of a product in any market is stating the obvious. But how far down and how long can one continue cutting the price? Not very far down and not for very long. As a short term strategy, price cut may certainly push one's products in a competitive market. But a country like ours which is scarcely in the international competition can hardly hope to become competitive by repeated devaluations or price cuts. Besides, the hard currency markets are perhaps not as price sensitive as

they are quality sensitive. Lower prices are welcome by all means, but not if the products do not meet a minimum quality standard. It might even be safe to say that a rupee worth of extra quality addition may go much further in the international market than a rupee worth of price cut.

It is not as if much of the Indian industry is inefficient, notwithstanding the common perception. The reality is that substantial portions of Indian industry are quite efficient. A World Bank study as early as in 1984, on the non-electrical machinery sector brought out this 'surprising' fact. Subsequent sectoral studies, as well as the fact that price based computations of the effective protection rates show that they are far below those indicated by tariff based computations, point in the same direction. Discussions with many private and certain public sector enterprises, reveal that Indian industry is quite confident of withstanding import competition in a wide variety of industries as tariff rates are lowered because of their low costs, primarily of skilled and unskilled labour.

The small size of the market in very many products, particularly new consumer goods would no doubt be a serious handicap. But even here by standardization, fewer models, and by taking advantage of the very low labour costs even with regard to skilled labour (in house and increasingly through subcontracting), the minimum economic scales in India are considerably lower than that in the advanced capitalist countries. This is particularly true of many engineering

industries, small volume chemicals like drugs, pharmaceuticals and dyestuffs, textiles, and assembly activities. Thus in trucks, many items of automobile ancillaries, scooters, white goods, diesel engines, electrical goods, agricultural implements, tractors, computer assembly, etc. India is one of the lowest cost producers. Yet significantly large exports have not taken place - certainly not the kind of export boom that Korea and Taiwan have shown, and now China is showing. Part of the answer is no doubt that, Indian industry does have to face up to higher costs of energy, materials and bureaucratic delays, and problems with the transport infrastructure. As these problems are overcome, the non price factors, namely, quality and specifications, meeting environmental norms and standards, and marketing - particularly quality, would circumscribe both the quantum and the nature of products exported from India, and not merely devaluation and trade tariffs.

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The efficiency and efficacy of government instruments in implementing policy have been particularly problematic in India. Take for instance, the incentives, mostly fiscal, to boost industrialization and exports from time to time. Many of these incentives have been linked to investments, e.g., development rebate and later investment rebate; others have been linked to depreciation like higher depreciation rates for certain categories of plant and machinery; and yet a host of other incentives have been in the form of various subsidies pertaining to backward areas and free trade zones; and various duty

drawbacks and value based export licencing and so forth. Many of these systems of incentives have long since become dysfunctional, while others are still in force, but surprisingly there has never been any incentive linked to quality, when it is quality which may be regarded as the single most important and fundamental hindrance to our exports and industrial growth. Is it perhaps that we have been a busy providing fish to the hungry, that we have forgotten teaching the hungry how to fish?

The two most important avenues through which less developed countries (LDCs), especially those in East Asia have increased their manufactured exports to the developed market economies (DMEs) are what have come to be known as international subcontracting, and OEM (Original Equipment Manufacture) production. Foreign direct investment, contrary to the widely held notions, including that in the export promotion zones, have had very small roles in the expansion of manufactured exports from the East Asian NICs (except Singapore). Manufactured exports have come largely from indigenous firms including the public sector in tie-ups with buying agents and traders abroad including super and retail chain stores, and through OEM supplies to largely domestically oriented firms in the DMEs, and to the large trading firms from Japan. Manufactured exports from India too, especially as the value grows, can be expected to be based on these two principal channels.

Exports via our own export houses with their own distribution and marketing channels in the DMEs are likely to be highly restricted

owing to the high cost of retailing and marketing operations in the DMEs and the large entry barriers therein. So quite like in Korea, Taiwan and Thailand, and in an earlier period Japan, Indian manufacturing firms would have to develop on the basis of international subcontracting arrangements. It is only when the volume of sales in countries abroad becomes very large that independent marketing channels become either feasible or meaningful.

International sub-contracting in items like clothes, shoes, crafts and toys, electronic products, camera parts and accessories, computers, kitchen goods, other white goods etc, items which are often sold through large retail outlets, have been vital in the success of the East Asian NICs. Buying agents of these retail stores have offices in these countries, and they regularly place orders on local manufacturers, where quality assurance and meeting strict delivery schedules are key success factors. While Indian firms could easily match or even undercut the East Asian firms on cost, it is on the scale of reliability and quality that they fail. Small lots, variations in the standards and specifications, poor quality, and uncertain deliveries often completely disqualify the Indian firms; they can hardly trade their lower costs for poorer performance on these dimensions.

OEM arrangements ought to concern much of Indian engineering industry, including the small scale, through the large firms with

whom they have sub-contracting links. The industry in general is woefully constrained by the small scale of output. Low scales have meant that activities like quality assurance, adaptation and modification of designs and drawings, and adaptive and innovative R&D are constrained. (The lower costs of these activities no doubt counteract this constraint to some extent). It has also meant that they have been less able to take advantage of the lower cost of labour to reduce costs than to reduce the minimum economic sizes. Formal quality control through good practices in the organisation is vital in the development of Indian firms as OEM suppliers, to transnationals and others who steadily lose the advantage in relatively simpler and standardised items of manufacture, in items with much skilled labour content. The chicken and egg problem of the scale of output and the emergence of quality can be broken by incentives that support and subsidise firms in their drive towards quality.

It is here that the assurance of quality and the confidence that implementing the ISO 9000 and its appropriate chapters provides to the buyer, becomes crucial. Today with the integration of the European Economic Community (EEC) being actively brought about, ISO 9000 is a vital necessity to sell in the EC countries. ISO 9000 would also provide the minimal assurance to buyers elsewhere in Japan and the USA that a virtual beginner like India, whose comparative advantage is in engineering, including the skilled labour intensive capital goods industry, needs. Thus, for the buyer the ISO 9000 series becomes vitally necessary in lowering the perceived risk in dealing with a newcomer. Would it therefore

be more meaningful to link tax incentives to quality via ISO 9000?

In our view, the answer is YES. The reasons are many. Some of these are:

a. An incentive system that rewards firms achieving the ISO certification would be a powerful mechanism. It would strike at a pivotal leverage point for change given the present situation and the overall thrust of economic policy in opening up the economy to speed up exports.

b. A quality oriented tax incentive will also make the domestic market more quality competitive vis-a-vis the multinationals whose entry is not only imminent, but actively being sought for.

c. The effort involved in obtaining the certification like the ISO 9000, and in adhering to it, will itself bring in a quality consciousness among Indian firms. This will help shed the image of shoddiness usually being associated with Indian products.

d. With improved thrust on quality, the overall competitiveness of firms, both in the export and in the domestic market, can only improve with time. This must in due course result in concomittant improvement in their profitability. This enhanced profitability should make up for the government's "investment" in quality through ISO linked tax benefits.

e. Incentives for industries based on their acquiring the ISO 9000 certification, to the exclusion of others such as incentives for R&D, capital investment, region of investment, export sales etc. has the potential to be simple to administer and yet very effective. And not the least, it will be relatively immune to misuse. For example, whether a certain plant and equipment is actually meant for R & D purposes, and even if so whether it has actually been effectively deployed for R & D; whether export sales have been maximised at the cost of profitability; or whether the decision to declare an area backward has not be essentially political, etc. are all open to endless queries. On the other hand, whether or not a firm has acquired ISO 9000 certification (or any other certification in the series), which itself is an international standard, is hardly a matter of opinion.

f. Also, an incentive system based on the throughput of firms rather than on the inputs is bound to be more effective. For instance, we have no dearth of examples of enormous unproductive investments, notwithstanding all the investment rebates. There are any number of one time exports, driven exclusively by short term considerations of duty drawback benefits and other export linked tax incentives. There are any number of backward areas which have remained backward, notwithstanding all the tax exempt investments there. A quality linked tax incentive on the other hand is far more fundamental, being essentially self sustaining, both in the domestic and the international markets. Thus, an

incentive linked to quality ought to go much further. Of course, ideally export incentives like currency depreciation or a dual exchange rate with a higher value of foreign currency for exporters would be most effective since these are output based and therefore immediately efficient. But even these, as discussed earlier cannot work in isolation; at least not without a minimal standards of quality. There is thus an important role for a throughput based incentive system, like the one being suggested, since there are local (temporary) barriers of quality and scale that need to be overcome.

g. Not all firms (and certainly not the firms that have the potential for exports, but are at present not exporting due to various constraints) can visualize the future benefits in reaching higher values of exports and outputs, and discount the same correctly, to make the investments on quality improvement today. No doubt part of the problem is that since the expenditure on quality assurance and certification creates only a long term or an intangible asset, the motivation to invest on this item, in contrast to investments creating tangible capital, is rather low. External thrust may be necessary to overcome this inertia.

What specific modality such a tax incentive takes is a non issue. The fact is that quality driven incentive for growth has perhaps never been tried by the government before and in our opinion, that may be one incentive which may have the greatest promise in

the present day context. An orientation to quality is something which goes to the root of the problem of our lack of international competitiveness.