

Study on

Identifying Regulatory Impediments of the Light Engineering Sector and Improving Transparency



International Business Forum of Bangladesh (IBFB)

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1.0. Introduction

The Light Engineering Sector (LES) occupies a unique position in the economy of Bangladesh. It practically acts as feeder or support industries to all other industries and plays a crucial role in the socio-economic development of the country. It is estimated that there are more than 40,000 units of Light Engineering Industries (LEIs) in the country employing some 800,000 persons and generating annual revenue of about BDT 9,500 crores (US\$ 1,600 Million). The major concentration of LEIs forming cluster areas is found in Dhaka, Chittagong, Pabna, Khulna, Bogra, Jessore, Rangpur, Gazipur, Narshindi, Narayanganj, Comilla, Kishorganj, Sylhet and Rajshahi. In general, LE industrial units produce products and offer relevant services mainly for local markets. Many LEIs products are import substituting.

There are hundreds of roadside LE workshops all over the Bangladesh, starting from small market place to metropolitan cities like Dhaka, Chittagong, Rajshahi and Khulna. These workshops manufacture and fabricate of different types of capital machinery, machine parts, households items, industrial products, etc. Some are also engaged in fabrication of simple machine parts like bolts and nuts, building grill, complex machine like lathe machines, concrete mixer machine and various machine parts of industries. The small manufactures are also involved in manufacturing household items like taps, bibcock, bowels, crockery, etc. made of different materials.

The product lines of the LES are quite large and diversified. The machinery and spare parts produced by the entrepreneurs of this sector are consumed by various mills and factories like Jute, cotton, sugar, paper, textile, garments, fertilizer, tea plantation and processing, ferry, railway, power plants, construction, transport, pharmaceuticals, etc. The customer industries range from tooth-brash and buckets to auto-parts and parts of machine used in textile , pharmaceutical and other sectors to diesel engines, irrigation pumps, power tillers etc.

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2.0. Objective

The major objectives of the study are -

- To explore the ground reality of the regulatory constraints and hurdles restricting the growth of Light Engineering Sector, and
- To put forward tangible recommendations for overcoming regulatory impediments to make the sector more transparent and corruption-free.

3.0. Methodology

A combination of primary and secondary research methods was employed. The primary data mainly derived from two focus group discussions (FGDs) organized at Bogra and in Dhaka with the participation of business technopreneurs and associates who are actively involved in the sector, along with some representative government officials and trade bodies. Secondary data were collected from diverse sources of literature as mentioned in the reference.

4.0. Contribution of LES to National Economy

LEIs have great potentials to contribute to economic development, GDP growth and employment generation. The LEIs in Bangladesh have made substantial contribution to GDP and created considerable employment opportunities during the last few decades.

LEIs sector have been providing critical support to other industries by supplying various types of machinery and spare parts. They also provide vital support to other sectors of the economy. This sector is now manufacturing a wide range of spare parts, casting, moulds and dices, oil and gas pipelines fittings and light machinery, as well as repair services. In the agricultural sector, all the shallow tubewell spare parts like liner, diesel engines are now coming from the LES located in the rural areas of the country.

The sector contributes about 2.2 percent to the GDP, which is more than the foreign aid that Bangladesh receives in one year. The average annual turnover of the sector now stands around Tk. 20, 000 crore. According to the official statistics, the market turnover of the sector was USD 2.1 billion in 2008 with an average growth of 7 percent.

4.1. Import Substitution

LES has emerged as potential cost cutting sector by providing at least 50 percent substitutes of imported items in the country. Manufacturers in the sector claim that electrical goods like switch, socket, light shed, channel, cables and electrical fans, which are manufactured by the LES are now meeting 48 percent of the country's demand that were earlier met through import. The sector makes import substitute products worth Tk. 2, 000 crore per year and also earn about Tk. 1,200-1,500 crore by exporting products. According to EPB data, the LES posted an export earning of Tk. 1507 crore in fiscal year 2007-08. EPB has documented that export earnings from this sector were \$310 million during 2007-08, which was \$285 million in 2006-07. Besides, the

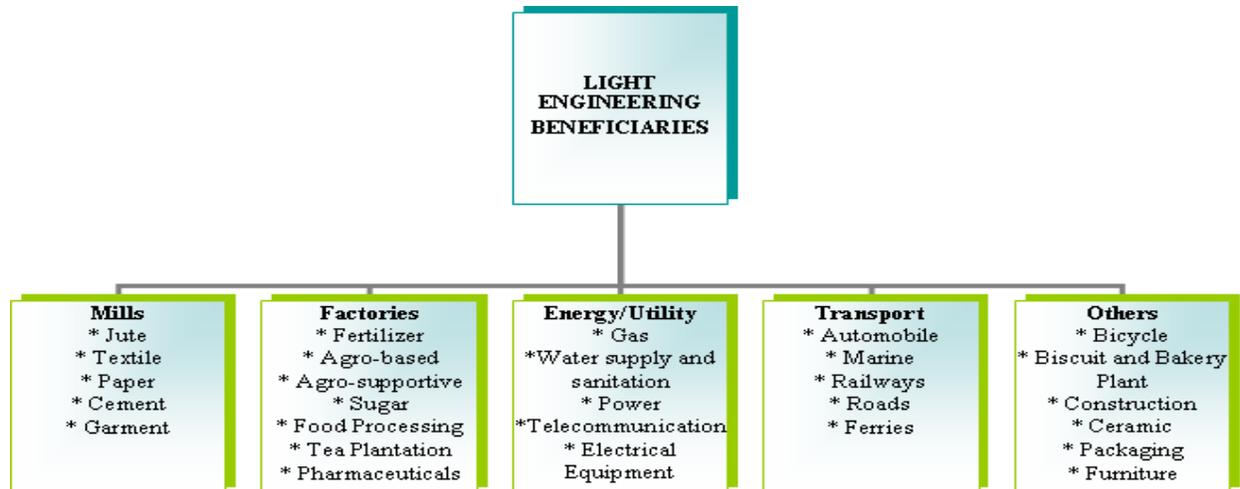
sector's contribution to production, maintenance and repair of automobile spare parts is worth about US\$ 75 million. Statistics show that the country spent US\$ 2.3 billion in import of cars and another US\$ 75 million in automobile spare parts in 2007-08 fiscal years.

4.2. Employment Generation

Contribution of LES to employment generation in Bangladesh is substantial. There are about 50,000 micro enterprises and 10,000 small and medium enterprises in LES, employing some 600,000 people. These estimates were drawn from recent study conducted by IFC in partnership with UK Department of International Development and Norwegian Government. Another study conducted by BUET, however, estimates that LES comprises of around 40,000 enterprises employing around 800,000 people.

4.3. Beneficiaries of LES Products

LES supports the industrial, agricultural, and other sectors of the economy by manufacturing a wide range of spare parts, casting, moulds and dices, oil and gas pipelines fittings and light machinery, etc and by providing repair services. LES manufactures spare parts for cement factories, paper mills, jute mills, textile mills, sugar mills, food processing industry, plastic industry, printing industry, fertilizer factories, railway, shipping, marine transport, automobiles, construction machinery, and pharmaceutical industry, etc. and caters to the basic requirement of industrialization as shown below:



4.4. Regional Dispersion of LEIs

It is estimated that there are more than 40,000 LE enterprises in Bangladesh spread all over the country in about 20 clusters. They are found in Dhaka, Chittagong, Pabna, Khulna, Kustia, Bogra, Rangpur, Gazipur, Narshindi, Narayangonj, Comilla, Kishorgonj, Sylhet and Rajshahi. The major ones are located in Dhaka, Chittagong and Bogra. The density of these enterprises is higher where the density of other industries is higher. The sectors served by the major clusters are as follows:

- Dhaka** : All the major sectors
- Chittagong** : Mainly Jute, Textile, Spinning, Fertilizer, Power Plants and Railway
- Bogra** : Agricultural equipment and machinery, Sugar
- Kustia** : Sugar, Power Plants and Agricultural Equipment.

5.0. Hurdles of the LES

Majority of the light engineering enterprises are small and medium unincorporated form of business with exception to a few. This was the scenario of the recent past and sadly it still remains the same. What this information reveals is that these enterprises were not able to grow due the unfavorable trading environment which acts as a barrier to the growth and prosperity of the country. One thing that must be mentioned is that when we say that small and medium enterprises are essential for the success of the economy, we do not ignore the fact that these business need room to grow till they are able to prosper in a large scale.

In the following sections, the nature and extent of the problems that relate to the regulatory constraints the LES sector has been facing are briefly stated.

- Getting land for Construction- 90% of LE entrepreneurs considers this as a major problem and what is necessary is the creation of an industrial park that would offer the right entitlements and ease the problem related to the harassment that is faced by these entrepreneurs.
- Price and Reliability of utilities- this an acute problem, and it is deepening as time progresses. Proper support for the business is absolutely absent. It should be highlighted that given the back drop of the problematic cases of utility, which includes gas, electricity and water; these businesses are continuing to grow. But now is the breaking point, the pace of growth and development of the light engineering sector is at stagnation, and one of the prime reasons is the problem with utilities.
- Accessibility and price of credits- is also another major problem. Due to the small nature of these businesses, they initiated their business venture through self finance, and due to the administrative difficulty, most of them try to avoid borrowing of being geared. However it is obvious, that initially, self finance may have been more of the easier way out, but after the initial start-up, borrowing becomes a necessity in order to pursue the growth strategy and enjoy the economies of scale that growth offers. This is when the problem takes a bigger shape and for their present size, it is very difficult to obtain credit at a lower cost.
- Tax Structure - The LE sector does not have any special tax structure. Like any other manufactured goods, 15% VAT is imposed on the finished LE products and 10% duty on the

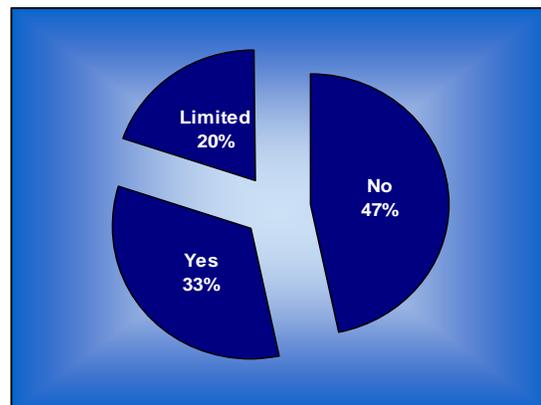
repairing services. In addition, customs duty is charged at the rate of 35%, which consists of import tariff (15%), VAT (15%), advance income tax (2.5%), and import permission fee (2.5%), on imported raw materials (e.g., metal). All small LE enterprises purchase their raw materials and components from bulk importers who pay 15% VAT at import and again 1.5% retail VAT, which is estimated on the basis of a 10% value addition at retail sale. Tax laws prohibit claiming VAT rebates on commodities for which 1.5% Retail VAT has been paid. Now because of the above situation the small manufacturers are to pay full 15% VAT on the above raw materials and components at the production stage where they cannot claim any rebate on these items. Thus effectively more than 30% VAT is being paid against imported raw materials and components which increase the cost of production significantly.

- Production Cost of Finished Products - Thousands of LE products of a wide variety are manufactured in Bangladesh. As such the cost of production of any particular product depends on the type and amount of raw materials, cost of labor, utilities, etc. In Bangladesh LE products largely use conventional and indigenous technologies, operating simple and semi-modern machines like lathe, shaper, milling machine, etc. Raw material cost is the major cost irrespective of the LE firm sizes. In Bangladesh LE producers heavily depend on the ship breaking yards for collecting iron scrap-the major raw material. Iron collected from ship breaking is not a standardized material and its use involves excessive wastage.

6.0. Respondents' View: Major Responses from the FGDs

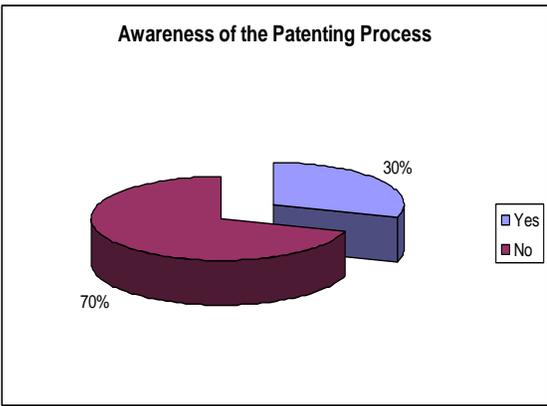
- *Access to Information about Light Engineering:*

Majority of the businesses have limited or no information with regard to light Engineering Sector.



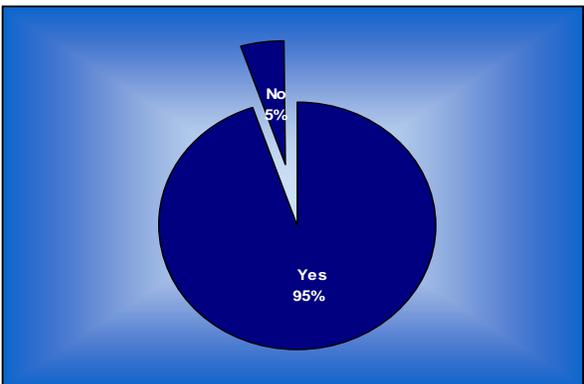
□ *Awareness of the process to patent the product:*

A very few are aware of the process to patent their product, however due to the absence of the patent offices to operate at a local level, and due to perception of corrupted activities of the offices, many businesses are reluctant to opt for patents. The majority however are not aware of the process. None of them have been able to acquire any form of patent yet.



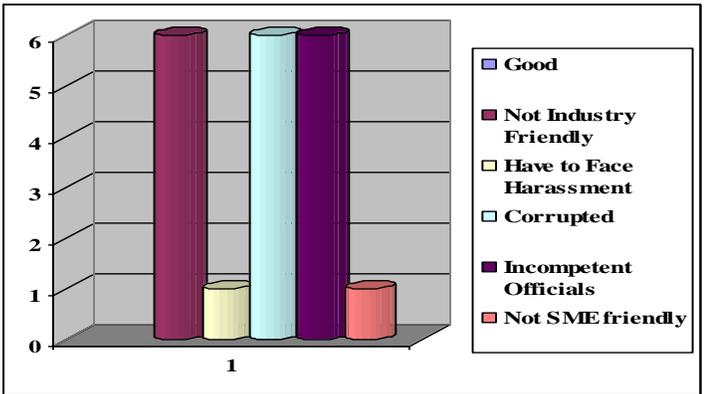
□ *Would gain a patent and product certification provide LES with a competitive advantage?*

Majority believe that obtaining patents will give them an enormous competitive advantage, but what more is necessary is quality assurance for LES and proper certification of their products



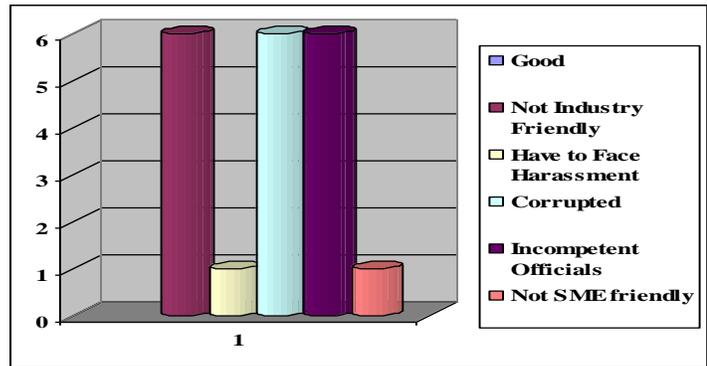
□ *Opinion on the activities of Department of Environment*

It transpired from the respondents that Department of Environment is not industry friendly, highly corrupted, along with the lack of competent officials creating a viscous circle. The Processes in the Department of Environment needs to be made hassle free.



□ *Problems Related to the Tax Imposition*

The LES does not have any special tax structure, and with exception to agricultural machinery, 15% VAT is imposed and 10% duty on repairing services.



7.0. Summary and Conclusion

Historically, large industries always drew the attraction of the policy makers since late 1950s and 1960s. In the eighties some supportive policies implemented through BSCIC favoring small industries resulted in considerable growth in LE/SME sectors. In the last 10-15 years, small manufacturing enterprises are facing unfavorable growth environment because of wrong policies possibly influenced by vested interest groups that favors import over local production. The Govt. tax policies finally dictate the variability of an industrial sector. Simply through wrong tax policies favoring import to local production, the Govt. can destroy a whole sector in spite of the presence of all other favorable factors for an enterprise. Wrong tax policies open up the opportunity of harassment by corrupt Govt. officials which form the major obstacle to the survival and growth of LE/small industries in Bangladesh.

It is a common scenario in Bangladesh that a certain small sector appears to grow and show promise, but after a few years, it starts declining. Factors behind this trend have been analyzed to identify the obstacles. Usually technology innovators seek out niches in the market and initiate new products. As soon as it succeeds and creates a large domestic market, rich traders influence the National Board of Revenue (NBR) to formulate policies to favor import of similar products against local production, and that is the point when the sector starts to decline.

Although NBR was created mainly for tax collection, it has now emerged as an authority for virtually all fiscal measures viz. budget, tax policy formation, their implementation, tax collection, and adjudication of tax evasion. It has transpired from a large section of respondents that NBR, as a single organization, is enjoying power particularly in financial matters which is the root cause for corruption affecting national interest in almost all sectors. Opinions have gone to the level of accusing NBR as the topmost obstacle to the growth of LE and small industries. Therefore the authorities presently vested with NBR need to be dispersed. Tax policies in particular be formulated by a body, completely isolated from NBR, represented by relevant ministries, trade bodies and experts from civil society.

Policy measures taken by India are very relevant as it shares a similar colonial past and similar culture and human behavior. To protect the small entrepreneurs from the harassment by tax officials, Indian Govt. took measures long ago. As of the year 2000, an enterprise with annual turnover of Rs. 1 crore or less does not have to register with any Govt. organization nor has to pay any excise duties. Besides, no excise officials can visit the premises of an enterprise which pays taxes up to Rs. 30 lac annually, without permission of higher authorities. In India for a revenue limit of Tk. 1 crore per annum (for small industries sector) all excise duties are exempted. Because of SAFTA and BIMSTEC agreements products made there under such facilities will be imported at very lower or negligible duty and will compete better against our products, so eventually we in Bangladesh may see the doom of our small industries if VAT at present level continues.

For the LES to grow and flourish in Bangladesh, an enabling environment has to be created so that small manufacturing enterprises can work uninhibited and can earn a profit. If these can be ensured through appropriate regulatory fiscal policies related to import and local production, all other factors will present themselves automatically through market dynamics. Proliferation of LE/small enterprises throughout the country is the only realistic way of reducing poverty. People have to be given the right environment where they themselves can fight poverty using their own intellect and skills, and where no one with authority of the Govt. is going to stop their endeavor. In this context one single step of the Govt. should be simply waive the tax and VAT on LE and small enterprises from which Govt. gets very little tax (as they have not proliferated) thus making negligible impact on the net revenue. On the other hand, the spectacular growth of the LES resulting from such measures will trigger a vibrant economic growth which will automatically increase the revenue earnings manifold, create employment, and will take people out of their poverty, and will allow the nation to stand on its own feet with dignity.

8.0. Recommendations

1. The indigenous Light Engineering (LE) industries should be given the opportunity of simplified VAT payment. The limit for VAT free turnover should be judiciously determined with lessons from neighboring countries.
2. Rationalization of tax structure on the imported raw materials and components of LE products that are not made locally should be judiciously settled.
3. The National Board of Revenue (NBR) be equipped with Raw Material Price database to prevent under-invoicing and associated fraudulence and corruption.
4. Since LE industry requires a high level of technical upgradation that should occur at both regional and rural levels, BITAC, BMTF, Technical Universities and Institutions should be better equipped and staffed with technical experts to create a platform for the LE entrepreneurs to have adequate access to all forms of technical and industrial assistance.
5. The mindset of NBR people, who favor importing of finished products than the production of the same within the country, needs to be seriously addressed and streamlined for the sake of overall development of LE industry in Bangladesh.
6. Since Light Engineering (LE) is considered to be a thrust sector by the Govt. (as reflected in the Industrial Policy), a comprehensive sectoral policy for LE alone be formulated to overcome the barriers and curb corruptions, and to provide a clear road map for the sector to flourish and contribute to economic growth of the country at desired level.

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