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**TAX EXEMPTION TO THE COTTAGE INDUSTRY:  
AN ANALYSIS OF SOME ISSUES**

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There has been an increased interest during the last few years in the development of small scale enterprises in the less developed countries. The important role which small enterprises can play in economic development has been examined in a number of World Bank studies [6,7,8]. The main arguments given in support of the small - as compared to the large scale enterprises are that the former are labour-intensive, have higher factor productivity, use less of the scarce factor (capital), and rely more on the domestically produced inputs. In addition, the level of required technical skills in small enterprises is moderate, and they mainly cater for the needs of the low- and middle-income groups. The extent of these general characteristics can vary from country to country and from industry to industry. While small scale enterprises exist in both manufacturing and non-manufacturing sectors, they lie predominantly in the former. This study only deals with small manufacturing enterprises.

In Pakistan small-scale industries are playing a significant role in the development process. The contribution of these industries in total industrial output was 26.6 percent in 1984-85, while their share in GDP was about 5 percent. These shares have been growing over time though at a very low rate. Small industries are also an important source of employment in the country. About 80 percent of the total industrial labour force is employed in this sector [4, p.140].

Realising the significance of the small industries in economic development, an important step which the Government of Pakistan took was the establishment of Small Industries Corporations in Punjab and Sind, Small Industries Development Board in N.W.F.P., and Small Industries Directorate in Baluchistan. These institutions are making valuable contributions to promoting small industries by providing a wide range of services to the investors. They are managing about eighteen small industrial estates and running a number of training-cum-development centres in the country.

The Government of Pakistan has also provided a number of fiscal and financial incentives in the past to encourage and promote this sector. || Cottage industry - a sub category of small industries has been given full exemption from central excise duty and sales tax. While the purpose of this exemption was to provide relief to very small manufacturers, it is alleged that the exemption is grossly misused and that in some cases, through undue competition, it is hitting hard the organised sector. || The objective of the present study is to examine the subject of tax exemption granted to the cottage industry and its possible implications for the economy.

#### Definition of Cottage Industry

The legal definition of the term 'cottage industry' is different from the one used in ordinary language and this definition



itself has been changing over time. In 1948 a cottage industry was defined in terms of its output level. Any unit whose turnover fell below a certain amount was exempted from paying sales tax. This definition was used with some variation up to 1959 when a cottage industry was redefined in terms of the capital employed. Any unit with a capital not exceeding Rs. 10,000 was exempted from tax payment irrespective of the level of its output. In 1972, besides the limit on capital, a limit on the maximum number of workers was also introduced in the definition. The limits on the value of capital and the number of workers were revised from time to time and the present definition of cottage industry is as follows<sup>1</sup>:

For the purpose of Central Excise "Cottage Industry" means an enterprise (not being owned by a joint stock company) which fulfils the following conditions, namely:

- (a) it is basically an enterprise in which the owner combines in himself the function of the investor and the labourer;
- (b) The capital employed therein does not exceed one hundred thousand rupees at any time during the financial year;
- (c) The number of workers employed therein on single shift basis does not, including the owner, the members of his family, relations, dependents or others, whether for or without any wages, remuneration or

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<sup>1</sup> See Chaudhry, Najib A. Manual of Central Excise Laws [1971].

compensation in cash or otherwise, exceed fifteen at any time during the year; and

(d) The owner thereof does not own any other cottage industry or another enterprise or where he does so, either wholly or in part, the capital employed at any time during the year in all such industries and enterprises, if any, taken together does not exceed one hundred thousand rupees; and

(e) "capital employed" means every type of capital whether invested in fixed or current assets including borrowed capital but investment in business premises shall not be considered while computing the amount of capital employed:

Provided that, if any property like plant, machinery, furniture or fixture is not owned by the manufacturer, the market value of such property shall be deemed to be a part of the capital employed.

The above definition of cottage industry also holds for the purpose of sales tax. With the exception of the following eight commodities all other goods produced by the cottage industry are exempt from sales tax.

1. Gas apparatus and appliances
2. Sanitary wares
3. Foam and foam products
4. Washing machines

5. Spring mattresses
6. Marble tiles
7. Flush doors
8. P.V.C. Pipes

While tax exemption to the cottage industry has been granted with a wide range of objectives in view, it is alleged that it is being grossly misused and has raised issues of equity and efficiency. The alleged gross misuse of cottage industry exemption essentially takes place in the form of undervaluation of capital stock and underreporting of workers. In the former case the use of secondhand machinery makes the correct valuation even more difficult. Also, it is argued that in some cases the cottage industry competes with the organised sector which owing to tax payments faces a different cost structure and where the entrepreneurs find their profits shrinking. This can have adverse effects on the growth of larger enterprises. Another misuse of the cottage industry exemption exists where a producer produces a commodity in different stages and at each stage production takes place in an enterprise which itself falls under the category of cottage industry. Thus by sub-contracting or by branching out the main activity, the producer manages to escape taxes and reap high profits. In this study we examine these allegations and their implications for the economy. In the course of our analysis we shall also discuss the need for any

change in the present policy of granting exemption to cottage industry from central excise duty and sales tax.

#### DATA

In order to examine the above - stated issues we need information about the size of cottage industry in the country classified according to the nature of commodities, their capital stock, and number of workers employed in each unit, and the level of their annual output. The same information is also required for all other manufacturing industries in the country. But unfortunately the required information was virtually nonexistent. Though some published data are available from the Punjab and Sind Small Industries Corporations, they are in highly aggregated form and are of no use for the purpose of this study. The data could have been obtained through a national sample survey but this option was again ruled out because of time constraint. We were therefore left with no other option except to use the limited information available with the collectorates of customs and central excise. A complete record is maintained in each collectorate concerning the tax paying and the tax-exempt industrial units. Cottage industry exemption certificates are issued by the Collector Customs and Central Excise to those units which satisfy the legal requirements. For the tax-paying units a monthly record is maintained for quantity



produced, quantity cleared, and amount of central excise duty and/or sales tax paid by each establishment.

We obtained from the Collectorates of Customs and Central Excise at Karachi, Lahore, Rawalpindi, and Peshawar, the available information concerning the units which had been issued the cottage industry exemption certificates and those which paid the central excise duty and/or sales tax in 1984-85. The information obtained from Lahore was for circle II only while for other areas it pertained to the entire area of each collectorate. Unfortunately the collectorates did not have any data concerning the output levels of tax-exempt, and the employment and capital stock levels of the tax-paying units. The above stated collectorates cover a major portion of the industrial areas in Pakistan. In 1984-85 more than 45 percent of the total central excise duty and sales tax on domestically produced goods came from these areas.

#### Analysis of the Issues

It is true that the exemption granted to cottage industry from payment of central excise duty and sales tax is grossly misused. This phenomenon is quite wide spread and is not restricted to any particular category of the industry or to any particular area. This observation is based on our visit to a few manufacturing units located in Lahore and Peshawar. As far as the definition of cottage industry is concerned, upper

limit on capital, i.e. Rs. 100,000, does not appear to be high in these inflationary days. However the limit on the number of workers on a single-shift basis, which is 15, seems a bit high. But we believe that with such a high limit on workers, government probably wants to encourage labor intensive techniques to generate employment in the country.

Strict enforcement of the law is necessary to minimize the misuse of the tax exemption. If the law can not be enforced strictly, the other available option is to totally withdraw the exemption. But we think that it would be very difficult and expensive to administer such a policy. However it is important to know the amount of revenue which will be generated if cottage industry is also made to pay taxes. Only when the tax revenue turns out to be large, would such a policy be worthwhile.

Estimation of Additional Tax Revenue In Case Cottage Industry Tax Exemption is Totally Withdrawn

In order to estimate the additional tax revenue from central excise duty and sales tax, if cottage industry tax exemption is totally withdrawn, we need to know (i) total number of units in the country in different categories of cottage industry, and (ii) their levels of output. Since this information was not available, we based our estimation on the number of units which had been granted exemption certificates by the concerned authorities. But, again, since the output levels of even the tax-exempt

units were not known we assumed that their maximum output was equal to that of the smallest tax paying unit in each category.

The list of exempted units according to their nature of output is given in Table 1. Total number of exempted units are 997 and most of them are located in Karachi. The tax-paying units are certainly larger than those classified as cottage industry units. We have identified in each category of the industry, the units paying minimum central excise duty and/or sales tax. The tax which a unit in cottage industry will pay, if exemption is withdrawn, has to be less than the tax being paid by the smallest tax-paying unit. But the problem is that we do not know its extent. It is, therefore, assumed that each cottage industry unit will pay the tax exactly equal to the tax being paid by the smallest unit in a particular category. Thus our estimates will have some upward bias.

The results of our estimation are given in Table 2. The excise duty and sales tax collected in our sample area amounted to Rs. 7443.707 million for the year 1984-85. Additional tax revenue to be generated from these areas if cottage industry tax exemption is withdrawn turns out to be Rs. 9.712 million, which is 0.130 percent of the existing revenue from the central excise and sales tax. Assuming that for the entire economy the total revenue from the central excise and sales tax will increase by the same percentage (0.130), the estimated amount of additional revenue comes out to be Rs. 21.373 million, which

Table-1

A COMMODITYWISE LIST OF MANUFACTURING UNITS AVAILING  
COTTAGE INDUSTRY TAX EXEMPTION

Commodity	Nature of Tax	Number of Tax Exempt Units
Arms and Ammunition	Sales Tax	2
Auto Parts	"	56
Beverages	Excise Duty	5
Brushware	Sales Tax	4
Bus/Truck Body Making	"	28
Cassettes	"	5
Chemicals	"	14
Confectionery and Bakery Products	"	120
Cosmetics	Excise Duty and Sales Tax	13
Electrical Goods	Sales Tax	96
Glass and Glassware	Excise Duty and Sales Tax	16
Gum and Gum Products	Sales Tax	3
Ice Cream	"	42
Laundry Soap	Excise Duty	3
Man Made Yarn	"	2
Metal Containers	Sales Tax	28
Metal Products	"	12
Paper and Paper Board	Excise Duty and Sales Tax	89
Plastic Products	Sales Tax	299
R.C.C. Pipes	Sales Tax	37
Roofing Felt	"	1
Rubber Products	Sales Tax	42
Sanitary Napkins	"	3
Spices	"	6
Steel Products	Excise Duty and Sales Tax	18
Tarpaulin and Tentage	Sales Tax	1
Paints and Varnishes	Excise Duty	5
Wire and Cables	Excise Duty and Sales Tax	29
Miscellaneous	Sales Tax	18
Total		997



Table-2

**ADDITIONAL TAX REVENUE GENERATION IN CASE COTTAGE INDUSTRY  
TAX EXEMPTION IS TOTALLY WITHDRAWN**

(Million Rs.)

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1. Central Excise Duty and Sales Tax (on Domestic Production) Collected from Karachi, Rawalpindi, and Peshawar Collectorates of Central Excise and Sales Tax, and Lahore-II for the Year 1984-85.	: 7443.707
2. Estimated Additional Tax (Excise and Sales) Revenue from the Above Listed Areas in Case Cottage Industry Tax Exemption is Totally Withdrawn.	: 9.712
3. Additional Tax Revenue as a Percentage of Existing Tax Collection $\left[ \frac{2}{1} \right] \times 100 \%$ .	: 0.130
4. Total Collection of Excise Duty and Sales Tax (on Domestic Production) from the Whole Country for the Year 1984-85.	: 16440.600
5. Estimated Additional Tax Revenue from the Whole Country in Case Cottage Industry Tax Exemption is Totally Withdrawn $\left[ \frac{.130 \times 16440.6}{100} \right]$ .	: 21.373
6. Estimated Additional Tax Revenue as a Percentage of Total Tax Revenue in the Country for the Year 1984-85.	: 0.041

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is only 0.041 percent of the total federal tax revenue for 1984-85. This is certainly not a large amount, and while computing it we have totally ignored the additional collection costs. In case of total withdrawal of tax exemption, since quite a large number of very small units will be involved, the collection costs may be substantial and may even outweigh the additional revenue.

#### Competition with the Organised Sector

Competition between cottage industry and the organised sector can be determined by commoditywise comparisons of the annual output levels in the two categories. But in the absence of the required data we are constrained to confine our analysis to a comparison of the number of manufacturing units, and the actual and estimated revenues from units in cottage and non-cottage industries. Since tax revenue is directly related with the level of output, it can be used as a proxy for the latter.

If we only look at the number of the tax-paying and tax-exempt units (i.e. non-cottage and cottage units) as shown in columns 2 and 4 of Table 3, competition appears to exist in quite a few industries. These industries include plastic products, rubber products, electrical goods, auto parts, brushware, bus/truck body making, cassettes, confectionary and bakery, ice cream, metal products, paper and paper board, and R.C.C. pipes. The largest number of manufacturing units was in plastic industry which is an important and a rapidly expanding

Table-3

A COMMODITYWISE COMPARISON OF ESTIMATED TAX REVENUE FROM COTTAGE INDUSTRY AND  
THE ACTUAL COLLECTION FROM OTHER INDUSTRIES

Commodity	No. of Tax Paying Units	Central Excise Duty and/or Sales Tax Paid	No. of Tax Exempt Units	Estimated Tax Revenue From Tax Exempt Units	Estimated Revenue as a Percentage of Tax Collected from Non-Cottage Industries
Arms and Ammunition	18	7157693	2	64884	0.91
Auto Parts	48	17151482	56	935928	5.46
Beverages	52	454263322	5	14635	0.00
Brushware	3	920909	4	131016	14.23
Bus/Truck Body Making	38	5740689	28	105000	1.83
Cassettes	5	5411519	5	39748	0.73
Chemicals	30	20450548	14	385224	1.88
Confectionary & Bakery	63	57849172	120	300000	0.52
Cosmetics	69	80090585	13	97786	0.12
Electrical Goods	17	7622821	96	203904	2.67
Glass & Glassware	19	38888592	16	345600	0.89
Gum & Gum Products	7	1089817	3	117648	10.79
Ice Cream	8	14763199	42	281232	1.90
Laundry Soap	35	110093826	3	28800	0.03
Man Made Yarn	70	82621922	2	18714	0.02
Metal Containers	37	68852202	28	20892	0.03
Metal Products	10	1648689	12	135360	8.21
Paper & Paper Board	22	105739552	89	3898200	3.69
Plastic Products	156	68119462	299	1308125	1.92
R.C.C. Pipes	16	356305	37	226625	63.60
Roofing Felt	3	76589	1	8167	10.66
Rubber Products	20	4267865	42	124872	2.92
Sanitary Napkins	6	2654975	3	236844	8.92
Spices	8	1484639	6	25938	1.75
Steel Products	100	23195351	18	240408	1.04
Tarpaulin & Tentage	16	2188122	1	18276	0.84
Varnishes & Paints	82	115131721	5	34310	0.03
Wire & Cables	43	27207291	29	172550	0.63
Miscellaneous	18	4083083	18	191689	4.69
Total	1019	1329121942	997	9712075	0.73

industry in the country. Out of 455 units in this category located in the areas of Karachi, Lahore, Rawalpindi, and Peshawar collectorates, and for which official record existed, 156 units were paying taxes in 1984-85 while 299 were operating under the umbrella of cottage industry exemption. Thus for each tax-paying unit there were almost two units in the cottage industry which were operating without paying any sales tax. Similarly, out of 113 units producing electrical goods, 17 tax-paying units were facing competition from 96 other units operating under cottage industry exemption. Manufacturing of paper and paperboard was another category where the number of cottage industry units (89) far exceeded the number of units in non-cottage industry (22). In the case of R.C.C. pipes, 37 out of 53 units were enjoying the cottage industry status. Similar situation prevailed in many other industries, although the degree of competition faced by them was not as great.

While comparison of the number of manufacturing units in cottage and non-cottage industry indicates the existence of some competition in certain areas, its magnitude, however, can not be ascertained without looking at the size of industry in the two categories. The output of 100 cottage industry tax-exempt units, for example, may only be a small fraction of the output of one large tax-paying unit. To have an idea about the relative size of the cottage industry we have estimated for each category the amount of tax that would be collected if cottage industry exemption



is withdrawn. These estimates are given in column 5 of Table 3. The estimates are based on the assumption that the maximum tax that can be obtained from a cottage industry unit is at most equal to the minimum tax paid by a unit producing the same commodity in the non-cottage category. The last column in Table 3 gives the estimated revenue as a percentage of tax collected from non-cottage industries. Figures in that column show that with the exception of only a few commodities the estimated revenue from cottage industry is negligible as compared to the actual collection from non-cottage industries. In the case of 12 out of 29 commodities it is less than 1 percent, while for another 10 commodities it is less than 5 percent. Only in the case of four commodities namely, brushware, gum and gum products, R.C.C. pipes, and roofing felt does the estimated revenue from cottage industry units amount to more than 10 percent of the actual tax collection. Strong competition appears to exist only in the case of R.C.C. pipes where the estimated revenue comes out to be almost 64 percent of the actual tax collection.

In short, the earlier impression that in quite a few cases the organised sector was getting competition from the cottage industry, as the number of units in the latter category far exceed those in the former, is negated by the evidence that we get from the comparisons of the estimated and actual revenue collections from cottage and non-cottage industries respectively. Most of the units in cottage industry are so small that they do not appear

to create any serious problem for the organised sector. The allegation of competition is not supported by the available evidence with only one major exception of R.C.C. pipe industry. Tax exemption may be withdrawn from this industry after a detailed study. There is also need for further examination of industries like brush-ware, gum and gum products, metal products, and roofing felt.

There is an incentive for entrepreneurs to split their business into small units and run them under different names just to avail themselves benefit of cottage industry tax exemption. The magnitude of this problem is not known. The problem can be easily overcome if in the definition of cottage industry some limit on turnover is introduced. When a commodity is produced at different stages, its value increases at each stage. At some stage, which can be the final stage, the producing unit may cross the limit on turnover and shall have to pay the taxes.

As there is no limit on turnover in the current definition of cottage industry, industries which are labour-intensive and do not need much capital, can do extensive business and yet enjoy cottage industry tax exemption. The objective of cottage industry tax exemption is to provide relief to small units, but in the process some large units also benefit. We think that this problem can be tackled by putting some limit on turnover in the definition of cottage industry.

### Conclusions

On the basis of this limited analysis we have arrived at the following conclusions:

1. . . . Though the misuse of cottage industry tax exemption of an unknown magnitude exists in the country, the available statistics show that the increase in government revenue if such an exemption is totally withdrawn would be very small. Even if we ignore the cost of collection the additional revenue from central excise duty and sales tax is expected to be only Rs. 21,373 million which is 0.041 percent of the total federal tax revenue for the year 1984-85. Total withdrawal of exemption under these circumstances is therefore not recommended.
2. Varying degrees of competition exists between cottage and other industries. Comparing only the number of units in the two categories, we find that the competition is strong in categories like plastic products, rubber products, auto parts, electrical goods, brushware, bus/truck body making, cassettes, paper and paper board, R.C.C. pipes, confectionary and bakery, ice cream, and metal products. But comparing the actual and estimated tax revenues (used as proxies for output levels) from non-cottage and cottage industries respectively, we find

that strong competition exists only in the case of R.C.C. pipes, while moderate competition exists in the cases of brushware, gum and gum products, roofing felt, and metal products. Detailed studies concerning these industries need to be undertaken to determine the exact degree of competition.

3. Sub-contracting or splitting up of a business provides a special incentive for the producers to evade taxes under the legal protection of cottage industry. In our opinion the solution to this problem lies in adding another clause to the definition of "Cottage Industry" in the form of a limit on turnover. Thus if a commodity is produced in three or four stages, its value may exceed the specified limit at some stage thereby making the producer liable to tax payments. All cottage industry units having large turnovers would automatically be covered under this clause.
4. This analysis is based entirely on the data obtained from official sources. A very large number of small units are believed to exist for which there is no official record. Even the best policies are of no use if they can not be properly implemented. Necessary steps therefore need to be undertaken for the rigorous enforcement of the existing tax laws.



5. Last but not the least is the urgent need for a detailed field survey of the cottage industry in Pakistan. In the absence of the very basic facts about the cottage industry the policy makers are seriously handicapped in working out future plans for this sector. The survey should be undertaken not only once but regularly which is the only way to monitor the fundamental changes in important economic variables.

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