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Removing Small-Scale Reservations and Quality Upgradation: Evidence from India

Executive Summary

The paper examines the impact of dismantling India's Small-Scale Industries (SSI) product reservation policy on manufacturing product quality. Introduced in 1967, the SSI reservation policy barred large firms from producing certain products, aiming to protect small firms and jobs but inadvertently constraining firm growth and innovation. Between 2000 and 2007, most of these products were progressively dereserved, providing a natural experiment to study the policy's effects. Using detailed plant-level data from the Annual Survey of Industries and a demand-residual approach to measure product quality, the study employs a difference-in-differences framework, complemented by robust estimators, to identify causal effects. The results show that dereservation significantly improved product quality, particularly among large and highly productive firms that could leverage economies of scale, invest in better inputs, capital, and skilled labor, and thus enhance product standards. Even firms constrained just below the SSI investment threshold experienced quality upgrades once restrictions were relaxed, indicating expansionary effects. The findings also reveal heterogeneity: in industries with greater scope for product differentiation (long "quality ladders"), firms competed on quality, whereas in industries with limited differentiation (short ladders), firms competed through lower prices. Importantly, despite higher input costs, productivity gains offset rising expenses, leaving marginal costs unchanged, while quality-adjusted prices declined, pointing to welfare gains for consumers. Overall, the study shows that size-based industrial policies, while designed to nurture small firms, may suppress quality upgrading and global competitiveness. Their removal fosters firm growth, innovation, and consumer welfare, underscoring the value of competition-oriented policy reforms