MSMEs in India

Micro, Small and Medium Enterprises (MSMEs) have played a crucial role in the socio-economic development of India. The sector is considered to be the growth engine of the Indian economy for not only its contribution in employment generation, but also for the role it has played in the industrialisation of rural and backward areas. Today, MSMEs are operating in both formal as well as the informal sectors of the economy, starting from cottage industries to the high-tech engineering segment.

Definition of MSMEs

MSMEs have been defined in the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006 passed by the Indian government to address the policy issues affecting SMEs, and to extend the coverage and investment ceiling of the sector. The Act further classifies these enterprises into micro, small and medium enterprises, based on their investment in plant & machinery (for manufacturing enterprises) or investment in equipment (for services enterprises).

Criteria for Classification of Micro, Small and Medium Enterprises

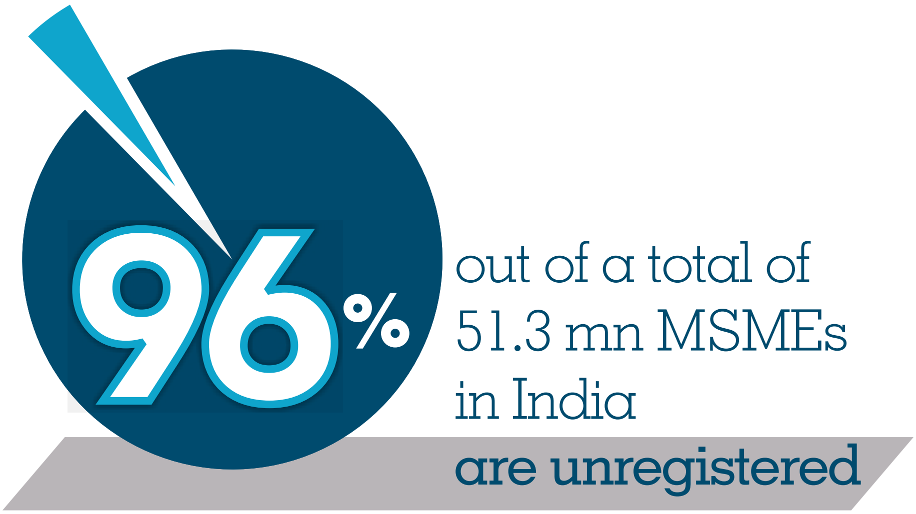
Manufacturing Sector	Investment in Plant & Machinery	Service Sector	Investment in Equipment
Micro	Upto ₹ 2.5 mn	Micro	Upto ₹ 1 mn
Small	Above ₹ 2.5 mn & upto ₹ 50 mn	Small	Above ₹ 1 mn & upto ₹ 20 mn
Medium	Above ₹ 50 mn & upto ₹ 100 mn	Medium	Above ₹ 20 mn & upto ₹ 50 mn

Source: Ministry of Micro, Small and Medium Enterprises, GoI

Growth of MSMEs

It would not be incorrect to call the MSME sector the backbone of the Indian economy. Overall, MSMEs account for an estimated 90% of all enterprises in India. In FY15, the sector accounted for 6% of the GDP, 33% of the manufacturing sector output and about 45% of the country's exports.

As per estimates made using results of the Sixth Economic Census, 2013, (results of which were published on 31 March 2016), the Fourth all-India Census of MSMEs, 2006-07 and the Fifth Economic Census, 2005, the number of working MSMEs in India stands at around 51.3 mn. Out of these, a whopping 96% are unregistered.

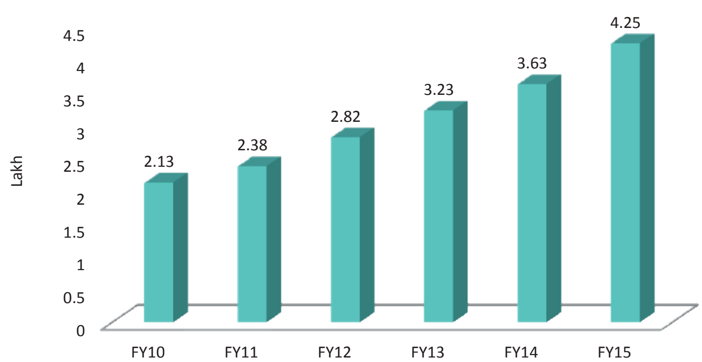


Key benefits of getting registered

- ☐ Avail the benefits from Ministry of MSME
- ☐ Easy access to finance
- ☐ Improve reputation with customers

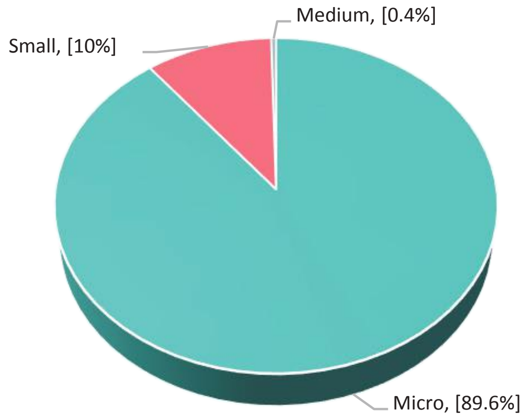
Nonetheless, the growth of MSMEs can be assessed from the rapid increase in the number of registrations in the past few years. The number of Entrepreneur Memorandum Part-II (EM-II) filed with State/UT Commissionerates/Directorates of Industries (DICs) during FY15 almost doubled to 0.43 mn as against 0.21 mn during FY10, reflecting a CAGR of 14.8%. From Sep 2015 onwards, the EM-II was replaced by the Udyog Aadhaar Memorandum (UAM). Since then, a whopping 3.7 mn enterprises have been registered under UAM till date, out of which 89.6% are micro enterprises, 10% are small enterprises and 0.4% are medium enterprises. The state-wise distribution reveals that Bihar, Uttar Pradesh, Tamil Nadu, Maharashtra and Gujarat are the top five states which collectively accounted for 63.4% i.e. of the UAM filings made, whereas the bottom ten states and UTs contributed to a minuscule 0.24% of the UAM filings.

Number of EM-II filed



Source: Development Commissioner Micro, Small and Medium Enterprises

Distribution of Micro, Small and Medium Enterprises as per UAM Filings (as on 12th Nov 2017)

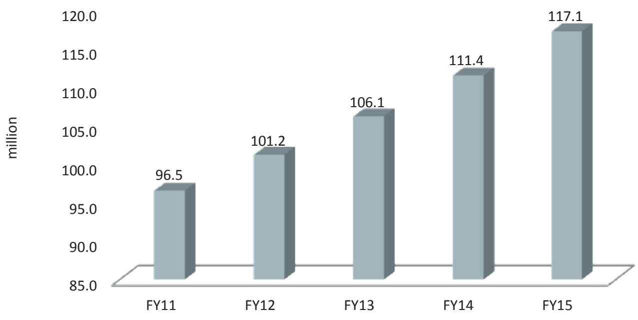


Source: Udyog Aadhar Website,Ministry of MSME

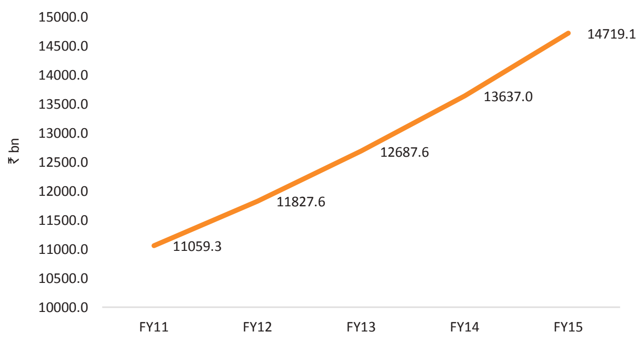
On the employment generation front, the MSME sector provided employment to 117.1 mn persons in FY15, reflecting a growth of 5.1% as compared to the preceding year. Employment in MSMEs grew by 4.9% per annum during FY11-FY15.

The growth of the MSME sector can also be gauged from the healthy growth in the quantum of investment in fixed assets. The market value of fixed assets of MSMEs reflected a growth of 7.2% per annum during FY11-FY15.

Projected growth in employment in the MSME sector



Projected market value of fixed assets



Source: Ministry of MSME, Annual Report 2016-17

Global MSME sector – Key Highlights

- The most widely used variable for defining an MSME is the number of employees, followed by turnover and assets.
- There are about 162.8 mn formal MSMEs, employing more than 508 mn employees. Out of this, about 96.3 mn MSMEs and 231.4 mn employees operate in emerging markets.
- Formal MSMEs account for a median share of employment totaling 67.1%. MSME's contribution to employment in high-income economies surpasses 65%, while in upper-middle income economies it is about 60% and in low-income economies it is approximately at 75%.
- Globally, MSMEs have registered a growth rate of around 5.2% annually since 2000. The lower-middle-income economies (for example, in the Europe and Central Asia region) have the highest growth rates of MSMEs.
- Overall, the median MSME density stands at 32.18 MSMEs per 1,000 people. The five economies with the highest formal MSME densities are the US (89.96), Czech Republic (89.31), Liechtenstein (80.69), Iceland (79.2), and Portugal (78.7).
- The density of MSMEs largely depends upon higher levels of GNI per capita, better access to finance, streamlined business environments, a more competitive landscape, adequate institutional frameworks, less poverty, and greater shared prosperity.

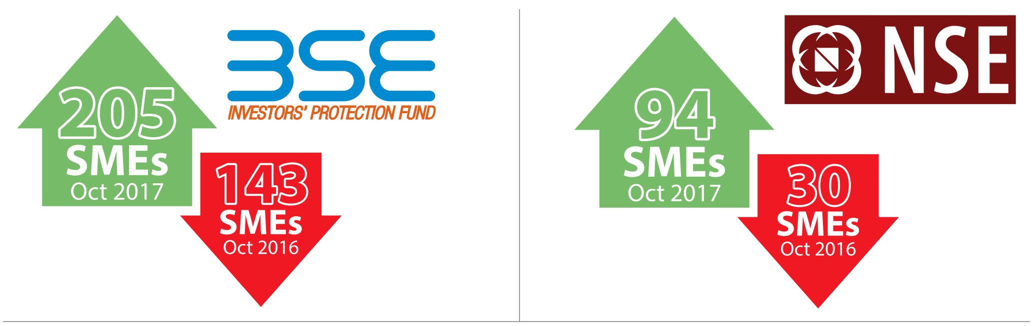
Source: MSME Country Indicators 2014, International Finance Corporation

SME Exchanges in India

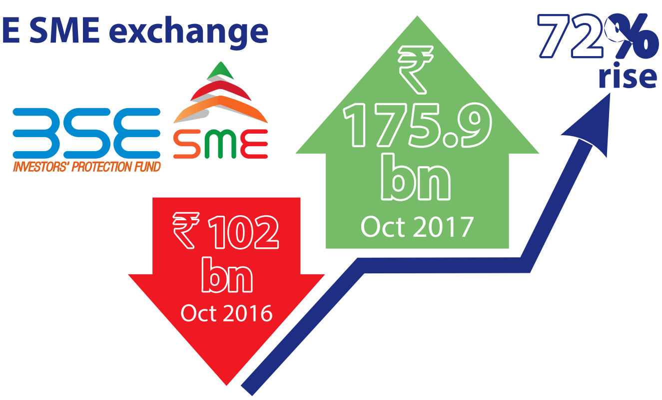
The lack of access to timely and sufficient funding has been one of the major impediments for growth and development of SMEs. Traditionally, the primary source of funding for SMEs has been the seed capital brought in by the entrepreneur and his/her friends and family. This form of financing has its limitations due to the ceiling on the amount of capital that can be raised through internal accruals, thereby hindering SMEs from pursuing possible growth opportunities and expansion plans. This financial crunch forces SMEs to rely heavily on long-term and short-term bank loans and other modes of debt financing, which poses significant constraints on growing SMEs. Higher risk weightages assigned to SMEs makes it challenging for them to raise funds through the traditional forms of debt financing such as bank loans. Eventually, debt servicing ends up denting their profitability and operating cash flows, thereby hindering their earning ability and organic growth prospects. The advent of SME exchanges in India has enabled Indian SMEs to gain greater visibility, enhance their brand image, and raise funds through the capital markets without having to be burdened by debt.

In 2012, BSE and NSE launched their respective SME exchange platforms. As of October 2017, the BSE SME Exchange had 205 companies listed with a total market capitalization of ₹ 176 billion, as against 143 companies listed with a total market capitalization of ₹ 102 billion in October 2016. Likewise, as at the end of October 2017, NSE's EMERGE had 94 companies listed with as against 30 in October 2016.

Rise in number of SMEs getting listed on Exchanges



Total Market cap of BSE SME exchange



Recent government initiatives to boost MSMEs

In view of the pivotal role played by MSMEs, the Government has introduced several initiatives to provide impetus to the sector. Some of the key policy measures taken by the government for the MSME sector are as follows:

- Augmentation of the corpus of Credit Guarantee Trust Fund from ₹ 25 bn to ₹ 75 bn, to be fully funded by the Government of India
- Increased coverage of the loans under the credit guarantee scheme from ₹ 10 mn to ₹ 20 mn.
- Increased coverage of the Credit Guarantee Scheme for loans being extended to micro and small enterprises by NBFCs as well

Post the demonetisation, the Government took several steps to promote digital transactions amongst MSMEs. Some of them are as under:-

- In the Union Budget FY18, the Government proposed that under the scheme of presumptive income tax for small and medium tax payers with turnover up to ₹ 20 mn, 6% of their turnover which is received by non-cash means will be counted as presumptive income as against 8% of their turnover earlier.
- To promote cashless transactions, it was proposed in the Union Budget FY18 to exempt BCD, Excise/CV duty and SAD on miniaturised POS card reader for m-POS, micro ATM standards version 1.5.1, Fingerprint Readers/Scanners and Iris Scanners.

The government has implemented various schemes for the promotion of MSMEs. The total expenditure on these schemes as on Oct 31, 2017 was ₹ 33.5 bn as against ₹ 4.5 bn till Oct 2016.

Scheme	Expenditure (₹ mn)		Physical Performance (number)		
	upto Oct 2016	upto Oct 2017		upto Oct 2016	upto Oct 2017
Technology Upgradation and Quality Certification	80.8	145.3	Trainees Benefitted	1037	1030
Credit Support Programme	177.8	28018	Credit Proposals Approved	161696	305903
Marketing Development Assistance	16.9	19.5	MSMEs Benefitted	4822	5531
Promotional Services Institutions and Programme	139.5	346.7	Trainees Benefitted	1	5
Infrastructure Development Programme	1689.1	2222.1	MSMEs Benefitted	20946	19159
NMCP - CLCSS	2273.9	2552.8	No of MSMEs	3553	4027

Source: Office of Development Commissioner, MSME

MSMEs – Some Key Issues

Impact of Demonetisation

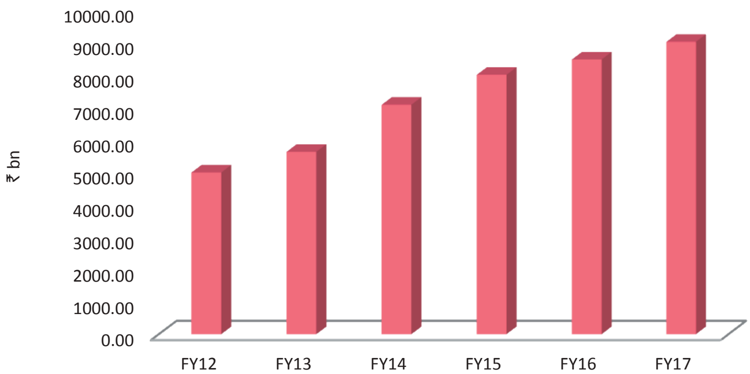
While Indian companies have witnessed significant level of digitisation in the past few years, a large number of MSMEs continue to operate completely offline. Even those with an access to digital infrastructure haven't fully leveraged its benefits. Consequently, the sector was hit hard when the Government of India announced that the Five Hundred and One Thousand Rupee notes would cease to be legal tender from the midnight of Nov 8, 2016. The demonetisation caused short-term disruption in terms of working capital, fall in consumer demand, supply disruptions, and debt repayment, especially in rural and semi-urban areas.

However, post demonetisation there has been a substantial shift away from cash transactions to cheque or electronic payment channels, especially in traditional cash-sensitive sectors such as textiles, agricultural products, electrical equipment, steel consumer durables and automobiles. Further, with liquidity and working capital drying up in the immediate aftermath of the demonetisation, the unbanked MSMEs had to approach banks for loans. Thus, while demonetisation has resulted in short term disruptions for SME business, it has also provided significant impetus for digital transactions, which in turn will benefit SMEs by way of easier record keeping, expansion to other geographical markets and quick processing of payments.

Access to Finance

Access to finance is one of the major challenges faced by the MSME sector in India. The MSME Census of 2006-07 revealed that almost 87% of MSMEs did not have access to secure finance and often had to approach internal sources like friends or relatives to meet their financial requirements. One of the major reasons for this demand-supply mismatch in SME financing is the perceived credit risk involved in financing SMEs. This is primarily due to non-availability of valid invoices, proper accounting systems and dearth of known buyers. In order to mitigate this credit risk, higher collateral is sought, which cannot be brought in by many SMEs. Further, due to their small size and local presence, the transaction costs involved in financing them are very high. In order to tackle this issue, SME lending is being treated as priority sector lending. The priority sector lending to SMEs reached ₹ 9 trillion in FY17 as against ₹ 8.5 trillion in FY16, registering a growth of 6.5%.

Priority sector lending to SMEs



Source: RBI

In addition to various efforts by the Ministry of Small and Medium Enterprises, Small Industries Development Bank of India (SIDBI) and the RBI, a World Bank project has been initiated to address the SME financing issue. Approved in 2015, the USD 550 mn World Bank project supports innovative financial products, frameworks and tools for MSME financing. This is the World Bank's first loan to support start-up debt development and franchising finance to India. The World Bank is working with the SIDBI for providing a credit line of USD 500 mn and supporting SIDBI's efforts in direct and indirect financing. As of March 2017, the MSME project of the World Bank has disbursed USD 265.38 mn to facilitating SME finance.

In addition to the traditional banking and financial institutions network, the emerging FinTech companies can also play a major role in bridging the gap in SME financing. FinTech companies can offer tech-based innovative financial products and services which will be low cost, require less paperwork and generate scalability and efficient last mile connectivity. For instance, certain business models like peer-to-peer lending (P2P), customised loan solutions on online platform can be an alternative source for SME finance. Recently, some banks have also started partnering with FinTech companies to expand their reach in the SME sector.

Concluding Remarks

The MSME sector in India has shown remarkable resilience amidst the challenging economic environment in the past few years. They have emerged as the backbone of the Indian economy due their contribution in terms of job creation and boosting economic growth. In view of its significance for the economic growth and poverty elimination, the Government of India has taken various initiatives to support the growth of MSMEs. Despite this, MSMEs continue to suffer some critical challenges like unavailability of adequate, timely and low-cost credit, lack of digitisation, lack of skilled manpower, inadequate marketing support and infrastructure facilities, etc. These challenges have turned out be the major dampener for the growth of MSMEs in India, and hence need to be resolved.

Impact of GST on the MSME Sector

After a 13-year long wait, the Goods and Services Tax (GST) was finally introduced in India on July 1, 2017. Among various other benefits, it was largely introduced to address the competitive disadvantage faced by the Indian manufacturing sector in the global market due to the complexity and cascading effect of the erstwhile indirect taxation regime. The erstwhile tax structure had inadvertently led to a scenario of disproportionate tax revenues from certain sectors, and the selection of inputs, production technologies and supply chains for tax optimization proposes rather than business efficiencies. Consequently, the growth of manufacturing was hindered to a significant extent.

GST was introduced to usher in a win-win situation for the industrial sector. Broadly speaking, it was sought as a measure to simplify taxation, make compliance easier, to remove complexities, to improve transparency, and improve the general ease of doing business in the country.

The GST was introduced to usher in the following benefits: -

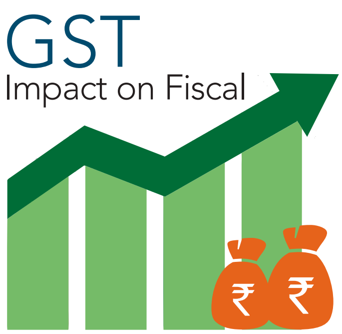
• To create a common market across states • To provide uniformity in tax rates and structures • To bring in a system that is simple and enables cost-saving • To help raise revenue in a transparent and neutral manner • To expand the tax base • To enable better controls on tax leakage • To facilitate administration and compliance • To promote neutrality between domestic production and imports by eliminating CVD/SAD exemptions	• To facilitate inter-state trade • To help reduce logistics costs • To abolish the cascading effect on tax • To support the Government's 'Make In India' initiative • To provide an incentive to manufacturers and exporters • To single and transparent tax for consumers proportionate to the value of goods and services • To provide relief to consumers in terms of overall tax burden • To improve the competitiveness of Indian goods and services

Challenges Faced in the Immediate Aftermath of Implementation

The implementation of the GST has simplified the process of tax-paying by merging of various taxes. Further, with the abolition of check posts, there has been a reduction in logistics costs. While the medium-to-long term benefits of the GST are indisputable, the immediate impact has been extremely disruptive, perhaps even more than was originally anticipated. The immediate aftermath of the introduction of the GST brought about a great deal of compliance hurdles, ambiguity with respect to valuations and rates, confusion and a roadblock in enterprises' inventory and working capital management. Consequently, the overall growth of Indian businesses was dented in the short run. Given the fact that India has probably the second largest MSME base in the world, of which more than 90% belong to the unorganized segment, micro and small companies were particularly significantly impacted.

The challenges can be enumerated as follows: -

- **Teething Problems** – The first three months since the implementation of the GST have proved to be challenging on various fronts. The implementation of GST has particularly impacted small and micro enterprises to a great extent, since many of them had to register under an indirect tax regime and file tax returns for the first time.
- **Lack of preparedness on the part of SMEs** - Although GST-related processes and laws were available to companies before implementation, the practical challenges became clear only after implementation. Manufacturing entities with warehouses located in different states were suddenly required to pay taxes for interstate transfer of goods, for which refund could only be claimed at a later stage. This led to a shortage of working capital as raising invoices and claiming input tax credit were deferred to the subsequent month(s).
- **Lack of clarity/awareness** – The GST brought in a certain degree of ambiguity regarding the valuation of services, especially in cases where services are shared within the organisation across states; this has also created room for fraud/manipulation with respect to valuation and categorization of services. Businesses also found the 'reverse charge' payment of tax on purchases from unregistered vendors to be a complex concept.
- **Increased compliance** - The fact that returns under the GST needed to be filed very frequently – three per month, one per quarter and one annually – meant that it was a time-consuming and costly affair. The emphasis on transparency has resulted in service providers now being required to execute branch level accounting, as every state now has separate requirements for compliance, documentation and return filing. Inter branch and intra branch invoicing has increased due to internal tax transfers. Also, while it is now possible to address queries/scrutiny/audits online, being physically present is still necessary in certain cases.
- **Factors beyond enterprises' control** - The multiple revisions in the format to pay taxes were hard to comprehend. This not only affected taxpayers, but also companies providing GST software to upgrade their systems. This, in turn, led to a delay in the filing of returns. There also arose the risk of companies potentially missing out on claiming their input tax credit on time due to errors committed while entering GSTN numbers and other sensitive data into the system.



- Achieving better tax compliance
- Widening the tax base and increase in tax revenue
- Cutting down exemptions
- Additional tax on alcohol
- Expected increase in public spending

Increase in cost of operation owing to GST - Some global examples

Global experience shows that MSMEs in certain countries witnessed an increase in the cost of operation after the adoption of GST and remained at a competitive disadvantage to their larger counterparts.

- The Report on the SME Taxation Survey 2016 conducted by The Associated Chinese Chambers of Commerce and Industry of Malaysia (ACCCIM) during the period of 29th April 2016 to 31st May 2016 shows that: for 82% respondents, GST has increased their cost of operation, while only 18% were not affected. The study also revealed that more than half of the respondents (58%) are still encountering cash flow problems due to GST.
- There is considerable evidence suggesting that the costs of compliance, relative to firm size, are greater for smaller firms. Pope and Rametse (2001), for instance, estimate the cost of complying with the Australian GST to be only about 0.04% of turnover for large businesses (turnover of around Australian $ 2 mn) but around 2% for smaller homes (at turnover of around Australian $ 100,000).
- The report on European Tax Survey (2004) by European Commission, for example, revealed that compliance costs for the VAT and corporate tax are around 0.02% of turnover for larger enterprises, but 2.6% for small businesses.

Steps taken to alleviate these issues

Taking cognizance of the various issues and challenges faced by businesses, especially by MSMEs and exporters, the government has now taken proactive steps to ease out these difficulties. Some of these are as under:-

- In its 22nd meeting, the GST Council announced many changes which for one, include the suspension of the Reverse Charge Mechanism (RCM) till March 2018. While this will provide some respite to small companies and those entities trading with them, it would necessitate substantial modification/customization of ERP and related IT systems for firms.
- The Council has also extended the composition scheme to taxpayers having an annual aggregate turnover of up to ₹ 10 million and has now permitted the otherwise eligible suppliers of exempt services, to avail of the composition scheme which will benefit the SMEs.
- The tax rates have now been reduced for certain goods and services and relief packages have been introduced for exporters. These are expected to provide some relief.
- The government's move to issue refunds of GST paid by exporters as soon as possible and to introduce an e-wallet system with automatic credit of a notional amount from April 1, 2018 will reduce the working capital issues currently being faced by exporters.
- The implementation of the e-way bill system has now been deferred. While this move offers interim relief to small traders and businesses, its eventual rollout will require real-time upgradation of the IT system, documentation and tracking. The validity of the e-way bill number (EBN) could pose a challenge for transportation of goods within city limits. This could result in additional transit time for smaller entities and expiry of e-way bill owing to system failure or change in destination of delivery would lead to challenges.

The Way Ahead

There exists an urgent need to standardize and simplify certain processes and procedures. Also, the government should strive to further simplify the processes and mechanisms, specifically for small businesses, so as to widen the tax net to a larger number of businesses. As we know, the Government is already considering bringing the 'real estate' and 'petroleum' sectors under the GST ambit. Compliance norms ought to be relaxed and streamlined for micro and small firms. Lastly, the government could explore the possibility of leveraging the GSTN registration number for all businesses operating in India for the purposes of accounting and policy formulation.