



MSME Definition in India: The Present State and the Imperatives

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FOREWORD

The Micro Small and Medium Enterprises Development Act, 2006, was a major step forward in providing a legal frame work, and in defining the specific roles of the related institutions. This legislation was the result of continuous articulation by business Associations and Chambers. Subsequently, the subject was discussed at length by the Dr.S.P.Gupta Committee on Development of Small Enterprises, at the Planning Commission. As a member of the Committee, Dr. P.M. Mathew was fortunate to understand and experience the concerns of the MSME community. There have also been arguments, over the last eight years, for a redefinition of the size limits of enterprises, as outlined by the Act. Since the definition is part of the Act, any change in it can be considered only through a Parliamentary process. Based on the experience over the last eight years, it is generally felt that this is the time for a review of the Act, in relation to the size-definition.

The Hon'ble Finance Minister, in the Union Budget 2014, announced that a review of the MSME Act 2006 is being considered by the Union government. In this context, the FICCI-CMSME has initiated a National level consultation on the subject. This document is being prepared by the Institute of Small Enterprise and Development, in its role as Knowledge Partner to the consultation.

The following pages report the state of the MSME size definition limits in a comparative perspective. This White Paper, prepared by an Expert Team of the Institute of Small Enterprises and Development, also spells out the key issues for debate in this context.

Institute of Small Enterprise and Development and the FICCI-CMSME hope that this document will spell out and demystify the leading issues in the subject area, and will contribute to a fruitful discussion in the country.

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MSME Definition in India: The Present State and the Imperatives

1.0. Introduction

The role of Small and Medium Enterprises (SMEs) in developing countries (in India, they are called 'micro, small and medium enterprises') is often argued in terms of their well-known contributions, such as employment and balanced regional development. However, in the modern world, sustainability of these enterprises is a more crucial concern. The need for ensuring sustainability demands that this 'bottom of the pyramid' be properly defined in relation to their relationship with the total enterprise system. The defining criteria that delineate the SMEs from the rest of the system, however, cannot be arbitrary. It needs to have a scientific basis, and should be subject to periodic review based on hard data and field experience. In India, the need for a revision of the definition of MSMEs has often been highlighted, but, their relevance needs to be examined from the point of view of empirical evidence and objective rationale.

2.0. MSME Definition: It's Purpose

SMEs, in most countries of the world, are defined under their policy framework for private sector development. Such a framework defines the purpose and operational modalities relating to the definition. Therefore, the definition is open to evaluation from time to time.

The purpose of an SME definition is to provide an instrument for the targeting of policy. While the social importance of SMEs is officially accepted in most countries, such an understanding is expected to lead to an operationally meaningful definition. Ensuring this operational meaningfulness into the above understanding leads to policy.

3.0. Definition in Various Countries: A Comparison

What is an appropriate definition of an SME? How SMEs are defined, and establishes their relevance to growth, poverty alleviation and inclusion. For SMEs to be a meaningful category of enterprises, it should be a group of firms that is specifically differentiated from others by the way that it experiences particular policy, institutional, or market failures or the way it benefits the economy, or the poor. The literature provides little guidance on an appropriate definition, with different research using alternative definitions, but little evidence of consensus. Within the

World Bank Group, IFC and MIGA have official definitions but also define SMEs in other ways. IFC and MIGA, for example, formally define SMEs as fulfilling two of the three criteria: a) Having more than 10 and fewer than 300? employees; b) Having between \$100,000 and \$15 million? in sales; and c) Having between \$100,000 and \$15 million? in assets.

It is tempting to try to find a universal MSME definition, as it would ease the design of loans, investments, grants and statistical research. One such effort is IFC's SME Definition. Besides, a wide range of approaches are taken by governments to define what exactly an 'SME' is in their economy. For example, in China an MSME can be an enterprise with 1 to 3000 employees; total assets from ¥ 40 to 400 million and business revenues from ¥10 to 300 million depending on the industry. Meanwhile, the EU considers an MSME, an enterprise with up to 250 employees and turnover of no more than €50 million or a total balance sheet of no more than € 43 millions.

Hypothetically, the choice of MSME definition could depend on many factors, such as business culture; the size of the country's population; industry; and the level of international economic integration. Or it could be the result of businesses lobbying for a particular definition, which would qualify their enterprises for governmental support programmes. This can result in some very strange distinctions between firms, according to the subsectors they belong to. For example, in one case, an enterprise manufacturing petroleum products is considered an MSME if it employs less than 68 persons; but if a similar enterprise manufactures chemical products, then the threshold for it to be considered an MSME is raised to a maximum of 100 employees. These issues make it difficult to adopt a universal MSME definition.

Tom Gibson and H. J. van der Vaartindeed suggest a less imperfect formula: An SME is a formal enterprise with annual turnover, in U.S. dollar terms, of between 10 and 1000 times the mean per capita gross national income, at purchasing power parity, of the country in which it operates. This definition is attractive, because annual turnover is a good tool to assess the contribution of MSMEs to GDP. It also fulfills the criterion of working as a single ruler. It might make more sense to measure MSMEs with a single ruler, e.g. annual sales or turnover and/or number of employees, but tailor the size-breakdown to particular conditions in the country of operation. However, it is extremely difficult to obtain data on the annual turnover by MSMEs in developing countries. Also, the informal MSMEs in some developing countries outnumber formal MSMEs by 8 times. Therefore, a uniform definition is difficult.

The number of employees is the most frequent characteristic used in the definitions of national governments and statistical agencies. The data on size breakdown is available for most of the countries. The number of employees is also a fair characteristic to assess MSMEs' contribution to GDP.

To sum up, there are technical and conceptual problems with seeking a universal definition of MSMEs. Technically, lack of data is a big problem. But even if that could be overcome, economies have diverse structural, cultural and political reasons to adopt different definitions of MSMEs that would run counter to any universally agreed definition.

4.0. The Need for a Review System

The central aim of a review or evaluation of an existing size-definition is to assess how effectively the definition is working as a targeting instrument. In fact, a range of policies are relevant here. They either directly target SMEs or have elements that require a distinguishing between different kinds of enterprises. In the latter case, the crucial differences relate to the size of the enterprises and the target group.

In order to undertake an assessment of the relevance and effectiveness of an existing SME definition in assisting an appropriate targeting of policy, periodic reviews are a must. It is necessary to establish clearly the reasons that it is applied. Targeting of development policies need the backed by relevant data. Such data and the presence of a mechanism for collection of such data, will support a review mechanism. Knowing how good the definition as an instrument is, will only be possible if the purpose for which it being used is clearly understood. Therefore, it is necessary to examine how relevant the size categories are, and the way they are set at a particular point of time.

The question of targeting of SME policy raises some fundamental issues from time to time. The targeting at a particular point of time can be compared with another point of time, wherein the following questions arise:

1. Do markets fail for SMEs?
2. What is the evidence for a gap to be filled by government support?
3. Does the geographical scale of delivery matter?
4. Does the delivery partner influence outcomes?
5. Are there discriminatory effects in social categories such as gender and caste?
6. Is there sufficient motivation for new entrants?
7. Is there sufficient motivation for innovation and growth?
8. Are the external behavior patterns, such as from banks and other government departments, hostile?
9. Is the macroeconomic environment hostile?

The review mechanism varies from country to country. In the European Union, the office of the DG-Enterprise and Industry (DG-EI) carries out a regular monitoring of the implementation of the SME definition through periodic evaluations. Building on the results of such evaluations performed in 2006 and 2009, an independent study was carried out in 2012, focusing on how the SME Definition works in practice in the implementation phase. In view of the development of SME demographics since 2003, the disruption that would be caused by any significant change, the policy of 'less and better targeted state aid' and the views of a majority of stakeholders, a 2012 review study of the EU concluded that there is no need for a major revision of the SME Definition at the present time. An eventual update of the Definition to adjust for inflation, labor productivity, and changes in the ratio of turnover-to-balance sheet total, is not considered urgent and it may be incorporated into a future revision. The EU agreed with the conclusions of the study that there is no need for a revision of the SME Definition for the time being.

In the case of European Union, one can find effective evaluation mechanisms and tools that help both policy makers and entrepreneurs alike. For example, in its recommendations, the study suggested to clarify the application of certain rules within the existing Recommendation, for example by means of further guidance or by updating the current SME Definition User Guide. To this end, an evaluation of the User Guide was carried out in 2013-2014. The conclusions and suggestions provided in the final report will be the basis for the revision of the User Guide, which should be available in all EU languages by March 2015.

In India, there is lack of a permanent review mechanism. For review of the provisions of the MSME Act 2006, the only mechanism available is the Parliamentary process.

5.0. Size Definition in India's MSME Policy Process

The post-Independence development policy in India evolved around targeted efforts to faster economic growth. As discussed by Bhagawati (1998), the key strategy then was to achieve rapid industrial growth by inducing private investment and import of newer technologies. However, within less than a decade, the initial policy prescription was radically altered towards "import substitution". It was envisaged that SSIs would help generate employment and expansion of industrial activity across the country (NIPFP, 1996). However, from 1991 onwards, general economic policy moved towards openness of the economy both for investment and imports, the very rationale for continuation of reservation of items to be produced exclusive by the SSI was brought under scrutiny. Consequently, the de-reservation process finally began in 1997.

Unlike in other countries, it is fixed investment (in plant and machinery) that defines the divide between small and large enterprises. Based on the recommendations of the Dr. S. P. Gupta

Committee on Development of Small Enterprises, the definition was further elaborated from a two-tier to a three-tier model. As a Member of the above Committee, I was fortunate to be part of the heated debates which led to a redefinition of the defining criteria. The major point of debate was essentially on preparing the ground for a change- over from a protective regime to a promotional regime. Accordingly, export-oriented sub sectors like, leather products, garments, hosiery, hand tools, toys, packaging materials, auto components, pharmaceuticals, food processing etc. were identified as border-line subsectors. While export competitiveness was the specific purpose for identification of the Medium sector as a special category, the Small and Micro sectors were meant to serve the other traditional objectives of small industry promotion.

Under a promotional regime, a level playing ground for different types of enterprises is visualized, and the regulatory role of the government is limited. The spirit of the deliberations of the Dr. S.P.Gupta Committee was as to how effectively a change- over from the protective to the promotional regime could be managed, with much less pains to the small entrepreneurs. This again was based on the perceived twin goal of the Vajpayee Government on the MSME sector: targeting 100 million employment opportunities, and an innovation thrust on the sector. In fact, this part of the argument remains partially addressed even today. The regulatory regime has gone, but the developmental role of the government is yet to gain solid grounds. It is necessary to analyse the reasons for this policy paralysis.

One of the arguments of the above debate was to make an effective provision for addressing the growth constraints of some of the sub sectors. In these sub sectors, the investment limits specified did not allow the industrial units to grow from small to medium and from medium to large. While this argument has some valid grounds, there is no reason for having a generalized approach, which is not likely to serve the purpose of MSMEs in an objective manner. The purpose of the MSME definition is implicit in the very purpose of the MSME Development Act, 2006. The Preamble of the Act: describes it as: "An Act to provide for facilitating the promotion and development, and enhancing the competitiveness of Micro, Small and Medium Enterprises, and for matters connected therewith or incidental thereto."

In accordance with the provisions of Micro, Small & Medium Enterprises Development (MSMED) Act, 2006 the Micro, Small and Medium Enterprises (MSME) are classified into two Classes:

- (a) Manufacturing Enterprises: The enterprises engaged in the manufacture or production of goods pertaining to any industry specified in the First Schedule to the Industries (Development and Regulation) Act, 1951) or employing plant and machinery in the process of value addition to the final product having a distinct name or character or use. The Manufacturing Enterprise is defined in terms of investment in Plant and Machinery.

(b) Service Enterprises: The enterprises engaged in providing or rendering of services and are defined in terms of investment in equipment.

The limit for investment in plant and machinery / equipment for manufacturing / service enterprises, as notified, vide S.O. 1642(E) dtd.29-09-2006, are as under:

Manufacturing Sector

Enterprise Categories	Investment in plant & machinery
Micro Enterprises	Does not exceed twenty five lakh rupees
Small Enterprises	More than twenty five lakh rupees but does not exceed five crore rupees
Medium Enterprises	More than five crore rupees but does not exceed ten crore rupees

Service Sector

Enterprises	Investment in equipments
Micro Enterprises	Does not exceed ten lakh rupees:
Small Enterprises	More than ten lakh rupees but does not exceed two crore rupees
Medium Enterprises	More than two crore rupees but does not exceed five core rupees

6.0. Constraints of Existing Definition

The purpose of having a definition criterion for SMEs is to provide a functional space for a particular category of entrepreneurs to serve their economic interests, in a conflicting environment of such interests by different sub categories. In a democracy, such a consensus is guided by the objectives of social policy. Given this basic objective, the primary condition that needs to be laid down is the presence of an appropriate legal and institutional framework. Besides the presence of such a framework, it is necessary to ensure that this framework is fully functional. While the conflicting interests of the small and large sectors dominated the debates until 2006, the enactment of the MSME Development Act 2006 provided the base for an articulation mechanism. While this is an important contribution of the MSME legislation, the question that stands out is, how effectively the legislation meets its objectives as outlined by the preamble of the Act. It is in this context that the need for a discussion on the distinction between government and governance become relevant.

Addressing these two problems are important from the point of view of the fact that, as indicated by the latest Economic Census, India has a vibrant start-up scene. The Census figures show that there has been a significant growth of the non- agriculture sector over the past eight years. It also indicates the need for segregating this growth in terms of the different size categories of units, and to evolve an appropriate strategy for their growth.

A paradigm shift from a protective regime to a promotional regime implies that the State needs to ensure a level-playing field for the MSMEs. Two important issues having far-reaching implications on the prospects of MSMEs stand out: 1) Competition regime; and 2) Delayed payments. While the experiences of many countries, both developing and emerging economies, stand out in this regard, the Indian situation demands much faster improvements.

The MSME Development Act of 2006 has set limits, such as the upper limit of Rs 10 crores investments in plant & machinery for a medium sized enterprise engaged in manufacturing and upper limit of Rs. 5 crores investment in equipments in the services sector . Due to rapid increase in all plant and material costs (including installation costs) in the last five years, it has become very difficult to set up units under the stipulated costs. Hence, there have been arguments from industry circles for the definition limits to be increased. It has been argued that, in over seven years, the definition of MSMEs has not been revised and it is time to enhance the limits.

The Union Budget 2014 has announced specific steps that provide a positive direction to the growth the MSME sector. The Budget speaks of the outline of a labour market policy, steps for boosting motivational skills and steps for gearing up start-ups. The test of realism also demands a fresh look at the MSME size limits.. The threshold limits of defining MSMEs were set way back in 2006. Therefore, there is a prima facie ground for evaluating the relevance of the existing definitional limits. Inflation has increased the cost of investment, and this strengthens the case to expeditiously review the definition based on investment criteria. The reported problem with the existing Definition demands a closer examination and review. The arguments reported are briefly as follows:

- 1) It is difficult for MSMEs to have a precise estimate of the value of their fixed assets. Therefore, they are skeptical about correct reporting of investment data for official purposes.
- 2) MSME are run by a single proprietor and their key stakeholders include family or relatives. There is a thin line of differentiation between private and business assets of MSMEs and hence they are not able to assess what to be included and what not to be included while calculating their investment in assets.

- 3) Further when there is inflation, prices of the same asset varies due to the time value of money. This phenomenon generally does not provide MSMEs with the real picture of the exact value of similar assets purchased at different time.

The MSME Development Act has provided the legal and institutional framework, but the operational mechanism is yet to be spelled out. Wherever there is a defined limit in the MSME Act for any parameters, changing it through a Parliamentary process from time to time, is a difficult and time-consuming exercise. But, being a sensitive subject, the wisdom of the Parliament need to prevail. It is in this context that the needs for scientific review mechanisms arise.

7.0. Issues for Debate

The key issues for debate, emerging from the above discussion, are the following:

7.1. Harmonisation of Definition

A definitional segregation of SMEs depends upon the end purpose for which it is segregated. Therefore, in many countries, the definition used for statistical purposes and that for promotional purposes vary. Harmonization of such varying definitions is important from the point of view of policy and administration. One method of harmonization is to have a flexible definition. In Malaysia, for example, SMEs have been defined on the basis of two specified criteria, viz, sales turnover and number of full-time employees, and whichever is lower is counted for definitional purposes. In USA, in an attempt to partially harmonize the various definitions, SBA Advocacy's "fewer than 500 employees" definition of SMEs across all sectors, has been used. This accounts for the vast majority (approximately 99 percent) of firms otherwise counted by several other agencies.

7.2. Need for Generally Acceptable Methodologies

While raising the investment limit on the basis of some valid and generally admissible criteria, other factors like the number of employees in the enterprises and the turnover, also warrant examination. However, the experience of appropriate mechanisms in the context of EU, offers important lessons for India. The current classification marks enterprises in manufacturing sector with an investment in plant and machinery of up to Rs 25 lakhs as micro, up to Rs 5 crore as small and up to Rs 10 crore as medium enterprises. Similarly, the limits for enterprises providing services are set at Rs 10 lakhs, Rs 2 crore and Rs 5 crore for micro, small and medium enterprises, respectively. Changing the definition of MSME in the backdrop of changing patterns

in the industrial sectors and overall inflationary conditions is an apparently valid argument. But it cannot be on the basis of arbitrary criteria. There is need for valid and generally acceptable methodologies for arriving at the style and degree of changes.

7.3. Need for a Permanent Mechanism

It is necessary to evolve a mechanism and relevant formula that could be applied from time to time. While the definition adopted by the MSME Act, 2006 defines the sectors based on the investment in plant machinery and equipment for manufacturing and services, in many countries the definition is linked to the enterprises' turnover and employee number. While it is important for some medium-scale enterprises of raising the investment limits, the critical question of offering an environment of competition still remains in the centre-stage of MSME imperatives in India. The concept of an 'MSME Observatory' can better address these and related issues in an effective manner.

7.4. Need for Periodic Review and Reporting

Review mechanisms as suggested, a scrutiny of the role of a possible reporting their findings, and deliberations in Parliament are vital since the whole exercise is based on a knowledge base rather than on ad-hoc enquiries, the quality of the Parliamentary deliberation and discussions themselves can be enriched. It would be desirable to take into account turnover or employment or a combination of both with increase in investment threshold in a revised definition. Sub-sectoral/product wise definition of MSMEs should also be looked at, as this would be more appropriate when looking at defining MSMEs on a turnover basis.

7.4. Safeguard Mechanism

There is need for a safeguard mechanism to ensure that the definitions serve the spirit of the MSME Act. "Promotion, development, competitiveness"- the three keywords of the Act, need to be interpreted in the letter and spirit on the basis of our MSME experience over the past eight years. In fact, since the submission of the recommendations of the Dr.S.P.Gupta Committee, serious efforts have not taken place in this regard.

7.6. Understandability to the Common Man

Definition should be understandable to the common man, and should not be in conflict with related laws. A synergy with the existing labour and taxation laws is important from the point of view of making the MSME definition easy to understand for the common man, and easy to administer.

7.7. Exploring a Need based Definition

All existing definitions of SMEs today start from an understanding of dominant characteristics of these enterprises. Having made such segregation, one finds that, most of these enterprises are subject to some degree of deprivation, in relation to functional areas such as finance, technology and market. This in essence means putting the cart before the horse! Instead, can we think of putting the horse before the cart? If so, one could explore arriving at a definition of MSMEs on the basis of their specific needs. For example the needs of a manufacturing enterprise and a service enterprise are different. Besides both a traditional service enterprise and a new economy enterprise are considered an par as services. In a practical sense, this has important implications. For example, an ordinary branch manager of a bank cannot and does not evaluate a new economy enterprise, such as an IT firm. Even if he is able to do that, the existing banking norms do not allow him to reach such an enterprise. The question here is, how to reach an enterprise on the basis of his objective needs, assessed on the basis of some objective criterion.

8.0. Conclusion

Cultivating entrepreneurship as a rich resource that contributes to the growth of the Indian economy: this is the role being expected from the MSME sector today. The twin pillars that can contribute to such a resource base are: (1) a vigorous growth of start-up; and (2) a trend towards inclusive innovation. The size definition of enterprises in India should contribute to this process.

