Regulatory Barriers for Micro Enterprises

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Abstract

Micro enterprises contribute significantly to India's GDP, output, exports and employment levels. However, over the past few years, the contribution of the Micro, Small and Medium Enterprises (MSMEs) to the country's growth has been declining. This paper examines the various regulatory barriers faced by micro enterprises, and deliberates on the possible impact of these barriers as a cause of this decline, specifically exploring barriers relating to the entry, financing exit, labour and taxation laws that govern this sector.

Introduction

Over the past few years, the contribution of the manufacturing sector to the GDP, output and exports of the country have been declining. Considering the fact that the MSME segment registers a division of 6% of the GDP, 45% of the manufacturing output and 40% of the total exports of India, and further provides employment to the second largest section of people following agriculture, this drop is alarming and of concern to the economy.

Micro enterprises contribute 7.3% of the MSME segment by company size, and 95% by number of working enterprises. These units, due to their high geographical spread, outreach to both rural and urban areas, product diversity, employment potential and low investment requirements, are a channel for the upcoming entrepreneurs of the country.

The possible reasons for this decline within the context of MSMEs has been attributed to a variety of reasons ranging from a lack of access to global markets to problems of storage, designing, packaging and product display, low technology levels and lack of access to modern technology (Sarkar, 2011).

The Ease of Doing Business Index (International Finance Corporation, World Bank, 2014) ranked India 134 out of 189 countries. The primary areas where it fared poorly were those associated with starting a business, dealing with construction permits, getting electricity, paying taxes, enforcing contracts and resolving insolvency.

Specifically in the case of micro enterprises has emerged an understanding of the situation that leads to the lack of these entrepreneurs to advocate on issues pertaining to their entry and operation. The notion is that in such industry-oriented spaces, the bulk of the expertise and knowledge rests with the management, the government, and hence they are accorded the roles of decision-makers. This leads to policy pronouncements aimed to benefit this segment, taken without the contribution of the concerned segment in the decision-making process. These policies tend to represent the opinions of other stake-holders, especially the governing authorities and machinery. What results is a complex and unfriendly environment for upcoming entrepreneurs, and further de-incentivizes them and pushes them into the unregistered sector. (Accelerating Manufacturing in the Micro, Small & Medium Enterprises Sector, 2013).

The implications of this swelling of the informal division are sweeping. The lack of recognition of these enterprises in the eyes of the government renders them ineligible to avail many of the benefits put in place precisely to aid them.

Various reports have examined the impact of existing regulatory and operational legislature on the ease of entry and functioning in the MSME sector. However, comprehensive study has not yet been done on the diverse regulatory barriers that pose a hindrance to the most vulnerable of the MSME division, i.e. the micro enterprises. Rudimentary research as currently documented in several documents has indicated these factors as highly conducive to the feeling of discontent and helplessness felt amongst operational and potential entrepreneurs in the micro segment.

The MSME sector is generally considered a separate entity, and is talked about as such, with few demarcations made between the micro, small and medium segments. This assumption in itself is flawed, as the sheer disparities in investment, employment per unit, and various other operational factors in themselves validate differentiating between the segments.

My hypothesis considers this, and assumes it as a premise for the research. It states, specifically, that **regulatory barriers in the fields of entry – i.e. registration and licensing, exit and taxation exist, and may be considered a hindrance to the set-up and growth of micro enterprises.**

My research question further attempts to recognize and analyse these barriers, and states: **What are the specific regulatory barriers that may act as a hindrance to the entry and growth of micro enterprises?**

Literature Review

Small scale industries have been acknowledged as being integral to the growth of a nation's economy, especially in the lesser developed ones. The lesser capital and workforce required has resulted in the mushrooming of such enterprises in virtually every manufacturing sector, particularly labour intensive fields.

Specifically in the Indian context, industrial policies put in place to spur the growth of such small scale industries have been done so with the motive of creating additional employment with low capital investment. (Mathur, 2001)

Opinions on the effects of these policies differ. One school of thought believe such protectionist measures such as reservation of items, excise and income tax, concessional loans and tax concessions must not be looked to by small scale industries as permanently available.

These have not resulted in sufficient growth for the small scale segment, and have perhaps even lead to micro enterprises purposely not expanding so as to be applicable for these benefits. Consequentially, they lack the self-sufficiency to compete in the globalised Indian market. (P.E. Vibhute, 2012)

However, another school believes that further policy protection to small enterprises is required, to prevent the inundation of the larger industries in the small-scale segment, a result of the vulnerability of the small industries in terms of capital, technology, skilled labour and lack of data and information (Bala, 2007).

This paper examines, through a combination of primary and secondary research, where currently the biggest barriers to micro enterprises lie. It further suggests policy changes keeping the above arguments in mind, drawing a balance between protection and self-sufficiency.

Various reports previously published studying the problems faced by the MSME sector have been extremely generic in nature, viz. focusing on the entire MSME sector as a whole, and considering both regulatory and operational barriers.

Comprehensive reports published by the Prime Minister's Task Force - Micro, Small and Medium Enterprises, 2010 and the Ministry of Micro, Small and Medium Enterprises - Recommendations of the Inter-Ministerial Committee for Accelerating Manufacturing in Micro, Small & Medium Enterprises Sector, 2013, were important documents in the research concerning the MSME sector. However, again, much of the data and recommendations were not micro enterprise specific, and hence did not address their issues conclusively.

Methodology and Primary Research

The analysis presented here is a result of field work in tandem with secondary research done through literature available on the internet and through other sources. The obtainment of a brief overview of micro enterprises, and the regulatory framework which governs the sector was the first step.

Next was the preliminary identification of key areas concerning micro enterprises. These regulatory aspects are those which might act as pressure points and potential barriers in the set-up and operations of the entrepreneurial activities. Difficulties arose with the lack of data specific only to micro enterprises available, as most surveys and research was done for micro, small and medium enterprises collectively, despite the significant disparities in capital and investment required for both, and hence unique and differentiable situations and barriers.

An examination of the Ease of Doing Business Index by the World Bank (International Finance Corporation, World Bank, 2014) provided clarity on various parameters to be used while judging the business environment. These were recognised as the entry – i.e. registration and licensing, exit and taxation fields.

The sample pool for the primary research, while limited by area and approachability, comprised as varied a group of entrepreneurs as possible considering the paucity of time. These included importers and distributers in the food industry, the artisans of Dilli Haat, the retailers of Chandni Chowk, and the garment makers of Shahpur Jat.

Field work was conducted in the form of qualitative interviews. Regulatory barriers as identified by these entrepreneurs were, in a slight contradiction to the hypothesis, identified as being primarily related to the entry, financing, exit and labour laws governing micro enterprises.

Further examination of these barriers, and the regulatory framework concerning them followed. This was supplemented by research into the current policies in place to address the issue. An understanding of the objective, provisions and failings of these provisions was essential for a comprehensive and satisfactory recommendatory process.

Once a particular regulation was identified as a hindrance to the set-up and expansion of a micro enterprise, an evaluation of the global best practices and policies in the specific area was done. This was to additionally give insight and seed a base on which to suggest reforms and amendments to the current framework.

What is a Micro Enterprise?

The definition of **Small Scale Industries** has changed over the years in terms of investment limits:

Year	Investment Limit in Fixed Assets*	Additional Conditions
1950	Up to ₹ 5 lakh	Less than 50/100 persons with/without power
1960	Up to ₹ 5 lakh	-
1966	Up to ₹ 7.5 lakh	-
1975	Up to ₹ 10 lakh	-
1980	Up to ₹ 20 lakh	-
1985	Up to ₹ 35 lakh	-
1991	Up to ₹ 60 lakh	-
1997	Up to ₹ 300 lakh	-
1999	Up to ₹ 100 lakh	-

Table 1 *Fixed Assets refers to plant and machinery

Further, post 1999, **Tiny Enterprises** were defined as having an investment in plant and machinery up to ₹ 25 lakh, irrespective of location. (Small Scale Industries in India: An Engine of Growth, 2002)

However, the **Micro, Small and Medium Enterprises Act, 2006**, scrapped this existing definition, and put in place the following:

	Manufacturing Sector[1]	**Services Sector**[2]
Micro	Up to ₹ 25 Lakh	Up to ₹ 10 Lakh
Small	Between ₹ 25 lakh and ₹ 500 lakh	Between ₹ 10 lakh and ₹ 200 lakh
Medium	Between ₹ 500 lakh and ₹ 1000 lakh	Between ₹ 200 lakh and ₹ 500 lakh

Table 2

This was put in place to comprehensively include the services sector, as earlier they were ignored by the definitions for SSI, except for a small positive list, and also to expressly define medium enterprises.

Current Regulatory Framework

2 October, 2006 – the day the Micro, Small and Medium Enterprises Act, 2006, came into effect – was a pivotal date in the timeline of micro enterprises. The existing Ministry for Small Scale Industries was revamped into the **Ministry for Micro, Small and Medium Enterprises**.

This ministry was divided into two divisions called **Small & Medium Enterprises (SME)** Division and **Agro & Rural Industry (ARI)** Division.

The SME Division is allocated the work:

(A) Of administration, vigilance and administrative supervision of:

1. **National Small Industries Corporation (NSIC) Ltd**. – a public sector enterprise
2. Three autonomous national level entrepreneurship development/training organizations
    - **(a) National Institute for Entrepreneurship and Small Business Development (NIESBUD)**
    - **(b) National Institute for Micro, Small and Medium Enterprises (NI-MSME)**
    - **(c) Indian Institute of Entrepreneurship (IIE)**

(B) Implementation of the schemes relating to Performance and Credit Rating and Assistance to Training Institution, among others.

[1] Investment in plant and machinery excluding land and building for enterprises engaged in manufacturing or production, processing or preservation of goods

[2] Investment in equipment excluding land and building for enterprises engaged in providing or rendering of services (loans up to Rs 1 crore)

(C) Preparation and monitoring of Results-Framework Document (RFD) as introduced in 2009 by the Cabinet Secretariat under Performance Monitoring and Evaluation System (PMES).

The ARI division:

(A) Looks after the administration of three statutory bodies
   (a) The Khadi and Village Industries Commission (KVIC)
   (b) Coir Board
   (c) Mahatma Gandhi Institute for Rural Industrialization (MGIRI)

(B) Supervises the implementation of the Prime Minister's Employment Generation Programme (PMEGP).

The Office of the Development Commissioner (DC (MSME)), National Small Industries Corporation (NSIC), Khadi and Village Industries Commission (KVIC); the Coir Board, and the three training institutes provide infrastructure and support services to MSMEs through implementation of policies and various programmes schemes.

The **National Board for Micro, Small and Medium Enterprises (NBMSME)** examines the factors affecting promotion and development of MSME, reviews existing policies and programmes and makes recommendations to the government in formulating the policies and programmes for the growth of MSME.

Contribution of Micro Enterprises

Micro enterprises constitute roughly 14.85 lakh out of 15.64 lakh MSMEs of the country, accounting for 97.18% of the enterprises in the rural sector, and 93.09% in the urban sector. (Fourth All India Census of Micro, Small and Medium Enterprises, 2006-07)

Distribution of Working Enterprises by Sector

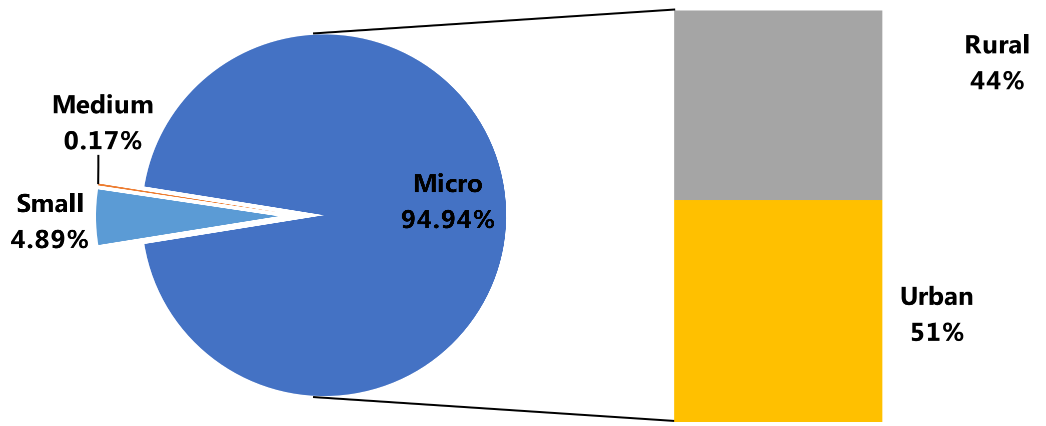
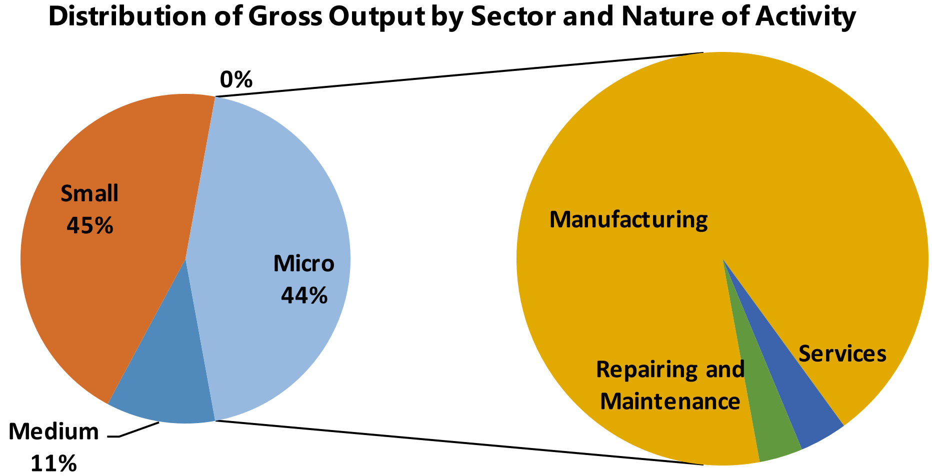


Figure 1 Source: Fourth All India Census of Micro, Small and Medium Enterprises, 2006-07

Micro enterprises, by their very nature, require low capital input. This makes them a viable option for aspiring entrepreneurs both in rural and urban areas. Not only do micro enterprises generate the highest employment per capita investment, they also go a long way in checking rural urban migration by providing villagers and people living in isolated areas with a sustainable source of employment (Jena, 2013). This conducive nature of micro enterprises is reflected in the diversity of products and geographical spread they are shown to have, which hence increases the output from the micro enterprise segment.

Output

Micro enterprises contributed to 44.24% of the gross output of the MSME sector, or ₹ 312973 crore.



Source: Fourth All India Census of Micro, Small and Medium Enterprises, 2006-07

Employment

The micro sector accounts for 65.34 lakh out of the total employment by the MSME segment of 93.09 lakh, or roughly 70%. Further, the employment intensity, i.e. the employment/fixed investment, was highest for micro enterprises.

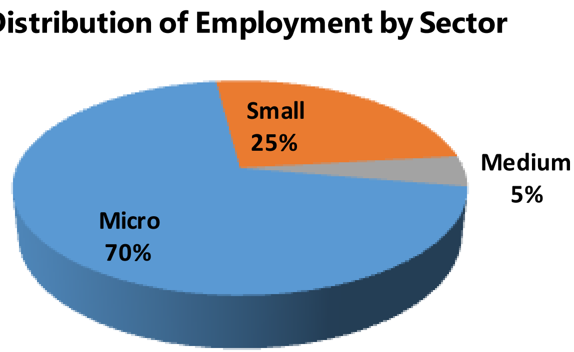


Figure 2 Source: Fourth All India Census of Micro, Small and Medium Enterprises, 2006-07

Employment Intensity by Sector

Sector	Employment/Fixed Investment
Micro	38.54
Small	10.48
Medium	7.71

Table 3 Source: Fourth All India Census of Micro, Small and Medium Enterprises, 2006-07

Geographical Spread[3]

Micro enterprises are fairly evenly distributed across both states as well as rural and urban areas.

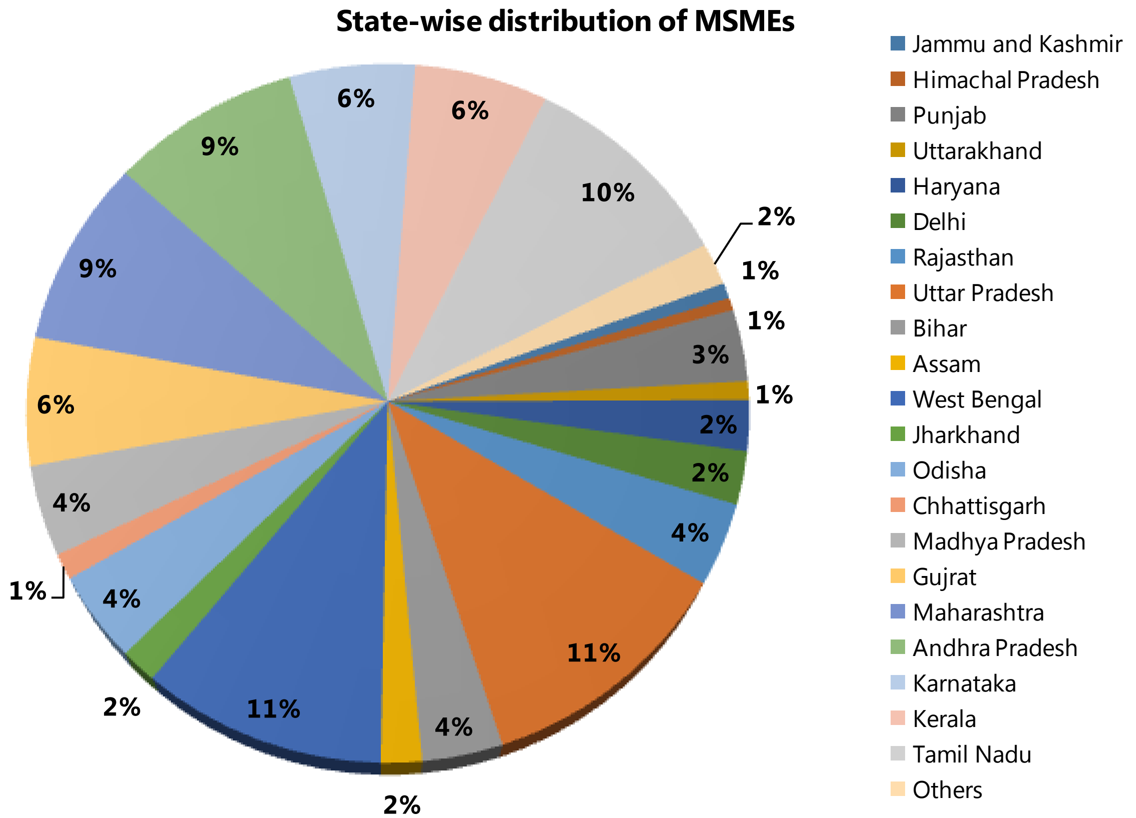


Figure 3 Source: Fourth All India Census of Micro, Small and Medium Enterprises, 2006-07

[3] Since data specific to micro enterprises is not available, a hypothesis must be assumed, and the geographical spread and product diversity characteristic of the MSME sector must be extrapolated to be applicable specifically to the micro enterprise segment as well.

Area-wise distribution of Micro Enterprises

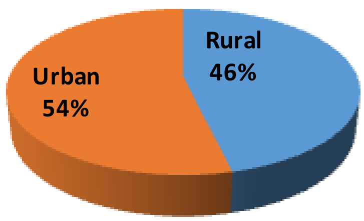


Figure 4 Source: Fourth All India Census of Micro, Small and Medium Enterprises, 2006-07

Product Diversity

Product Diversity of MSMEs

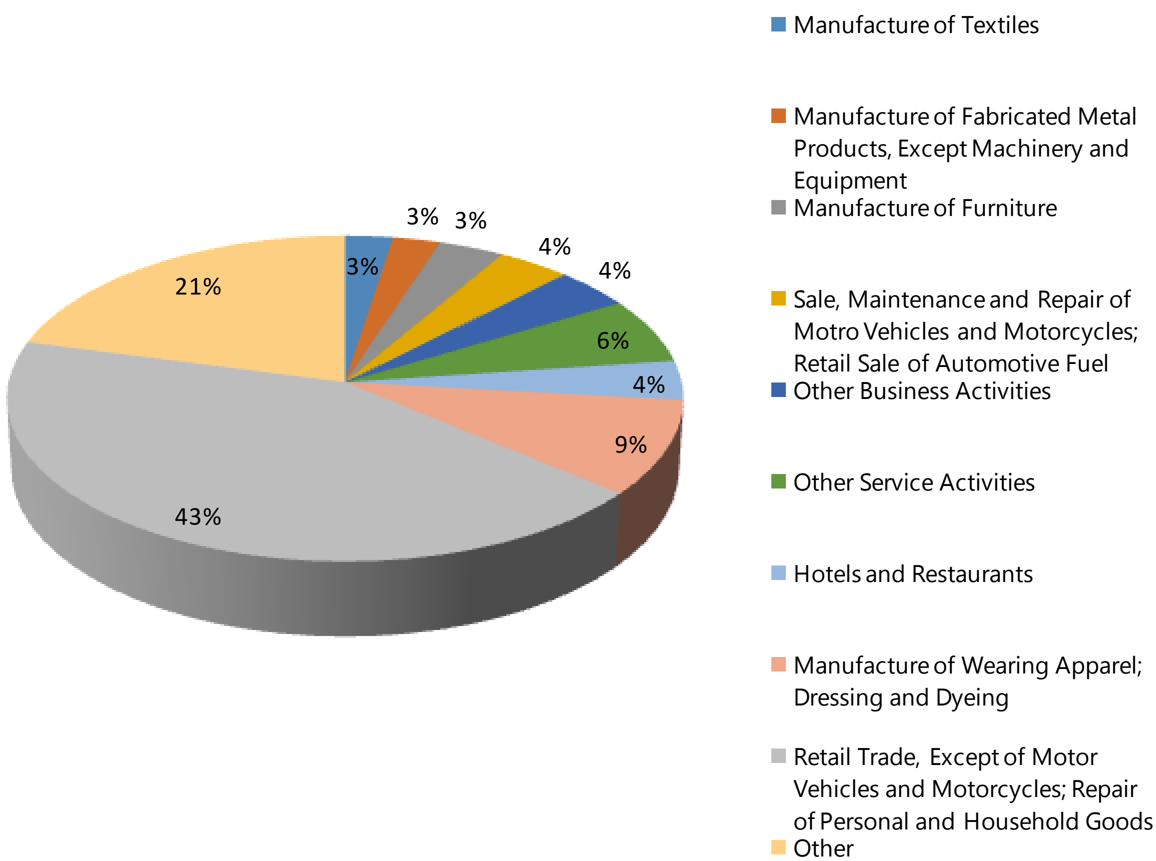


Figure 5 Source: Fourth All India Census of Micro, Small and Medium Enterprises, 2006-07

Beyond statistics, however, is a notion of the spurring that micro enterprises, indeed the entire MSME sector, provide to the engine of India's economic and social growth. In a country like India, with an immense labour force but a lack of capital, the concept of small scale industries fits with the economic structure. The industrial decentralisation it provides, the complimentary effect it has on large scale industries and the assurance of production of artistic products like handlooms all imply the relevance of the sector for India. (Mathur, 2001)

Performance of MSMEs

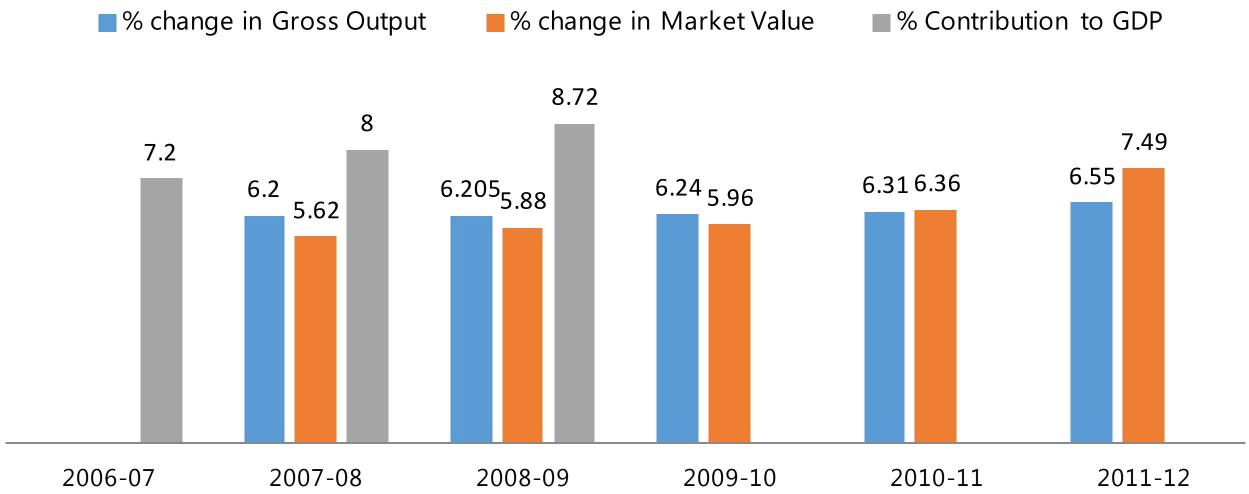


Figure 6 Source: Annual Report 2012-13 on Micro, Small and Medium Enterprises

While the data for MSME's GDP contribution is not available post 2009, reports have indicated a decline in their share. (Accelerating Manufacturing in the Micro, Small & Medium Enterprises Sector, 2013)

The MSMED Act, 2006

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.

The Micro; Small and Medium Enterprises Development (MSMED) Act was a landmark act notified in 2006. It aimed to address policy issues affecting MSMEs, their development and competitiveness, as well as the coverage and investment ceiling of the sector. It provided a single national legislative standard by which the MSME sector had to operate.

Various policies were introduced and restructured to aid in the start-up and expansion of the MSME sector, specifically the micro and small enterprises. The relevant benefits available to MSMEs currently, under the Act are, briefly:

A. **Reservation Policy**: Reserves certain items for exclusive manufacture by these enterprises

B. **Credit Guarantee Fund Trust for Micro and Small Enterprises (CGFTMSE)**

C. **Special Economic Zones**: The SEZs are required to allocate 10 per cent space for the small-scale units

D. **Protections against delay in payment** and **Right to interest for delayed payments** and time-bound settlement of payment-related disputes through conciliation and arbitration

E. **Preferential access to credit**

F. **Tax benefits:**
   1. Excise Exemption Scheme
   2. Exemption under Direct Tax Laws

G. **Preferential Procurement Policy** – Reserves 20% of the government's annual purchases from the MSME sector

H. **Price and Purchase Preference Policy** –
   1. Availability of tender sets free of costs.
   2. Exemption from payment of earnest money deposit.
   3. Exemption from payment of security.
   4. Price preference up to 15% over the lowest quotation of the large scale units.
   5. 358 items including 8 handicraft items are reserved for exclusive purchase from SSIs

I. **Classification as a priority lending sector** – Reserves 40% and 32% of overall lending for domestic commercial banks and foreign banks, respectively. Out of this, 60% is reserved for micro enterprises and the balance 40% for the small enterprises.

Unfortunately, these benefits fail to reach a majority of micro enterprises as 94% of MSMEs are unregistered, according to the Fourth All India MSME Census of Micro, Small and Medium Enterprises, 2006-07

Entry and Registration Barriers

The overwhelming regulations associated with the registration and licensing of micro enterprises were, as primary and secondary research indicated, extremely cumbersome, extensive and protracted.

These, as also reported by the Ease of Doing Business Index for India (International Finance Corporation, World Bank, 2014), have been reported to be a disincentive to doing business in India.

Examination into these various legal regulatory procedures revealed significant results and provided an insight into the reluctance of micro enterprises to register and license themselves.

Applicable Laws – Registration as a MSME

- Micro, Small and Medium Enterprises Development (MSMED) Act, 2006
- Industrial Development Regulation Act, 1951
- Factories Act, 1948

Applicable Laws - Licensing

Environment

- The Environment (Protection) Act, 1986
- The Public Liability Insurance Act, 1991
- The Biological Diversity Act, 2002
- Water (Prevention and Control of Pollution) Act, 1974
- Air (Prevention and Control of Pollution) Act, 1981
- Forest Conservation Act 1980

Product & Process

- Bureau of Indian Standards Act, 1986
- Drugs and Cosmetics Act, 1940
- Packaged Commodities Regulation Order, 1975
- Pharmacy Act, 1948
- Standards of Weight & Measures Act, 1976
- Legal Metrology Act 2009
- The Insecticides Act, 1968
- The Prevention of Food Adulteration Act, 1954
- The Trade Marks Act, 1999
- The Geographical Indications of Goods (Registration and Protection) Act, 1999
- The Designs Act, 2000
- The Patents Act, 1970

Industry Specific Laws

Applicable Laws – Land Acquisition

- Municipality Act/Municipal Corporation Act
- Notified Areas Land Regulation and Land Use Act
- Urban Land Ceiling and Regulation Act 1976
- Transfer of Property Act, 1882
- Indian Contract Act, 1872
- Registration Act, 1908

- Indian Stamp Act, 1899
- Powers of Attorney Act, 1882
- Land Acquisition Act 1894
- Architects Act 1972
- Town Areas Act
- Urban Land Development Act **(Adukia, 2012)**

Entry and Licensing

The first step to setting up a business is registering it as a proprietorship, partnership, Hindu undivided family, Association of person, Co-operative Society, Company or undertaking, and further obtaining all the miscellaneous licenses to start operations. These include obtaining Service Tax Registration, PAN Card, TAN (Tax Collection & Deduction Account Number), VAT/ CST Registration, Shops & Establishment License, Central Excise License, Importer Exporter Code, Professional Tax, Employee Provident Fund Registration and ESI (Employee State Insurance) Registration, and construction permits from, to name a few – the sewerage, fire, electricity, environmental departments.

Two features play a role here. One, the applicability of numerous laws implies the need to obtain several licenses for legalisation. Further, the lack of a single window clearance system entails the approaching and involvement of several different government agencies, each with its own machinery, to acquire the specific, separate licenses the department is concerned with. As a result, only the entrepreneurs who can afford to hire consultants or chartered accountants can obtain the required licenses with relative ease.

More importantly, the prevalence of corruption that is intertwined with the following of regulations and involvement with state machinations is a significant disincentive. The bribery ensuing with every stage of the registration and licensing process renders it expensive, especially in the context of micro enterprises, who necessarily have a low capital which to invest.

This results in an extremely cumbersome, expensive and time-consuming progression, and ultimately, in an unfriendly business entry environment.

Case Study: Food Processing

An examination of the licenses required to operate as a food processing private limited company gave an insight into the high number of licenses and the circuitous routes involved. For a tea manufacturer operating out of Delhi, the initial steps to set up a business is fraught with hurdles. Numerous licenses are to be obtained from the Central government, the State government, the local governing municipal body – in this case, the Municipal Corporation of Delhi (MCD), and the Food Safety and Standards Authority of India (FSSAI).

At the Central level, this includes registration – under the Companies Act, 1956 with the Ministry of Corporate Affairs, Central Sales Tax registration – at both the state and central level, registration for Permanent Account Number (to file tax returns), registration for Import and Export Code (IEC), TAN (Tax Collection & Deduction Account Number), and Shops & Establishment License. At the state and local level, the company had obtained VAT registration.

However, various other licenses, such as approval from the local municipality, MCD, and certain clearances from safety departments, which are considered mandatory to be obtained were avoided. This, as stated by the entrepreneur, was because of a reluctance to engage in the red tape, corruption, a lack of information about the obtainment procedure, and a general vagueness concerning the necessity of procurement of all such licenses.

Industry specific clearances, according to the entrepreneur, were the main hurdles. These included clearances from the Food Safety Standard Authority of India, and legal metrology to ensure packaging standards are met and the weight are accurate.
Further, several industry sub-segment specific clearances, the multiple licenses required from Tea Board of India, which included the buyer license, Darjeeling logo, export license, flavouring license etc, also created perplexity and further posed a barrier to easy set-up of the company.

Apart from these, he stated, the annual renewal of the licenses, and the regulatory compliances related to accounts such as Tax Deducted at Source (TDS), quarterly tax returns, F-Forms, Annual balance sheet and audits were time consuming and cumbersome.

MSME Registration

Registration as a micro enterprise with the District Industries Centre is voluntary and not compulsory under the MSMED Act. However, it does entitle registered proprietorships, partnerships, Hindu undivided families, Association of persons, Co-operative Societies, Companies or undertakings to certain government schemes. These schemes have been put in place to aid the entry and growth of MSMEs, and are conditional to the registration as an MSME at the District Industries Centre.

According to the Fourth All India Census of Micro, Small and Medium Enterprises, 2006-07, the percentage of unregistered MSMEs is a staggering 94%.

Distribution of Registered and Non-Registered MSMEs by Sector

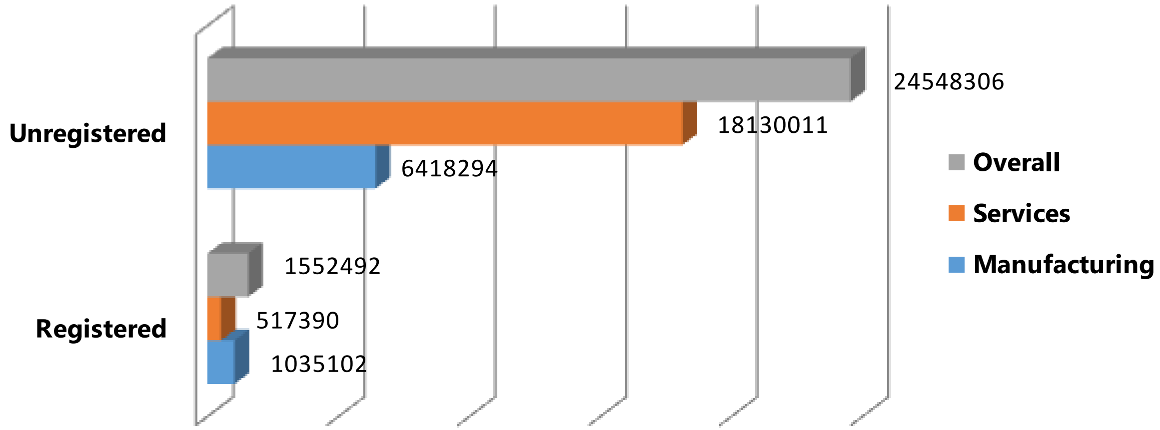


Figure 7 Source: Fourth All India Census of Micro, Small and Medium Enterprises, 2006-07

Primary research indicated a lack of knowledge associated with registering as a micro enterprise as a major reason for this disparity in the number of registered MSMEs and unregistered MSMEs. Especially among the most vulnerable sections of micro enterprises, information about the benefits and procedure of registration relating to obtaining finance and tax concessions had hardly percolated.

Additionally, there existed a perception concerning the MSME registration process, with preliminary opinions having prematurely formed about the bribery and difficulties, after previous experiences during the initial registration with unhelpful government officials and red tape.

Financing

One prevalent predicament which emerged was the lack of micro enterprise owners' ability to obtain financing for their activities. 20.49% of sick MSMEs had cited a shortage of working capital as the reason for a lag in performance (Fourth All India Census of Micro, Small and Medium Enterprises, 2006-07).

Analysis of the viable and addressable debt demand indicates that at least 106 lakh micro enterprises with an estimated average credit requirement of ₹ 30 lakh – ₹ 40 lakh constitute a viable financing segment for formal financial institutions in the near term. (International Finance Corporation, 2012)

Viable and Addressable Debt Gap in MSMEs

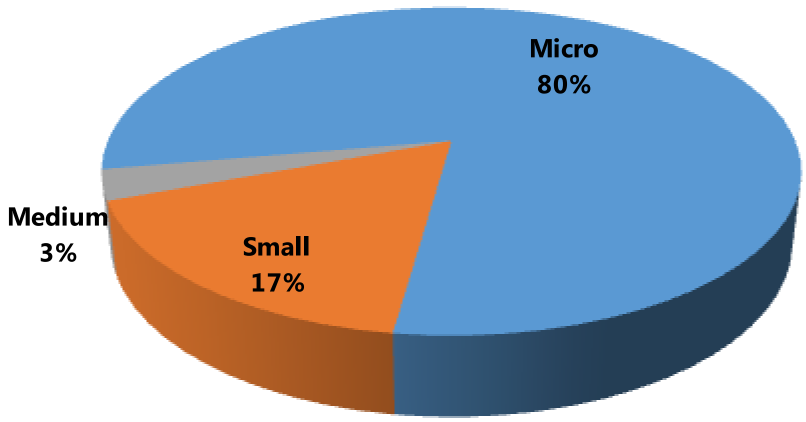


Figure 8 Source: Micro, Small and Medium Enterprise Finance in India, IFC

The following have been identified as the predominant sources of financing for MSMEs:

- Retained earnings, funding through sale of assets
- Ancestral capital, personal savings, loans from relatives, loans from unregulated market
- Institutional financing from scheduled commercial banks
- Venture capital funds/ seed funds

Financial Exclusion in the MSME Sector

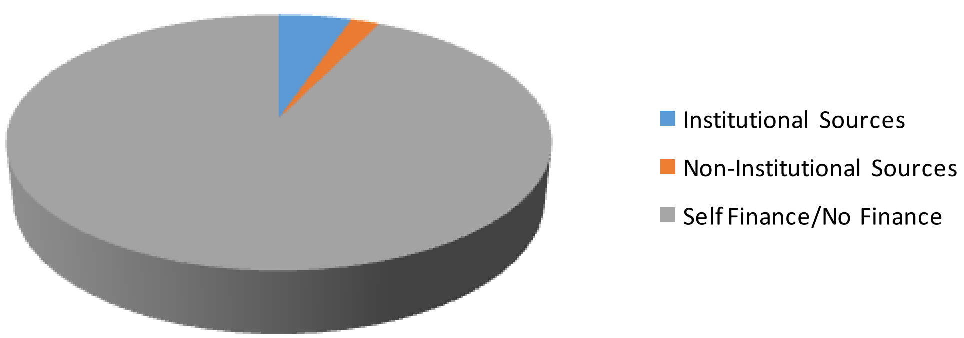


Figure 9 Source: RBI Monthly Bulletin, December 2013

Non banking institutions account for a very low percent of the total financing of MSME primarily because of the high rate of interests they charge to cover up transactional and operational costs. Further, the entrepreneurs expressed a lack of knowledge about non-mainstream financing options available to them.

The inclination of the micro entrepreneurs to resort to informal sources of credit arises primarily from a deficiency in the capacity of the entrepreneurs to obtain the collateral security required to obtain a loan, and the high cost of credit they see as available to them though commercial banks.

This, despite the schemes put in place to ease the credit procurement process for micro enterprises.

(A) **Priority sector lending** – Reserves 40% and 32% of overall lending for domestic commercial banks and foreign banks, respectively. Out of this, 60% is reserved for micro enterprises and the balance 40% for the small enterprises.

(B) **Specialised SME Bank branches** in industrial clusters

(C) **Performance and Credit Rating Scheme** – MSMEs can get themselves rated at a 75% subsidized fee by any of seven accredited agencies, which will further help them in approaching banks for financing

(D) **Credit Guarantee Fund Trust Scheme for Micro and Small Enterprises** - Allows for collateral free loans up to ₹ 1 crore

There is no dearth of schemes available for credit facilitation (Bikky Khosla, 2013), apart from those mentioned above, but the inadequacies lie in the implementation inefficiencies in the system.

Primary research indicated a lack of knowledge amongst many of the smaller enterprises about the credit procurement options schemes put in place for their aid. The information about the availability of such schemes barely percolated to those most in need of their benefits.

This may be a result of the inadequate access of the neediest micro entrepreneurs to sources of information. The same information which might be accessible to the larger micro enterprises, considering the environmental circumstances,

An extension of this idea of the existence of an information gap could lead to an extrapolation of it to consider the possibility of insufficient knowledge even on the part of the bank officials advising potential entrepreneurs. This could alternately be considered taking into account the fact that a conflict of interest may arise in the provision of loans by self-interested banks to the smallest of the micro enterprises. This, despite the existence of a monitoring cell at the Ministry of Micro, Small and Medium Enterprises to ensure that banks sanction loans under the schemes available to MSMEs.

The requirement of financial institutions, while assessing the credit worthiness of an enterprise, involves perusing accurately recorded financials, which micro enterprises may not possess, given their propensity to transact primarily in cash. Many of the formalities associated with completing their formalities and the paperwork involved further discourage many micro entrepreneurs. (International Finance Corporation, 2012).

Banks very often lack the area specific knowledge and insight required to pass a comprehensive result of the credit worthiness of these enterprises. This has been countered by the initiation of the Performance and Credit Rating Scheme. This outsources the evaluation of the credit worthiness of enterprises to seven specialised private agencies through the government, at subsidised rates of 25% of the normal fee. This scheme, however, involves the submission of records of audited accounts, verified by a Chartered Accountant, quality certificates, and several other documents which are highly difficult to obtain for micro enterprises at the lower end of the socio-economic spectra.

The delivery of collateral free loans by banks, as in the case of the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGFTMSE), might seem an unattractive option for the banks, who would rather obtain collateral as security for extended loans. They have often been reported as asking for collateral even under the CGFTMSE. Further, despite the loan limit under the CGFTMSE is ₹ 100 lakh, current RBI directives to banks puts the limit at ₹ 5 lakh.

Similarly in the case of the Priority Lending Scheme, though banks are obligated to extend 40% of their lending capabilities to micro and small enterprises, the security associated with larger enterprises might have resulted in a natural inclination of these banks to redirect these funds towards the larger, more established enterprises of both the small and micro enterprises spectra.

Exit

The sickness and exit process, in any industry is associated with a great deal of financial and social stress. However, micro enterprises are generally considered more vulnerable because of the lack of limited liability for most micro enterprises and the non-availability or disinterest of many formal sources of aid.

Applicable Laws

Corporate Insolvency

- Companies Act 1956
- Sick Industrial Companies (Special Provisions) Act, 1985 [SICA]
- Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI) Act, 2002 also known as the
- Securitization Act

Insolvency of individuals and unincorporated bodies

- Presidency Towns Insolvency Act, 1909
- Provisional Insolvency Act, 1920 **(Adukia, 2012)**

In addition to these laws, such closure entails compliance with various other legislature dealing with the exit of enterprises, to name a few - company law, labour laws, direct taxes, excise and service tax, customs and DGFT, VAT, power utility, water utility, municipal body, creditors, financial institutions etc.

Sickness

What is sickness and how does it occur?

RBI guidelines define sickness as follows:

A Micro or Small Enterprise may be said to have become **sick**, if

(A) Any of the borrowal accounts of the enterprise remains NPA for three months or more

OR

(B) There is erosion in the net worth due to accumulated losses to the extent of 50% of its net worth during the previous accounting year.

Reason for Sickness	Proportion of Sick Units
Lack of demand	41.94%
Shortage of working capital	20.49%
Non availability of raw material	5.11%
Power shortage	5.71%
Labour problems	5.64%
Marketing problems	11.48%
Equipment problems	3.17%
Management problems	6.46%

Table 4 Source: Fourth All India Census of Micro, Small and Medium Enterprises, 2006-07

How many sick MSEs are there, and how many are considered viable by banks?

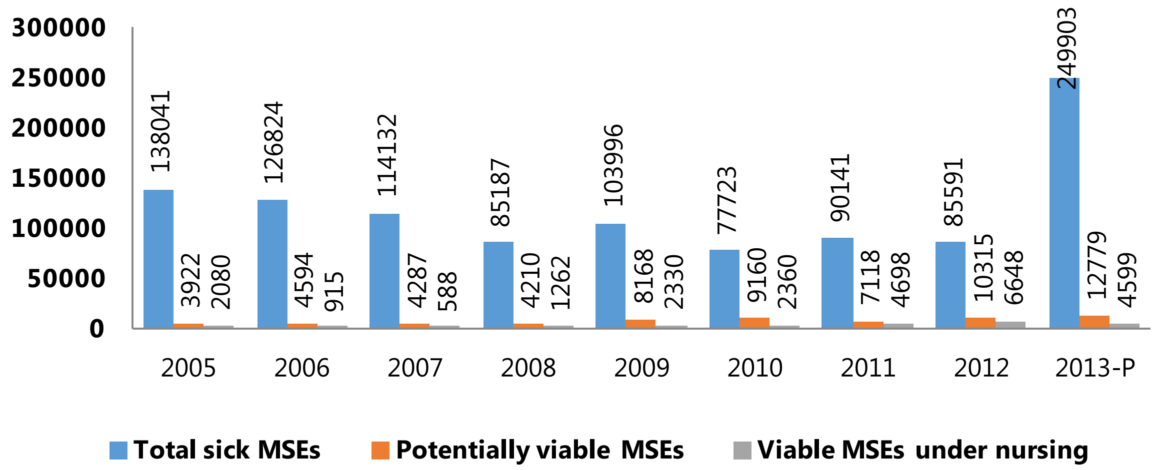


Figure 10 Source: RBI

The number of enterprises deemed viable compared to the number of sick enterprises, as indicated, is very low. Further, only a small number of these are put under nursing. This indicated a tendency of banks to prefer vying for the closure of MSEs as opposed to providing financial aid for them and preventing them from becoming insolvent.

The evaluation of banks, while considering sick enterprises for revival, is very often influenced by a conflict of interest, as stakeholders. As is apparent from Table, the number of units deemed potentially viable as a percent of the total number of sick enterprises is extremely low. The figure is 12.1% for March 2012 of which 7.8% were put under nursing, which came down to 5.1% sick units in March, 2013, and further only 1.8% were put under nursing. This might be a result of banks preferring not to extend aid towards the uncertain area of sick micro enterprises. This is in sharp contrast to the corporates whose loan portfolios are routinely rescheduled.

Regardless, since a low percentage of micro enterprises obtain loans through formal sources i.e. banks, the facilities extended towards the revival of such sick units very often do not impact the most vulnerable section of the segment.

The vulnerability of micro enterprises

Percentage Distribution of Enterprises by Type of Organization and Sector

Sector	Proprietary	Partnership	Private Company	Public Ltd. Company	Cooperative	Others
Micro	91.77	3.47	1.78	0.37	0.28	2.33
Small	59.12	14.24	21.02	3.37	0.57	1.68
Medium	38.11	9.75	34.46	13.06	1.86	2.75
All	90.08	4.01	2.77	0.54	0.30	2.30

Table 5 Source: Fourth All India Census of Micro, Small and Medium Enterprises, 2006-07

As around 94% of MSMEs are unincorporated bodies i.e. proprietorships or partnerships, as opposed to a significantly lesser number for small and medium enterprises (Fourth All India Census of Micro, Small and Medium Enterprises, 2006-07), they are governed by the Presidency Towns Insolvency Act, 1909, and the Provisional Insolvency Act, 1920. These acts disregard the concept of limited liability, which implies the non-separation of the personal assets of the entrepreneur with those of the enterprise. This results in an intertwining of the insolvency of an enterprise and the bankruptcy of the entrepreneur. As long as an entrepreneur possesses within his personal assets the finances to pay off the enterprise's dues, he is culpable and will be considered an insolvent.

These laws have largely remained static since their inception, and are carried out by district courts, which culminates in a long drawn out, court driven process of seizing debtor assets, and appointing receiver, and initiating punitive action against the debtor, which may very well result in his subsequent imprisonment. The focus of any proceedings undertaken is recovery of statutory dues, rather than an attempt at revival of the enterprise. (Report of Prime Minister's Task Force on Micro, Small and Medium Enterprises, 2010)

During this period, the entrepreneur, alongside struggling to revive his business, further had to face the possibility of being sued or penalized under various regulations. In addition, the stigma attached with owning a failed enterprise has a social impact on the entrepreneur, and severely affects his abilities to obtain financing for a future entrepreneurial undertaking.

Measures have been taken to mitigate this, such as establishing the Limited Liability Partnerships Act, 2008, and allowing the registration of one-person companies (OPCs) under the Companies Act. The ease of compliance, taxation laws, and registration process make these viable options for micro entrepreneurs to limit their personal liability. However, steps must be taken to ensure the availability of information channels to micro enterprises, the most vulnerable of the MSMEs.

For now, there is an urgent need to recognize that the very nature of entrepreneurial activities entails a certain amount of risk, and very often that risk results in the declaration of a unit as temporary or permanently sick, regardless of the viability of the entrepreneurial initiative.

Labour

Labour conditions in the context of MSMEs, particularly micro enterprises, are a delicate and complex issue, due to the high number of labour intensive, unregistered enterprises. 5.64% of sick MSMEs had cited labour problems as the reason for a lag in performance (Fourth All India Census of Micro, Small and Medium Enterprises, 2006-07).

The average number of employees per micro enterprise is 4.4% (Fourth All India Census of Micro, Small and Medium Enterprises, 2006-07). Such a low labour force per unit, however, perhaps is not indicative of the large numbers that may be employed in certain micro enterprises, which puts them under the scope of certain Acts such as the Factories Act, 1948, which covers units applying 10 or more persons with power.

Conversely, calls for a separate, comprehensive policy for MSME are redundant and impractical as the definition of MSMEs is in terms of investment, not manpower, so correlating the threshold levels as applicable under different laws and consolidating them into a single act will be difficult.

Applicable Laws

- Apprentices Act, 1961
- The Bidi and Cigar Workers (Conditions of Employment) Act, 1966
- Bonded Labour System (Abolition) Act, 1976
- The Building and Other Construction Workers Act, 1996
- Child Labour (Prohibition & Regulation) Act, 1986
- The Children (Pledging of Labour) Act, 1933
- The Contract Labour (Regulation & Abolition) Act, 1970
- The Employees Provident Funds and Misc. Provisions Act, 1952
- Employees State Insurance Act, 1948
- Employers Liability Act, 1938
- Employment Exchange (Compulsory Notification of Vacancies) Act, 1959
- Equal Remuneration Act, 1976
- The Factories Act, 1948
- The Industrial Disputes Act, 1947
- The Industrial Employment (Standing Orders) Act,1946
- The Inter-state Migrant Workmen (Regulation of Employment and Conditions of Service) Act, 1979
- Labour Laws (Exemption from Furnishing Returns & Maintaining Registers by Certain Establishments) Act, 1988
- Maternity Benefit Act, 1961
- The Minimum Wages Act, 1948
- The Payment of Bonus Act, 1965
- The Payment of Gratuity Act, 1972
- The Payment of Wages Act, 1936
- The Sales Promotion Employees (Conditions of Service) Act, 1976
- The Shops and Establishments Act, 1953
- The Trade Union Act, 1926
- Workmen's Compensation Act, 1923
- The Weekly Holidays Act, 1942 **(Adukia, 2012)**

Documentation and Declarations

While the Labour Laws (Exemption from Furnishing Returns and Maintaining Register by Certain Establishments) Act 1988 simplifies the documentation and declarations on wages that 'small enterprises' (10-19 employees) and 'very small enterprises' (up to nine workers) must submit to the labour authority under 9 Acts, primary research did indicate a barrier felt amongst micro entrepreneurs with the various existing regulatory compliances in the labour department.

Primary research suggested discontent with the maintenance of registers, filing of returns, conduction of inspections, and the procedures thereof. The transaction costs and energy input was considered disproportionately high for these micro enterprises.

A study of labour laws applicable in the Indian state of Uttar Pradesh found that there were 38 central laws and 10 state laws with which enterprises were required to comply (Labour and Labour-Related Laws in Micro and Small Enterprises: Innovative Regulatory, 2007). The large number of returns to be filed and reports to be maintained very often entail the need for legal advice, which in turn leads to further expenses. Almost every Act requires the employer to maintain a set of registers, submit periodic returns and display certain notices near the main entrance of the establishment. There is lot of duplication and overlapping of these paper work formalities.[4]

In light of this problem, the Central Labour Commissioner combined the filing of returns under five Acts, these being - Payment of Wages Act, 1936; Minimum Wages Act, 1948; Contract Labour (Regulation & Abolition) Act, 1970; Building and Other Construction Workers Act, 1996; and the Inter-State Migrant Workmen Act, 1979. However, establishments are still vulnerable to an inordinate number of regulations, and the state governments have hence been advised to similarly aim for the simplification of such laws. (Dhoot, 2013)

Establishments are liable for inspection by several Inspectors with little or no co-ordination amongst them. There are half a dozen or so Inspectors appointed under various labour laws who make several visits to the establishment on the pretext of overseeing compliance of statutory provisions. This results in undue harassment of the enterprise. The inspection process is often very rudimentary, and simply involves the bribing of inspectors to overlook deficiencies.

Inefficiencies in government departments and difficulties in acquiring the required information lead entrepreneurs and factory owners to delay obtaining and maintaining certain licenses and registers. They prefer to wait until a notice sent to them by the concerned government department informs them of the need to follow through with the procedure.

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[4] For example, Accident Register has to be maintained under the Factories Act, 1948, and Accident Report has to be sent under the Employees State Insurance Act, 1948. Likewise inspection book is required to be maintained under the Factories Act, 1948, Employees' State Insurance Act, 1948 and the Employees Provident Fund and Miscellaneous Provisions Act, 1952.

Complications in implementation result in corruption and lack of accountability, and improper and inefficient regulatory practices, which form disincentives and hence, barriers, to entrepreneurs.

Employee Lay-off Regulations

The World Bank, in 2010, noted that "India is one of the most restrictive countries in the world in terms of regulations governing retrenchment and layoffs" (The World Bank, 2010), and this has been reflected in India's rank in the Ease of Doing Business Index. (International Finance Corporation, World Bank, 2014).

However, many of the restrictive laws concerning the laying off of employees whilst downsizing or adjusting to market signals does not affect micro enterprises, as these restrictions come under the scope of the Industrial Disputes Act, 1947, which imposes stringent regulations on enterprises with more than 100 employees.

Taxation

Taxation remains an issue of relevance in the context of Indian industries, a result of it being considered flawed with regards to the number of payments required, procedures for filing these payments, and the non-uniformity across states associated with them, as was indicated by the World Bank in their Ease of Doing Business Index (International Finance Corporation, World Bank, 2014).

Reports and research suggested a combination of three factors affect the psyche of the entrepreneur with respect to the tax system she is bound to: (Bernadette Kamleitner, 2012):

A. Perception about Non-Compliance Opportunity
B. Decision-Frame Rendering Taxes as Painful Losses
C. Knowledge about Tax-System

Applicable Laws

- The Workmen's Compensation Act, 1923
- Income Tax Act, 1961
- Central Excise and Salt Act, 1944
- Central Sales Tax Act/State Sales Tax Act
- Professional Tax
- Service Tax **(Adukia, 2012)**

However, most primary data collected did not indicate a tendency amongst micro enterprises to consider the taxation laws applicable to them as being a hindrance, beyond certain difficulties in filing. The laws in place, available o registration as an MSME, currently grant concessions to MSMEs, such as Excise Exemption Scheme and Exemption under Direct Tax Laws. The low rate of registration does imply that these tax benefits do not reach a large number of micro enterprises, regardless; tax was not reported to be a regulatory barrier per se.

Miscellaneous Issues

1. The benefits granted by the MSMED Act, 2006, both tax and non-tax, trigger a tendency of small enterprises to stay small. These benefits are associated with being a micro enterprise, and hence entrepreneurs weigh expansion over the loss of vital benefits.
2. Most of the compliance related issues affect micro enterprises the hardest, because the larger the enterprise, the greater power they have to hire consultants to monitor the regulatory aspect of entry and operations.
3. The confusion and ambiguity concerning products to be sent to different states. This transport involves the obtainment of certain state-specific forms from the buyer. These forms vary from state-to-state and product-to-product, and there is no single source of information.

Conclusion

The key finding from the research was that the main regulatory barriers for the set up, operations and growth of micro enterprises lay in the fields of entry, financing, exit and labour.

Inefficient government channels

The registration and licensing process were greatly hampered by the inefficient channels available to entrepreneurs. Multiple requirements from multiple departments entailed a great deal of hassle. The lack of a streamlined process was felt. This lead to a feeling of cynicism amongst the entrepreneurs concerning the government's efforts to aid them, and they were often quoted as saying that the government intentionally hampers their entry into the sector.

Sufficient government schemes

Plenty of government schemes have been put in place so far, addressing all the important spheres of MSME operations and growth. These are close to 58 only from the Ministry of MSME, excluding those offered by NSIC, KVIC, and Coir Board. However, these, perhaps, haven't had a satisfactory impact on the MSME sector's performance. The reason lies in the operational inefficiencies and lack of awareness associated with the schemes. (Bikky Khosla, 2013)

Information gap

Wide information gaps were discovered in several aspects. Entrepreneurs were simply not aware of the procedures for registration or licensing, the requirement of various licenses, applicability of different laws, or the benefits associated with MSME registration. While financing requirements were often cited as a barrier, awareness of the many schemes put in place was lacking. For example, while banks' requirement for collateral was censured, few had information about the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGFTMSE), a collateral free loaning process.

A general disinterest had arisen among many entrepreneurs in the government, a result of their angst and lack of faith in it. This prevented them from perusing whatever limited information sources they had available to them.

Primary research also revealed indifference among government officials towards aspiring entrepreneurs, and a lack of interest in providing information to them.

Further, with respect to financing, banks themselves were reported to not have provided sufficient information about the various schemed they were directed to provide. This might have resulted from both a lack of information on their end, as well as a conflict of interest.

Implementation deficiencies

The outreach and implementation of the many schemes that are in place are a major issue. Financial institutions were reported to have withheld information about schemes, and not following directives, like asking for collateral even under the CGFTMSE.

Outdated legislature

This arose with respect to the insolvency laws currently applicable to proprietorships and partnerships. The Presidency Towns Insolvency Act, 1909, and the Provisional Insolvency Act, 1920, are outdated as they have no concept of limited liability. The assets of an entrepreneur are intertwined with the enterprise's, and the insolvency of the enterprise implies the bankruptcy of the entrepreneur.

Compliance burden

New entrepreneurs generally face difficulties in completing and complying with various formalities and legal requirements under various laws/regulations, such as the annual renewal of many licenses they require for operation, and the requirements for obtaining a loan from formal sources of finance. This is particularly acute for the smaller micro enterprises as they can usually not afford to hire consultants and accountants to oversee the regulatory compliances.

Further, the compliances under the labour laws were reported to be cumbersome and overlapping, involving the maintaining of registers and filing of returns.

Corruption

Corruption was prevalent at every stage of the entry and operation, according to primary sources. Throughout the registration process, license obtainment and the conduction of inspections, a great deal of money was spent by the entrepreneurs in paying off unaccountable government officials.

Policy Recommendations

Enhancing business environment

Implementation of the single window clearance system for the obtainment of the many licenses required, as is currently in operation in certain states, such as Andhra Pradesh. This system operates through the District Industries Centres, and should hence be enforced in every state.

Installation of MSME telephone helpline to provide single point assistance to entrepreneurs concerning procedures, available benefits and miscellaneous information

Preventing stagnation

Extension of benefits associated with a particular investment group for three years following its graduation to a higher investment level.

Targeting Awareness about MSME registration

Greater levels of MSME registration must be targeted by spreading awareness about the benefits of registering. This involves investing in eliminating information gap at the grass roots level to ensure the benefits percolate to the neediest

A. Identification of investments bands done at time of enterprise registration, and further extending information about MSME registration to all potential MSMEs. This information should include steps for registration, documents required and benefits of registration
B. Improvement of communication networks through the use of media such as radio, television and newspapers

Phase-out outdated insolvency laws

Introduce the concept of limited liability in the concept of proprietorships and partnership laws by reforming The Presidency Towns Insolvency Act, 1909, and the Provisional Insolvency Act, 1920

Easing compliance burden

Easing compliance burden associated with registration, licensing, financing and labour

A. Introduction of long period licenses to prevent the burden of getting several licenses renewed every year
B. Amendment the Factories Act to exclude micro enterprises
C. Merging of the following Acts: Employees' Compensation Act, 1923, Employees' State Insurance Act, 1948; Employees Provident Fund and Miscellaneous Provisions Act, 1952, into a single law contributing towards social security.
D. As is under consideration, modification of the Labour Laws (Exemption from Furnishing Returns & Maintaining Registers by Certain Establishments) Act, 1988 as per the Labour Laws (Exemption from Furnishing Returns and Maintaining Registers by Certain Establishments) Amendment Bill, 2010
E. As in Gujarat, conduction of inspections only in cases of defaulters and wherever the compliance is irregular, and regular annual inspection only in cases of major employers employing more than 250 workers

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