

# Regulatory Barriers to Micro, Small and Medium Enterprises

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## Section I: Background to the Study

### 1.1 Aims and Objectives

Against the post-New Industrial Policy (1991) growth witnessed in large-scale industries, a corresponding boom in the small and mid-sized domestic industry has been conspicuously absent. The paper seeks to document the causes for the same. Further, a comparative evaluation of Indian MSMEs with those operating in other BRICS nations will be conducted, in an attempt to understand the overall effect of the business, policy and legal/regulatory environment on the growth of MSMEs.

### 1.2 Research Question and Hypothesis

#### Research Question:

What have been the causes behind the inability of MSMEs to realise their growth potential?

#### Hypothesis:

It has been observed that given the business environment in India, large-scale companies have thrived while MSMEs have not been able to realise their full growth potential. The study hypothesises—and seeks to verify whether and the extent to which—this handicap of MSMEs is attributable to the regulatory norms applicable to them. Further, it is suggested that the business environment in India, as contrasted against that of other BRICS nations, is not sufficiently conducive to MSME growth.

### 1.3 Methodology

The paper employs secondary data analysis as the major tool of research. Primary methods were used to supplement this analysis, by means of telephonic, semi-structured interviews with officials from the concerned government ministries and departments.

## Section II: Introduction

### 2.1 Definition of MSMEs

Generally, Micro, Small and Medium Enterprises (MSMEs) are defined in terms of investment made towards plant, machinery and/or equipment, as also in terms of number of people employed and the annual turnover. In India, however, Section 7 of the MSME Development Act, 2006, classifies them along the investment ceiling. For manufacturing enterprises, the investment ceiling lies below INR 25 lakhs (Micro), between INR 25 lakhs and 5 crore (Medium) and between INR 5 crore and 10 crore. The criterion for service enterprises lies as follows: below INR 10 lakh (Micro), between INR 10 lakh and 2 crore (Small) and finally, between INR 2 crore and 5 crore (Medium) (MSMED Act, 2006).

**Table 1: Definition Of MSMEs**

<b>Industry</b>	Enterprises engaged in the manufacture or production of goods: investment in plant and machinery	Enterprises engaged in providing or rendering of services: investment in equipment
<b>Micro</b>	Not exceeding INR 25 lakh	Not exceeding INR 10 lakh
<b>Small</b>	Between INR 25 lakh and INR 5 crore	Between INR 10 lakh and INR 2 crore
<b>Medium</b>	Between INR 5 crore and INR 10 crore	Between INR 2 crore and INR 5 crore

This comprehensive definition of MSMEs came in post the enactment of The Micro, Small and Medium Enterprises Development Act (MSMED), 2006. Formerly, MSMEs were collectively termed as Small Scale Industries (SSIs) under the Industrial Development and Regulation (IDR) Act, 1951 and the criteria for their classification was marked by ambiguity; acquiring clarity of definition and objectives has been a definite achievement of the MSMED, 2006. The need for an enactment specific to MSMEs has been clarified in the Statement of Objects and Reasons of the MSMED Act:

*Small scale industry is at present defined by notification under section 11B of the Industries (Development and Regulation) Act, 1951. Section 29B of the Act provides for notifying reservation of items for exclusive manufacture in the small scale industry sector. Except for these two provisions, there exists no legal framework for this dynamic and vibrant sector of the country's economy...Central enactment to provide an appropriate*

*legal framework for the sector to facilitate its growth and development...a growing need is being felt to extend policy support for the small enterprises so that they are enabled to grow into medium ones, adopt better and higher levels of technology and achieve higher productivity to remain competitive in a fast globalization area"*

(MSMED Act, 2006).

This shift in policy perspective towards MSMEs has been a positive development. A policy specifically aimed at MSMEs, is bound to integrate them into economic development strategies and plans.

## 2.2 Challenges Faced by the MSME Sector

From this section on, the focus of the paper lies on identifying and briefly documenting problems that hinder and threaten to severely limit, the growth prospects of MSMEs. It becomes imperative to do so in order to later be in a position to analyse the impact of policy measures and regulatory norms on these challenges: whether these are mitigated or aggravated by the said norms.

"Poor infrastructure and inadequate market linkages are among key factors that have constrained the growth of the sector. However, lack of adequate and timely access to finance continued to be the biggest challenge" (International Finance Corporation, Year Unknown). The sector's total financial demand was estimated to be INR 32.5 trillion in 2009-10, with 80 percent of the demand originating from the informal sector. Inability to market their products well is a challenge associated with this financial crunch. Further, even the tax system in place in India has been criticised along several aspects deemed undesirable for the business environment: number of payments required, procedures for filing payments and non-uniformity across states associated with taxation (Ease of Doing Business Index, International Finance Corporation, World Bank, 2014).

The Ease of Doing Business Index 2014 places India at the 142<sup>nd</sup> position (as opposed to 134<sup>th</sup> in 2013), amongst a total of 189 countries; the index is composed of 10 indicators, a majority of them being associated with regulatory norms, automatically drawing attention to the potentially adverse effect of these norms on the general business environment and subsequently, on the performance of MSMEs. These regulatory norms may pertain to the entry, continuance or exit of MSMEs, as has been discussed in detail later in this paper. Documentation and declaration procedures under several regulatory statutes are seen to be rather cumbersome, extensive and protracted.

Lack of information and awareness on part of entrepreneurs as to governmental benefits and schemes designed to facilitate their induction into and continuance in the MSME sector could be a cause of their sub-optimal performance. In the event of imperfect information, the efficacy and actual operationalisation of schemes is rendered to the status of a secondary concern; individuals must be aware of potential benefits in order to be in a position to avail them.

Given these problems faced by MSMEs, coupled with globalisation and international competitive pressures, there is a recognised and “urgent need of a dynamic and self-sustaining culture of innovation” (FICCI Summit, 2012). As per the FICCI report, share of innovating firms in India rested at a mere 19 percent. India is ranked 62<sup>nd</sup> on the Global Innovation Index and 8<sup>th</sup> in its income group, following China, Moldova, Jordan, Thailand, Vietnam, Ukraine and Guyana. The necessity of an R & D wing is underestimated by most MSME owners, presumably driven by the financial crunch they are constantly faced with.

Despite the fact that MSMEs account for 40 percent of overall employment, non-availability of skilled labour is a problem reported by several MSME owners. The educated and sufficiently skilled prefer the higher wages and job security offered by larger enterprises. Labour retention is, in itself, an added challenge. MSMEs often rely on informal contracts in their operation, rendering their obligatory value negligible.

Further, the smaller the firm, the likelier it is to be affected by corruption. More SMEs than larger firms believe that corruption is “part of the way things work in the country”. They pay much higher percentages of annual revenues in bribes to public officials and make additional payments to get things done much more frequently than larger companies (UNIDO, 2007).

These challenges faced by MSMEs cannot be treated in isolation from one another. They must be studied holistically for they interact with one another only to compound themselves.

A challenge faced by the sector from a policy perspective, and which cannot be readily quantified, lies in the fact that Micro, Small and Medium enterprises are often lumped together—in making budgetary allocations, devising policy measures and in the subsequent application and implementation of policies so drafted. The distinction between them is not merely academic; it comes with variations in their requirements and, therefore, holds practical value. Micro, Small and Medium enterprises, for instance, have different finance needs. Micro enterprises primarily rely on debt for both early and growth-stage financing; micro and small services enterprises primarily transact in cash and tend to keep minimal records. Finally, manufacturing enterprises and those with order-driven services tend to need more finance because of longer working capital cycle and higher capital expenditure (International Finance

Corporation, Year Unknown). These different requirements can naturally not be catered to and addressed when they are not even recognised in making policy decisions.

### **2.3 Trends: Implications for the Economy**

A study of macroeconomic trends indicates that the contribution of the manufacturing sector to the GDP, output and exports of the country has been declining. Considering the fact that the MSME segment registers 6 percent of the GDP, 45 percent of the manufacturing output, 40 percent of the total exports from India and is the second largest employer (following agriculture), an overall decline can safely be presumed to be indicative of a decline in the MSME sector. This decline can be attributed, in part, to a variety of reasons ranging from 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).

Given this undesirable trend, it becomes imperative to undertake a systematic study aimed at identifying the causes behind the same, from a policy perspective; and to deliberate upon possible policy measures that could be employed to remedy the same.

### Section III: Large Enterprises and MSMEs: A Comparative Overview Post 1991

A need for a reform in the economic structure of the country was recognised when India had acquired a reputation as one of the most protected and heavily regulated economies in the world. The broader view with which the government liberalised the economic policies of the country (with the New Economic Policy, 1991) was that it would result in growth in productivity. The broad reforms in India's industrial policy were outlined as follows:

*"Industrial policy was restructured to a great extent and most of the central government industrial controls were dismantled. Massive deregulation of the industrial sector was done in order to bring in the element of competition and increase efficiency. Industrial licensing by the central government was almost abolished except for a few hazardous and environmentally sensitive industries. The list of industries reserved solely for the public sector -- which used to cover 18 industries, including iron and steel, heavy plant and machinery, telecommunications and telecom equipment, minerals, oil, mining, air transport services and electricity generation and distribution was drastically reduced to three: defense aircrafts and warships, atomic energy generation, and railway transport. Further, restrictions that existed on the import of foreign technology were withdrawn."*

(Ministry of External Affairs, Government of India, Year Unknown)

However, growth in productivity of the economy as intended by these reforms occurred through a process; that is, import liberalisation provides domestic firms with access to capital embodied with technology. Freedom to invest and enter the market increases the extent of competition and puts pressure on the incumbents to upgrade their technologies. With the entry of new firms in a more competitive market, the process of creative destruction goes to work. Efficient firms drive the inefficient firms, resources gets reallocated to more productive use and the overall productivity of the factors in the economy increases. Due to technology transfer, productivity in the industry and service sectors grows rapidly.

(Kotwal, Ramaswami and Wadhwa, 2011)

Relying on the standard criteria of growth rates in national income and per capital income, the Indian economy has done well post liberalisation. The data of selected time periods before as well as after economic liberalisation is as follows:

**Table 2: GDP Growth Rates: Before and After Liberalisation**

<b>Year</b>	<b>GDP</b>	<b>Secondary Sector</b>
1951-52 to 1980-81	3.63	5.29
1981-82 to 1985-86	4.92	5.08
1986-87 to 1990-91	5.88	6.86
1992-93	5.40	3.60
1994-95	6.40	9.30
1996-97	8.00	7.30
1998-99	6.70	4.30
2000-01	4.40	6.80
2002-03	3.80	6.90
2004-05	7.50	10.50
2006-07	9.60	12.70
2008-09 (P)	6.80	4.70
1992-93 to 2009-10	6.86	7.34

(P) – provisional estimate.

Source: (Saikia, 2012)

Facilitating the growth of Small Scale Industries post 1991 has been a major concern for the Government because of its direct impact on the economy due to its potential for employment opportunities, output and exports. According to the Annual Report 2012-2013 on MSMEs published by the Ministry of MSME, there has been a significant increase in the employment and performance of MSMEs over the last decade.

**Table 3: Employment and Performance Of MSMEs (\*Estimated Values)**

<b>S. No.</b>	<b>Year</b>	<b>Total Working Enterprise (In Lakh)</b>	<b>Employment (In Lakh)</b>	<b>Gross Output (In Crore)</b>
1	2001-02	105.21	249.33	282270.00
2	2002-03	109.49	260.21	314850.00
3	2003-04	113.95	271.42	364547.00
4	2004-05	118.59	282.57	429796.00
5	2005-06	123.42	294.91	497842.00
6	2006-07	361.76	805.23	1351383.45

7	2007-08*	377.37	842.23	1435179.26
8	2008-09*	393.70	881.14	1524234.83
9	2009-10*	410.82	922.19	1619355.53
10	2010-11*	428.77	965.69	1721553.42
11	2011-12*	447.73	1012.59	1834332.05

Source: (Ministry of Micro, Small and Medium Enterprises, Government of India, 2012-13)

With the initiation of market liberalisation, there have been many significant concomitant changes in the institutional arrangements that governed various operations of SMEs. The changes, *inter alia*, included de-reservation<sup>1</sup> of the products for the small-scale sector and de-licensing, leading to increased competition with the large-scale sector from within the country. Further, dismantling of tariff barriers led to the replacement of the earlier policy of infant industry protection with a regime of open competition with foreign firms. Along with the integration of India's innovation system with the world market, certain sectors within SMEs could manage to get access to global market *inter alia* on account of their increasing participation in the global production network (GPN). But, given the weakness of the innovation system with the absence of institutional arrangements for interactive learning and competence building, and the varied constraints in the spheres of credit market, factor market (including labor and skill), product market, and technology, the large number of units in the SME sector could hardly withstand the heightened competition resulting from liberalisation.

This sudden induction into a competitive environment while they were still in their nascent stages of development gave MSMEs a shock that they were unable to absorb effectively. The outcome has been an unprecedented increase in the number of sick units and decline in the rate of growth in exports by the SME sector.

<sup>1</sup>

Year	Items Reserved for MSMEs	Items on Open General License (OGL)	Remaining items under Reserved List
1998-1999	821	478	343
1999-2000	812	576	236
2000-2001	812	643	169
2001-2002	799	799	NIL

(<http://www.dcmsme.gov.in/policies/preseve.htm>)

**Table 4: The Decline of MSMEs**

Year	Number of Sick Units	Year	Rate of Growth in Exports
1990	0.2 million	1986-91	31%
2000	0.3 million	2000-2010	18%

Large industries, meanwhile, had the definite advantage of having been established and found their footing in the economy, thus being able to sustain themselves against the wave of newfound competition, both domestic and international.

India has experienced rapid industrial growth since the enactment of the economic liberalisation policies in 1991. Economic liberalisation has accounted for a substantial impact on the manufacturing industry through an increase in the presence of manufacturing units, from 98,379 in the pre-liberalisation period of 1987 to 140,355 industrial units in 2007 reflecting a 42.67 percent growth during this 20 year period, and a rise in the production capacity and output within individual manufacturing facilities.

**Table 5(A): Growth of Manufacturing Sector in India**

Sector	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
<b>Manufacturing</b>	10.1	14.3	10.3	4.2	8.8	8.8
<b>Construction</b>	12.8	10.3	10.7	5.4	7	8
<b>Mining &amp; Quarrying</b>	1.3	7.5	3.7	1.3	6.9	6.2
<b>GDP at Factor Cost</b>	9.5	9.6	9.3	6.8	8	8.6

The table below represents the growth rate of factories, employees and gross output.

**Table 5(B): Growth of Manufacturing Sector in India**

Years	Factories (%)		Employees (%)		Gross Output (%)	
	SSI	Large	SSI	Large	SSI	Large
1980-81 to 1984-85	-0.6	11.9	-2.1	2.1	0.6	8.7
1985-86 to 1990-91	0.7	15.0	1.5	0.5	7.9	9.6
1980-81 to 1990-91	0.2	13.7	0.1	1.1	5.0	9.3

The larger industries have been performing better, since MSMEs are generally equipped with obsolete, inefficient and polluting technologies and processes due to lack of funding. 70 percent of the total industrial pollution load of India is attributed to MSMEs. Regulatory mechanisms to ensure compliance are ill-suited towards MSMEs, as they are tailored more towards larger industries, creating a scenario where MSMEs are unable to comply with regulations. (Such regulatory barriers will be discussed in detail in the next section.) A vast majority of them are actually self-employed people who survive by producing something or by providing a service. Estimates are that more than 90 percent of them do not have access to any approved developed industrial or business space for work, nor any form of institutional finance nor any government support schemes. Another reason is because of their inability to access affordable planned industrial space because of which they are compelled to work in 'industrial slums' (Planning Commission of India, 2012).

Having accounted for the gap in terms of opportunity and growth differential between SSIs and large enterprises, that remained even after the liberalisation reforms, the question automatically arises: what were the factors that impeded, and in fact continue to stop, MSMEs from realising their growth potential. While socio-cultural factors cannot be ignored in their entirety, it is a safe presumption that the business environment and regulatory framework prevalent in India are the primary cause of this differential. The study therefore seeks to document and analyse Indian regulatory norms in an attempt to identify whether, and the extent to which, they contribute to a retardation of MSME growth.

## Section IV: Documentation and Analysis of Regulatory Norms

This section seeks to document regulatory norms associated with MSMEs; for convenient and systematic study. These norms will then be discussed, classified along those pertaining to entry, continuance (broadly including labour, taxation and finance) and exit. Further, procedural formalities and documentation associated with these three stages will also be listed and evaluated, as to their justification and requirement.

### 3.1 Entry: Documentation

The process of entry, in terms of regulatory barriers, can largely be studied along registration and licensing obligations.

#### 3.1.1 Registration

##### 3.1.1.1 Process

As per section 8(1) of the MSMED Act, registration of micro or small enterprise (both, manufacturing and service-oriented units) or a medium enterprise engaged in providing or rendering of services is optional. However, a medium enterprise engaged in manufacture or production of goods<sup>2</sup> is required to mandatorily file the memorandum of registration with the General Manager, District Industries Centre or any District level officer of equivalent rank in the Directorate or the Department dealing with MSMEs of the state government or union territory.<sup>3</sup>

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<sup>2</sup> With the rider that these goods must pertain to an industry specified in the First Schedule to the Industrial Development Regulation Act, 1951.

<sup>3</sup> The MSMED Act, 2006 provides any enterprise established before this Act came to force i.e. enterprise pre-existing before 2<sup>nd</sup> October 2006:

- (i) In case of a registered small scale industry filing of memorandum is optional;
- (ii) In case of an industry engaged in manufacture or production of goods pertaining to industry specified in the First Schedule to IDR Act, 1951 having investment in plant and machinery more than INR 1 crore but not exceeding INR 10 crore, shall within 180 days i.e. by 31<sup>st</sup> of March 2007 file an Industrial Entrepreneurs' Memorandum.

### **3.1.1.2 Justification Behind the Registration Process**

Registering under the MSMED Act, 2006 ensure certain advantages.<sup>4</sup>

- The Act provides that if the buyer has purchased goods or availed services from micro or small enterprise, which has filed a memorandum with the authority, then the buyer shall make payment on or before the date agreed upon between him and the supplier in writing.
- If no agreement in writing is available, then payment will be made within a period of 15 days from the day the goods are delivered or services are rendered.
- The Act further stipulates that even if the period between the buyer and supplier is agreed to in writing, such period shall not exceed 45 days from the day of delivery of goods or rendering of services. In short, any credit term from a micro or small enterprise stipulating payment terms beyond 45 days, shall be in violation of the MSMED Act, 2006. Failing this, the buyer is liable to pay compounded interest with monthly rests from the date falling after due date, at three times of the bank rate notified by the RBI (Kantilal Patel & Co., Year Unknown).

Under Section 27, this Act also prescribes a penalty for, “whoever intentionally contravenes or attempts to contravene or abets the contravention of any of the provisions contained in sub-section (1) of section 8 (as mentioned above) or sub-section (2) of section 26<sup>5</sup> shall be punishable:

- (a) in the case of the first conviction, with fine which may extend to rupees one thousand; and
- (b) in case of any second or subsequent conviction, with fine which shall not be less than rupees one thousand but may extend to rupees ten thousand.

Further, where a buyer contravenes the provisions of Section 22<sup>6</sup>, he shall be punishable with fine which shall not be less than rupees ten thousand; Section 22 seeks to ensure that the buyer

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<sup>4</sup> With the enactment of the MSMED Act, 2006, the Interest on Delayed Payments to Small Scale and Ancillary Industrial Undertakings Act, 1993 was repealed.

<sup>5</sup> Section 26 states that:

- (1) The Central Government or the State Government may appoint such officers with such designations and such other employees as it thinks fit for the purposes of this Act and may entrust to them such of the powers and functions under this Act as it may deem fit.
- (2) The Officers appointed under sub-section (1) may, for the purpose of this Act, by order require any person to furnish such information, in such form, as may be prescribed.

<sup>6</sup> Section 22 requires that:

provides complete information about the amount due on his end to the seller, so as to keep tabs on and thereby protect the basic financial interest of the seller, that is, recovery of remunerative price.

### 3.1.2 Licensing

Licensing in the industries sector is governed by the Licensing Exemption Notification issued by Government of India on July 25, 1991 under the Industries (Development and Regulation) Act, 1951. In the case of SSIs, there are virtually no licensing restrictions. No industrial license is required except in case of six product groups included in compulsory licensing. These products groups include distillation and brewing of alcoholic drinks, cigars and cigarettes of tobacco and manufactured tobacco substitutes, electronic aerospace and defence equipment of all types, industrial explosives (including detonating fuses, safety fuses, gun powder, nitrocellulose and matches), hazardous chemicals extending to hydrocyanic acid and its derivatives, phosgene and its derivatives, isocyanates and di-isocyanates of hydrocarbon, not elsewhere specified. These are mainly cover products that can only be made in large sector. But if a small-scale unit employs less than 50 to 100 workers with/without power then it would not require a license from the Government of India even for the six product groups covered in licensing (under Schedule II of the notification). Subject to this minor limitation, an entrepreneur can set up a SSI unit anywhere in the country without any restriction. The units are, of course, subject to the locational/land use and zoning restrictions in force under the local laws (Development Commissioner, Ministry on MSMEs, Government of India).

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**Where any buyer is required to get his annual accounts audited under any law for the time being in force, such buyer shall furnish the following additional information in his annual statement of accounts, namely:-**

- (i) The principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier as at the end of each accounting year;**
- (ii) The amount of interest paid by the buyer in terms of Section 16, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year;**
- (iii) The amount of interest due and payable for the period of delay in making payment (which has been paid but beyond the appointed day during the year) but without adding the interest specified under this Act;**
- (iv) The amount of interest accrued and remaining unpaid at the end of each accounting year; and**
- (v) The amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues as above are actually paid to the small enterprise, for the purpose of disallowance as a deductible expenditure under section 23.**

Further, item groups reserved for exclusive manufacture by micro and small enterprises, as per the Gazette notification include: food and allied industries, wood and wood products, paper products, injection moulding thermo-plastic products, chemicals and chemical products, glass and ceramics and mechanical engineering products excluding transport equipment (Anand G, 2009).

### **3.1.3 Procedural Norms: Starting a Business, Acquiring Construction Permits, Registering Property**

More than statutory stipulations, it is the procedural aspects of registration and licensing that have the potential to serve as hindrances to MSME owners, owing to their tedious and protracted nature. Starting a business, acquiring a construction permit (for the purpose of setting up a manufacturing unit/warehouse for storage purposes) and registering or transferring property are fundamental, and often essential, processes associated with the establishment and entry of an enterprise into the MSME sector. Identified here, in detail, are the processes that have to be fulfilled before these basic necessities of setting up an enterprise can be fulfilled.

#### ***Starting a Business***

The steps involved in starting a business in Delhi have been listed below; the detailed procedure entailed by each step has also been tabulated.

1. Obtaining a Director Identification Number (DIN) online from the Ministry of Corporate Affairs (MCA) portal
2. Obtaining a digital signature certificate from a private agency authorised by MCA
3. Reserving the company name with the Registrar of Companies (ROC) online
4. Paying stamp duties online, filing all incorporation forms and documents online and obtaining the certificate of incorporation
5. Requesting and obtaining Certificate to Commence Operation
6. Making a seal
7. Obtaining a Permanent Account Number (PAN) from an authorised franchise or agent appointed by National Securities Depository Services Limited (NSDL) or Unit Trust of India (UTI) Investors Services Ltd., as outsourced by the Income Tax (I-T) Department
8. Registering with Employees' Provident Fund Organisation
9. Register for medical insurance at the regional office of Employees' State Insurance Corporation (ESIC)
10. Register for VAT online

11. Obtaining a tax account number (TAN) for income taxes deducted at source from an authorised franchise or agent appointed by the National Securities Depository Ltd. (NSDL), as outsourced by the I-T Department

In Mumbai, the process is marked by two additional steps:

12. Registration with Office of Inspector, Mumbai Shops and Establishment Act
13. Registration for profession tax

The detailed procedure can be seen in Table 2.2 of the Doing Business Report 2015.

### ***Acquiring a Construction Permit***

The procedure involves the following steps:

1. Submit application and design plans and pay scrutiny fee
2. Receive site inspection from Building Proposal Office
3. Obtain Intimation of Disapproval and pay fees
4. Submit structural plans approved by a structural engineer
5. Apply for No-Objection Certificate (NOC) from Tree Authority
6. Receive inspection from Tree Authority
7. Obtain NOC from Tree Authority
8. Request and obtain NOC from Storm Water and Drain Department
9. Request and obtain NOC from Sewerage Department
10. Request and obtain NOC from Electric Department
11. Request and obtain NOC from Traffic & Coordination Department
12. Request and obtain NOC from Chief Fire Office
13. Obtain commencement certificate and pay development charges
14. Request and receive inspection of plinth
15. Submit letter stating completion of building works to obtain an occupancy certificate and certificate of completion
16. Request and obtain completion NOC from Tree Authority
17. Request and obtain completion NOC from Storm Water and Drain Department
18. Request and obtain completion NOC from Sewerage Department
19. Request and obtain completion NOC from Electric Department
20. Request and obtain completion NOC from Traffic and Coordination Department
21. Request and obtain completion NOC from Chief Fire Office
22. Apply for permanent water and sewer connection

23. Receive on-site inspection for connection to water and sewer
24. Request and receive completion inspection from Building Proposal Office
25. Obtain completion certificate
26. Obtain occupancy certificate
27. Obtain permanent water and sewer connection

More information on the time, cost and procedures for dealing with construction permits in Mumbai can be seen in Table 3.2 of the Doing Business Report 2015.

### ***Registering Property***

The following procedure has to be complied with, uniformly throughout India, in order for property to get registered, transferred or in any manner dealt with.

1. Obtain non-encumbrance certificate
2. Ensure that property is clear of all local tax dues
3. Conduct charges search at the Registrar of Companies
4. Preparation of the final sale deed by the purchaser's lawyer
5. Payment of Stamp Duty on the final Sale Deed through franking at the designated bank
6. Execute final sale deed and submit documents to the local office of the Sub-Registrar of Assurances;
7. Apply to the Land & Survey Office for mutation of the title of the property

More information on time, cost and procedures for registering property in India can be found in Table 5.2 of the Doing Business Report 2015.

## **3.2 Entry: Analysis of Regulatory Norms**

### **Simplification of the Registration Process**

The MSMED Act, 2006, replaces the erstwhile system of two-stage registration (provisional and permanent) for SSIs, with 'filing of memorandum' under Section 8 of the Act. Meanwhile, there is no provision that necessitates the surrendering of the SSI Registration Certificate before filing for the Entrepreneurs' Memorandum (EM).

The attempt, rather evidently, has been to simplify the registration process and in doing so, to allow MSME owners to avail the several benefits that accompany registration. However, it

becomes crucial to also note that Standing Order 941 (E), dated 7 June 2007, provides for separate filing of Ems. That is to say, an enterprise engaged in both, manufacturing and service activity, has to file two separate EMs with the same ownership/management/office/work address etcetera.

### **Statutory Protection of Financial Interest of MSME Owner**

The MSMED Act is punitive in a manner that serves to protect the financial interest of the supplier (or the MSME unit in question) by ensuring that apprehension of non-payment is not a deterrent for an enterprise otherwise willing to indulge in productive/service-providing activity. This fact is evident from the discussion on Sections 22, 26 and 27, as conducted in the foregoing section dealing with documentation of regulatory norms.

### **Minimal Licensing Obligations**

We observe that licensing requirements are rather liberal so far as MSMEs are concerned and contrary to general understanding, are not a major hindrance or deterrent to their entry and subsequent growth. The very notification that provides for licensing is termed the 'Exemption from Licensing Notification, 1991', pointing rather significantly at the shift in policy attitude towards small-scale entrepreneurial ventures.

### **Procedural Barriers**

A major drawback of the procedures associated with entry, as studied above, is the time and cost involved. As per the analysis conducted by the World Bank Group in coming up with the Ease of Doing Business Index, compliance with formalities to build a warehouse requires 25.4 procedures, takes 185.9 days and costs 28.2 percent of the warehouse value. Such costs cannot be borne by most MSMEs, given that financial crunches are one of the major problems faced by them. Further, the protracted nature of the procedure encourages and incentivises non-compliance; greater instance of unregistered property transfer being a befitting illustration.

While transferring a large part of procedure (obtaining a DIN for instance, or applying for a PAN card) to electronic form has facilitated entrepreneurs, it becomes difficult for those relying on conventional methods and physical filing of applications to adapt to these new forms. Thus both modes of complying with procedure—physical and electronic—must be kept open.

Further, it is witnessed that while carrying out the procedure for several entry-associated activities (obtaining construction permits, in particular) necessitates the obtainment of NOCs from multiple authorities. This process is tedious and time-consuming for the entrepreneurs and can have a dampening effect on the business environment.

### **3.3 Continuance: Documentation of Regulatory Norms**

Regulatory norms associated with continuance of a firm in the MSME sector can be studied along three broad dimensions: Financing, Taxation and Labour.

#### **3.3.1 Financing**

As discussed in a former section of the paper dealing with challenges faced by MSMEs, insufficiency of finances, funding sources and the resultant debt gap are a cause of major concern for the MSME sector. A sub-group established by the Planning Commission estimates the outstanding credit gap for the MSME sector at 62 percent of credit demand at the beginning of the 12th Five Year Plan. Total credit demand, just for microenterprises, comes to around INR 7.9 trillion for 2012.

According to the Ministry of MSMEs, the need for financing can be categorised as:

1. Long and medium term loans
2. Short term or working capital requirements
3. Risk Capital
4. Seed Capital/Marginal Money
5. Bridge loans

The important potential sources of funding for MSMEs are:

1. Commercial/Regional Rural/Co-operative Banks.
2. SIDBI: Small Industries Development Bank of India (refinance and direct lending)
3. SFCs/SIDCs: State Financial Corporations (Delhi Financial Corporation, for instance)/State Industrial Development Corporations.

This list, however, is not exhaustive. Financing of MSMEs need not be restricted to these sources. It also includes venture capital funds and non-government finance companies.

### 3.3.1.1 Availability of Credit

The table below gives the status of credit flow to the micro and small enterprises (MSE) sector from the public sector banks since 2000:

**Table 6: Credit Flow to MSMEs**

As at the end of March								
	2000	2001	2002	2003	2004	2005	2006	2007
<b>Net Bank Credit (NBC)</b>	3,16,427	3,41,291	3,96,954	4,77,899	5,58,849	7,18,722	10,17,614	13,17,705
<b>Credit to MSEs</b>	46,045	48,400	49,743	52,988	58,278	67,634	82,492	1,04,703
<b>% to NBC</b>	14.6	14.2	12.5	11.1	10.4	9.4	8.1	8.0

(Source: <http://www.dcmsme.gov.in/thrustareas/credit.htm>)

The Reserve Bank of India had issued a Master Circular in 2010 comprising guidelines for lending to Micro and Small Enterprises (MSE) sector on part of Domestic Commercial Banks and Foreign Banks operating in India, as under Section 3 of the circular. In terms of the recommendations of the Prime Minister's Task Force on MSMEs, banks are advised to achieve a 20 percent year-on-year growth in credit to micro and small enterprises and a 10 percent annual growth in the number of Micro enterprise accounts (Reserve Bank of India, 2010).

The data shows that banks have succeeded in doing so. As per the provisional data of March 2011, there has been an increase by 34.13 percent in credit to MSMEs since March 2010 thereby achieving the 20 per cent year-on-year growth in credit to micro and small enterprises. However, the number of accounts just manages to cross the set limit of 10 percent.

(Table 2A, [http://planningcommission.gov.in/aboutus/committee/wg\\_sub\\_pvtsec\\_MSME.pdf](http://planningcommission.gov.in/aboutus/committee/wg_sub_pvtsec_MSME.pdf))

Further, public sector banks have been advised by the RBI to open at least one specialised branch in each district. Banks have also been permitted to categorise their MSME general banking branches having 60 percent or more of their advances to MSME sector in order to encourage them to open more specialised MSME branches for providing better service to this sector as a whole (Reserve Bank of India, 2010).

### **3.3.1.2 High Credit Cost**

Another issue that has come to light persistently, besides low availability of credit, is the high cost of credits. The Planning Commission has held that high cost of credit is a major impediment in upbringing of MSMEs (Planning Commission of India, 2010). An overwhelming 80 percent of the 100 participants said high cost of credit was the biggest impediment in the growth and development of the MSME sector. About 55 percent said that procurement of raw material at competitive rates and delayed payment along with lack of availability of credit are also crucial factors that inhibit growth and development of MSMEs (The Economic Times, 2010).

The Confederation of Indian Industries (CII) in its report (2010) 'Financing for MSMEs' has elucidated some reasons as to why institutions like banks are not readily willing to finance MSMEs. MSMEs depend predominantly on internal sources of finance (personal savings, loan from relatives, and loan from local money lenders) than that of institutional financing by banks and other financing institutions. An indication of this is that even in recent times, MSME credit as a percentage of net bank credit of commercial banks has been below 15 percent.

Banks perceive MSMEs as a risky field of investment due to the following:

- Low growth rate of small firms
- Firms following informal business practices
- Inability of MSME owners to maintain collateral securities
- Lack of credit worthiness and goodwill
- Relatively high processing costs (in background checks, etc)
- Lack of transparency due to poor reporting of firm data

(Confederation of Indian Industries, 2010)

### **3.3.1.3 Deceleration of Credit Growth in the MSME Sector: Solutions**

In view of the concerns emerging from the deceleration in credit growth to the MSME sector, an Indian Banks' Association (IBA)-led sub-committee was set up to suggest a structured mechanism to be put in place by banks to monitor the entire gamut of credit related issues pertaining to the sector. Based on the recommendations of the committee, banks have been advised to:

- (a) Strengthen their existing systems of monitoring credit growth to the sector and put in place a system-driven comprehensive performance management information system (MIS) at every supervisory level (branch, region, zone, head office) which should be critically evaluated on a regular basis

- (b) Put in place a system of e-tracking of MSME loan applications and monitor the loan application disposal process in banks, giving branch-wise, region-wise, zone-wise and State-wise positions. The position in this regard is to be displayed by banks on their websites; and
- (c) Monitor timely rehabilitation of sick MSE units. The progress in rehabilitation of sick MSE units is to be made available on the website of banks.

(Reserve Bank of India, Year Unknown)

That being said, there has been a high extent of financial exclusion<sup>7</sup> (92 percent) in the MSME sector. Keeping in mind the aforesaid condition, RBI has set forth guidelines for commercial banks to effectively address the issue by setting up Financial Literary Centres (FLCs) (Reserve Bank of India, 2012).

#### ***3.3.1.4 Significance of Credit Rating for MSMEs***

One of the most important procedures undertaken by financial institutions that offer credit to MSMEs is the scrutiny of their credit rating status in order to determine the creditworthiness of the enterprise in question.

Credit rating is done on the basis of credit scores that are numerical values assigned to the MSMEs based on a statistical analysis. This score and rating serves to notify their credit worthiness or the ability to maintain non-default on credit borrowed. These scores are often evaluated on the basis of the credit reputation of a company, commonly known as a credit report, available from the Credit Bureau of India.

In this direction, the Government of India operates a specialised rating agency known as the SME Rating Agency of India Limited (SMERA), which is a third-party rating agency exclusively set up for micro, small and medium enterprises in India for ratings on creditworthiness. It provides ratings which enable only MSME units to raise bank loans at competitive rates of interest. (Pricewaterhouse Coopers, 2013)

#### ***3.3.1.5 Identification of Policy-Level Finance-Oriented Problems***

A high level committee on MSME set up by the Prime Minister—Prime Minister’s Task Force on MSME (January 2010), has reported some major finance-related problems faced by MSMEs that persist despite the aforesaid measures put in place in an attempt to remedy them.

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<sup>7</sup> **Financial exclusion can be defined as the non-availability of banking services to people with low or no income.**

Access to adequate and timely credit at a reasonable cost is the most critical problems faced by the sector. The major reason for this has been the high risk perception among banks about this sector and the high transaction costs for loan appraisal for the aforementioned reasons. While the quantum of advances from the public sector banks (PSBs) to the MSEs has increased over the years in absolute terms, from INR 46, 045 crore in March 2000 to INR 185,208 crore in March 2009, the share of the credit to the MSE sector in the Net Bank Credit (NBC) has declined from 12.5 percent to 10.9 percent during the same period (2000-09). Similarly, there has been a decline in the share of the micro sector as a percentage of NBC from 7.8 percent in March 2000 to 4.9 percent in March 2009.

Some recommendations of the Task Force were:

- While loans up to INR 50, 000 are covered under microfinance, banks are generally not inclined to provide loans below INR 500,000 due to a high risk perception and transaction costs. Banks may, given this context, lend to a pool of micro entrepreneurs who have been financed by Micro Finance Institutions and are now ready for borrowing at higher levels in the missing middle segment of INR 50,000 to INR 500,000 by covering them under the Credit Guarantee Scheme.
- The Task Force noted that a Working Group under the chairmanship of Executive Director, RBI is looking into the issues regarding: (a) enhancement of the collateral-free loan limit for MSEs from INR 500,000 to INR 1,000,000; and (ii) absorption of the one-time guarantee fee and annual service charges by the banks under the Credit Guarantee Scheme to facilitate higher flow of credit to MSEs without collateral/third party guarantee. The Working Group was required to submit its report within three months.
- The ability of MSMEs (especially those involving innovations and new technologies) to access alternative sources of capital like angel funds/risk capital needs to be enhanced considerably. For this purpose, removing fiscal/regulatory impediments to use such funds by the MSMEs should be considered on priority (Prime Minister's Task Force on MSMEs, Report 2010).

### **3.3.1.6 FDI into an SSI Undertaking/MSME**

Foreign Direct Investment (FDI) can be a potentially viable source of finance for MSMEs. It therefore becomes important to understand the legal norms that govern FDI in MSMEs.

Prior to 2006, an SSI undertaking was defined in terms of: (a) investment in fixed assets in plant and machinery and (b) equity participation (both, foreign and domestic) in the SSI by other industrial undertakings. *Vide* Press Note 18 (1997), it was further notified that in cases involving

foreign collaboration, proposals for induction of foreign equity in excess of 24 percent would be subject to certain conditions, since the maximum equity participation allowed for in SSIs was limited to 24 percent. These conditions were that the company would get itself de-registered as an SSI and also, obtain an industrial license or file for an Industrial Entrepreneur Memorandum, as per prescribed procedure.

With the promulgation of the MSMED Act, the ceiling for equity participation (both domestic and foreign) in MSMEs by other enterprises/undertakings was removed and MSMEs, unlike their predecessor SSIs, were defined solely in terms of the investment in plant and machinery (for micro and small enterprise engaged in manufacturing) and equipment (for micro and small enterprise engaged in the rendering of service).

Accordingly, as under Notification Number S.O. 563 (E), dated 27 February 2009, issued by the Department of Industrial Policy and Promotion (DIPP), Ministry of Commerce and Industry and as clarified in Press Note 6 (2009):

*"The present policy in FDI in MSE (as defined under the MSMED Act, 2006) permits FDI subject only to the sectoral equity caps, entry routes and other relevant sectoral regulations."*

In Press Note 14 (1997), it was also clarified that Industrial Undertakings manufacturing items reserved for the small scale sector were not eligible for automatic approval for induction of foreign investment. Accordingly, the FDI policy notified *vide* Press Note 2 (2000) prescribed prior approval of the government where foreign investment exceeded 24 percent in the equity capital of units manufacturing items reserved for SSIs.

The DIPP has also clarified through Press Note 6 (2009) that any industrial undertaking (with or without FDI) which is not an MSE manufacturing items reserved for the MSME sector (presently, 21 in number and clubbed into seven categories, as discussed previously in the paper) would require an Industrial License under the Industries (Development and Regulation) Act, 1951, for such manufacture. The issue of the Industrial License will be subject to a few general conditions and the specific condition that the undertaking shall "export a minimum of 50 percent of the new or additional annual production of the MSE reserved items to be achieved within a maximum period of three years. The export obligation would be applicable from the date of commencement of commercial production." Such an industrial undertaking would also require prior approval of the Foreign Investment Promotion Board (FIPB) where foreign investment is more than 24 percent in the equity capital. (Anand G., 2009)

So far as the ease of getting credit in India is concerned, the Ease of Doing Business Index ranks it at 36 of the 189 countries. Questions pertinent to the strength of legal rights and the depth of credit can be seen in the Doing Business Report 2015 (Page 76).

### **3.3.2 Labour**

#### ***3.3.2.1 Problems Associated with Labour in MSMEs***

The most effective manner of identifying problems pertaining to the labour associated with the MSME sector would presumably be to bring together the representatives of the labour class itself, as opposed to sticking with a top-down model of study. The Sub Group on Labour under the Prime Minister Task Force, created in 2010 adopted this approach to identify problems relating to labour in the MSME sector. The views and concerns of various stakeholders, as put forth in a meet organised by the Task Force have been documented as follows:

- The representatives of Industry Associations felt that considering limited additional absorption capacity of labour force in agriculture, the mantle of promoting employment falls on the manufacturing sector, especially on SMEs. Hence, a facilitating environment needs to be created by enacting a separate comprehensive labour law for SME Sector, which has been recommended by Second National Commission on Labour (SNCL). This would serve to make regulation more comprehensive and compliance more effective. Presently, most labor laws are not even applicable to the Micro and Small Enterprises, given that they do not satisfy the statistical requirements necessary to ensure the applicability of said laws; this aspect has been dealt with in further detail in the next section of the paper, whereby these laws have been enumerated and their provisions discussed.  
The representatives recognised that while the intention of the existing labour laws is good, the unintended consequences are the complications in implementation, automatically resulting in corruption and lack of accountability. Hence, a re-vamping is required even by prescribing higher limits for applicability of such laws and provision of social security for MSE employers through cross subsidy.
- The representatives of Trade Unions, on the other hand, stated that workers' interests should not be compromised, the existing laws and their provisions should not be diluted, wage standards should be maintained and protection should be available in terms of job and social security. While the MSEs need to be helped through marketing, technology and financial assistance, there should not be any relaxation on applicability of labour laws, otherwise it may lead to serious problems on labour front. While implementation of labour laws cannot be ensured without inspectors, the system of inspection can be improved by encouraging self-certification, prescribing reduced number of registers and returns etcetera. Difficulties in registration and recognition of unions, non-payment of minimum wages and

not having national minimum wage, and prevalence of huge number of contract labourers were stated to be problem areas.

The Ministry of MSMEs and the Confederation of Indian Industries (CII) made the following input on the subject of labour-related concerns:

- Ministry of MSMEs
  - (i) Presently, the Labour Laws (Exemption from Furnishing Returns and Maintaining Registers by Certain Establishments) Act, 1988 covers nine Acts. The Ministry of MSME proposed that the Act be amended so as to expand its coverage to 16 principal Acts; such expansion should incorporate, amongst others, the Employees' State Insurance Act, 1948 and the Employees' Provident Fund and Miscellaneous Provisions Act, 1952. This would lessen the burden of procedural compliance (maintaining registers, for instance) on MSMEs.
  - (ii) Further, the Ministry also suggested that the traditional inspection regime where Government inspectors are the only ones empowered to undertake inspection jobs is in need for review. It suggested that a mechanism may be evolved where the burden of inspection could be shared by the Government inspectors and other parties in a balanced manner, for this has been one of the best practices prevailing internationally.

- CII

The CII, having recognised that archaic labour laws fetter the growth and competitiveness of most manufacturing MSMEs in the country, recommended the simplification of several labour laws governing the sector. These regulations are purported to protect the interests of worker; however, they are in fact redundant and detrimental to the interests of all stakeholders in the sector.

### ***3.3.2.2 Law and Regulation Relating to Labour***

The subject of 'labour' figures in the Concurrent List of the Constitution. Thus, both the Centre and the States can legislate in this area. There are about 44 labour related statutes enacted by the Central Government. They have been classified along eight broad categories by the Ministry of Labour and Employment, each comprising a certain number of statutes within itself:

- Industrial Relations (4 statutes)
- Industrial Safety and Health (3 statutes)
- Child and Women Labour (3 statutes)

- Social Security (8 statutes)
- Labour Welfare (15 statutes)
- Employment and Training (2 statutes)
- Wages (7 statutes)
- Other (12 statutes)

(Ministry of Labour and Employment, <http://labour.gov.in/content/>)

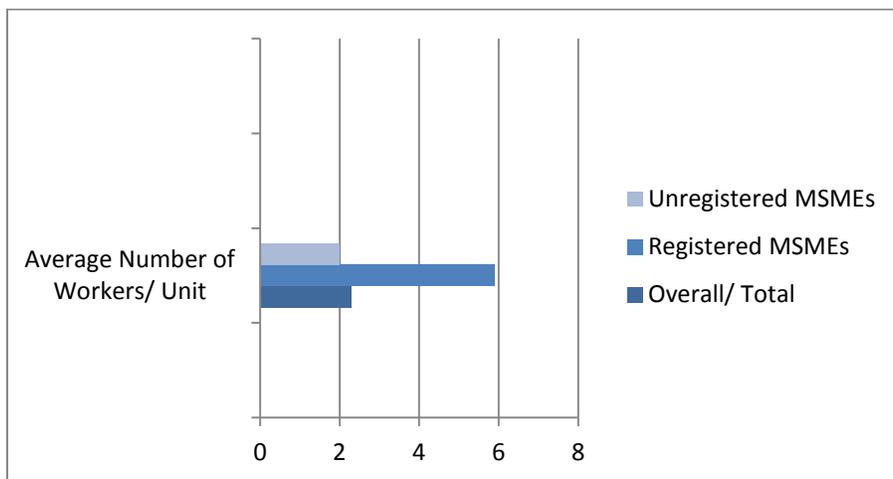
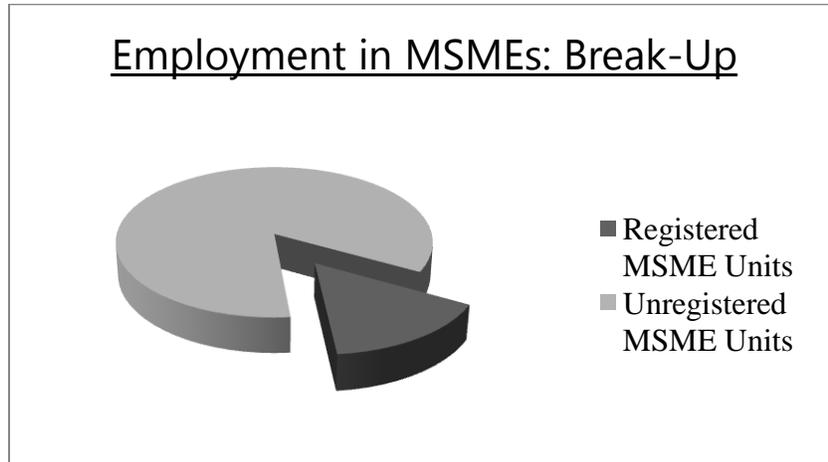
All the statutes find specific enumeration in Annexure A. The applicability of some of these statutes is as follows:

- Factories Act, 1948 is applicable to the establishments employing ten or more workers with power, or 20 or more workers, without making use of power.
- The Payment of Wages Act, 1936 is applicable to the employees drawing wages upto INR 10,000 per month and the Minimum Wages Act, 1948 is universally applicable.
- So far as important Social Security Acts are concerned, the Employees' State Insurance Act, 1948 provides for healthcare and cash benefit payments in the case of sickness, maternity and employment injury. The Act is applicable to non-seasonal factories using power and employing ten or more employees and non-power using factories and certain other establishments employing 20 or more employees.
- Further, the Employees' Provident Fund and Miscellaneous Provisions Act, 1952 is applicable to factories and other classes of establishments engaged in specific industries and classes of establishments employing 20 or more persons.

Most Micro and Small Enterprises get automatically exempted unless they cross the number filter. Many MSMEs, as can be seen below statistically, do not cross the minimum number of workers required for the aforementioned Acts to be applicable. (Prime Minister's Task Force on Micro, Small and Medium Enterprises Report, 2010).

According to the MSME survey of 2006-07 their workforce was very large. While the registered MSME units employed 92 lakh workers, the unregistered units employed 502.6 lakh workers, pushing up total employment in the MSME sector to 594.6 lakh workers. However, despite the large numbers, the MSME units were of very small size. While the average number of workers per unit was 5.9 in the registered units, the numbers was only 2 in the unregistered units, which pushed down the average number of workers in each MSME unit to just 2.3. Despite some reports claiming that the total number of employees in the MSME sector for the period of

2006-07 to be 805.23 lakh, the numbers are still not enough to meet the requisite criteria for the above mentioned Acts to be applicable. (Council of State Industrial Development and Investment Corporations of India, 2011).



**Figure 1: Employment Pattern and Distribution in MSME Sector**

The Second National Commission on Labour (SNCL) had recommended enactment of the Small Enterprises (Employment Relations) Act for establishments having less than 19 workers with a view to reduce pressure on them. One of the demands of the MSE Associations relates to formulation of a separate legislation for MSE Sector. This would ensure the relevance of the regulatory framework so far as labour associated with the MSME sector is conducted, as opposed to a majority of the existing legislation, which as discussed above, is largely redundant and inapplicable to Micro and Small Enterprises.

So far as labour is concerned, regulatory norms do not present the sole hindrance to the growth of MSMEs. Lack of skills among labourers is another issue that adversely affects MSMEs. There are many schemes that the Government has launched in order to train the workers. These schemes have been discussed in the later sections.

### **3.3.3 Taxation**

Here, the study seeks to document the tax obligations that MSMEs have to comply with and the tax concessions that are made available to them. It will go further to determine whether, and the extent to which, taxation procedures serve as a barrier to MSME owners in their operation and successful continuance.

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).

On an average, firms in India make 33 tax payments annually; spend 243 hours a year filing, preparing and paying taxes; and the total tax payment amounts to 61.7 percent of profit. Globally, India stands at 156<sup>th</sup> position along the 'Paying Taxes' parameter, from amongst 189 countries.

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

#### ***3.3.3.1 Structure for Tax Payments in India: Regulatory Framework***

##### ***Direct Taxes***

The authority to levy taxes in India is divided between the central and state governments; the Central government levies direct taxes comprising income tax and wealth tax. Administration,

supervision and control in the area of direct taxes lie with the Central Board of Direct Taxes (CBDT). The CBDT works under the Ministry of Finance (MoF) and exercises significant influence over the working of the country's direct tax laws.

The Indian tax year extends from 1 April of a year to 31 March of the subsequent year. The tax year for a corporation also follows the same calendar. All corporations (except those who are required to submit a transfer pricing certificate in Form 3CEB, with respect to international transactions or specified domestic transactions) are required to file a Return on Investment (ROI) by 30 September, even in the event of loss. However, corporations who are required to submit a transfer pricing certificate in Form 3CEB are required to file a ROI by 30 November. Non-resident corporations are also required to file a ROI in India if they earn income in India or have a physical presence or economic nexus with India. Corporate tax liability needs to be estimated and discharged by way of advance tax in four installments on 15 June, 15 September, 15 December and 15 March of every year.

Late filing of a ROI and delays in payment or shortfalls in taxes are liable to attract penal interest at prescribed rates. Interest is generally imposed on the balance of the unpaid tax and on underpayment of the advance tax (Ernst and Young, Doing Business in India, 2014).

### ***Indirect Taxes***

The Central Government levies indirect taxes comprising customs duty, excise duty, central sales tax and service tax. The states are empowered to levy profession tax and state sales tax apart from various other local taxes, including entry tax and octroi or local body tax.

The procedure for filing taxes, along with the rates of taxation, can be seen in Table 8.2 in the Doing Business Report 2015.

#### ***3.3.3.2 Tax Benefits, Schemes and Incentives for the MSME Sector***

The most important promotional policy of the Government for the SSIs is fiscal incentives in the form of tax concessions and exemptions from direct or indirect taxes which are levied on production or profits.

- Deduction in Respect of Profit and Gains

With effect from financial year 2005-06, SSIs can claim deductions in respect of profits and gains (under section 80IB of Income tax Act) at the following rates:

- If SSI unit is owned by a company, the deduction available is 30 percent for first 10 years. If SSI unit is owned by a co-operative society, the deduction available is 25 percent for first 10 years.
- If any other person owns SSI unit, the deduction to be claimed is 25 percent for first 10 years.

SSI unit can avail this tax exemption after fulfilling following conditions:

- (i) They should not be subsidiary of, or owned or controlled by other industrial undertakings.
- (ii) They should not be formed as a result of splitting up or reconstruction of any industrial undertaking/business.
- (iii) SSI units can manufacture any nature or type of goods, which they are permitted to.
- (iv) They should have commenced business between 1 April 1991 and 31 March 2002.
- (v) They should employ at least 10 workers in a manufacturing process carried out with aid of power or at least 20 workers without aid of power.

This tax exemption from total income is allowed from the assessment year in which the unit begins to manufacture goods.

According to the Income Tax Act, 1961 the amount of interest payable or paid by any buyer, for delayed payments to Micro and Small Enterprises shall not be allowed as deduction for the purpose of computation of income under the Income Tax Act, 1961.

- Ambiguity as to the Definition of SSIs for Purposes of Tax Deduction

No special tax benefits have been made available to MSMEs under the MSMED Act, 2006. Even the tax incentives available under Section 80-IB(3) of the I-T Act, 1961, as discussed above, display ambiguity as to their validity.

For the purposes of section 80-IB(3), 'Small Scale Industrial Undertaking' (SSI) means an undertaking which on the last day of the previous financial year was regarded as such under Section 11B of the Industries (Development and Regulation) Act, 1951. However, the notification providing for this definition [SO 857 (E), dated 10 December 1997], was itself rescinded *vide* notification number SO 563 (E), dated 27 February 1997. Therefore, as the position stands with effect from 27 February 2009, no industrial undertaking is considered an SSI under the said section 11B.

This ambiguity, therefore, requires clarification from the Central Board of Direct Taxes so as to make the scheme actually operational and allow the benefits to reach the intended beneficiaries, which are MSME owners. (Anand G., 2009)

- Excise Exemption

Small Scale Industries are subjected to excise duties under the Central Excise Tariff Act, 1985 (five of 1986). The eligibility for excise concessions for SSIs has been based on annual turnover rather than SSI registration. Only SSI units having turnover of less than INR 4 crores are eligible for concessions. Government of India has provided various concessions to SSIs by granting full exemption from payment of central excise duty on a specified output and thereafter slab-wise concessions.

- SSI units producing goods upto INR 100 lakhs are exempted from payment of excise duties.
- SSI units having turnover less than INR 60 lakhs per annum need not have a separate storeroom for storing finished products.
- SSI units are not required to maintain any statutory records such as daily stock accounts, etc. Their own records are adequate.
- SSI exemption is available for goods for home consumption as well as goods exported to Nepal and Bhutan.

(Author Unknown, Year Unknown)

- Presumptive Taxation Scheme, Union Budget (2009-10)

A presumptive tax scheme was introduced in the Union Budget 2009-10, particularly for small businesses, and declared by the Finance Minister in his budget speech:

*"...I propose to expand the scope of presumptive taxation to all small businesses with a turnover up to INR 40 lakhs. All such taxpayers will have the option to declare their income from business at the rate of 8% of their turnover and simultaneously enjoy exemption from the compliance burden of maintaining books of account. As a procedural simplification, I also propose to allow them to pay their entire tax liability from business at the time of filing their return by exempting them from paying advance tax. This new scheme will come into effect from the Financial Year 2010-11..."*

Accordingly, the Finance (No. 2) Act, 2009 amended the Income-Tax Act, 1961 (Section 44AD). Having understood the tax structure and regulatory framework applicable to MSMEs, it also becomes significant to note that the tendency amongst micro enterprises to consider taxation

laws applicable to them as being a hindrance (beyond certain difficulties in filing) was largely absent. The laws in place, available for 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 of this tax was not reported to be a regulatory barrier per se (Centre for Civil Society, 2014).

### **3.4 Continuance: Analysis of Regulatory Norms**

#### **Increasing Availability of Credit: Positive Role of RBI**

The RBI, through its Master Circulars and periodic guidelines, has consistently been seen to channelise credit from banks in the public sector to MSMEs. As has been documented above, credit to the MSME sector has displayed a steady rise from 2000 to 2007, as also beyond this period.

#### **Betterment in FDI Policy Towards MSMEs**

Removal of the 24 percent equity cap on FDI in the MSME sector and the retention of reasonable sectoral caps has managed to achieve a balance between sufficient credit flow to the sector and protecting MSMEs from foreign control, as was the apprehension expressed by several owners.

#### **Labour Interests vis-à-vis Restrictive Labour Regulatory Framework**

As gathered from the various points of view brought together by the PM's Task Force on MSMEs, labour interests (such as reasonable working hours, payment of timely and adequate wages and the like) that are sought to be secured by existing labour laws, need to be weighed against and balanced out with the maintenance of a business environment only reasonably checked by a labour regulatory framework.

The present legal framework, it has been observed, is one of 'over-legislation', so to speak. The excessive number of laws, and the extent of their stringency, is unnecessary and in fact, detrimental to a healthy business environment.

## **Redundancy of Labour Laws**

With respect to MSMEs, the existing labour laws are largely redundant. They are not even applicable to most micro and small enterprises, owing to the fact that their small employment figures do not qualify to fall within the ambit of the Acts. Simplification of Labour Laws becomes an automatic and necessary requirement. Further, the codification of a single, comprehensive labour legislation particularly for MSMEs, is desirable.

## **Protracted Procedure for Tax**

It acts as an incentive for non-payment and may presumably serve as a deterrent to MSME owners for continuance of their enterprises.

## **Ambiguity as to Definition of SSIs for Tax Purposes**

The regulatory framework is in need of clarity on what constitutes 'Small Scale Industrial Undertakings' for the purposes of availing tax benefits vide the I-T Act, 1961, as formerly discussed.

### **3.5 Exit: Documentation of Regulatory Norms**

The scheme for closure of business of micro, small and medium enterprises, as under Section 25 of the MSMED Act, 2006, states that:

*"Notwithstanding anything contained in any law for the time being in force, the Central Government may, with a view to facilitating closure of business by a micro, small or medium enterprise, not being a company registered under the Companies Act, 1956 (1 of 1956), notify a scheme within one year from the date of commencement of this Act."*

Till now, however, there is no legal framework for the reorganisation/winding up/exit of small units leading to a huge wastage of human resources (promoters and employees), capital (banks and financial institutions) and physical resources (industrial land and buildings, plant, machinery).

(The Times of India, 2014)

This policy gap and failure remains, despite the Prime Minister's Task Force on MSMEs (2010) having recognised a comprehensive and settled exit policy as necessary:

*"The MSME sector remains in a state of dynamic flux- with a large number of startups counterbalanced by a substantial number of exits. This is typical of entrepreneurial search*

*for not only business viability but of activities that provide the most suitable outlet to talent. Therefore efficient exit is as important to this sector as easy entry."*

Exit and sickness are associated, often correlated, phenomenon. Sickness in a firm may be followed by attempts at revival, by placing the firm under a nursing and rehabilitation regimen. Failure in terms of revival, however, leads to exit. The sickness and exit process in any industry is associated with immense financial and social stress. However, MSMEs are generally considered more vulnerable because of non-availability or disinterest of many sources of aid.

### **3.5.1 Definition of Sickness**

An older definition given by the Working Group on Rehabilitation of Sick Units set up by RBI (Kohli Committee) states:

*"A small scale industrial unit is considered as sick when if any of the borrowal accounts of the unit remains substandard for more than six months; that is, principal or interest, in respect of any of its borrowal accounts has remained overdue for a period exceeding one year;*

OR

*There is erosion in the net worth due to accumulated losses to the extent of 50 per cent of its net worth during the previous accounting year, and the unit has been in commercial production for at least two years."*

This implies that if the net worth of a unit diminishes under circumstances whereby loss incurred amounts to 50 percent of its net worth in the preceding year, the unit is deemed to be sick, given that its operation at such point had been continuing for a minimum period of 2 years.

The changed definition as notified by RBI stands as follows:

*"An MSE is considered 'sick' when:*

*a) any of the borrowal account of the enterprise remains NPA (Non-Performing Asset) 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."*

The stipulation that the unit should have been in commercial production for at least two years has been removed.

### 3.5.2 Sickness: Trends, Causes and Criteria

Of two lakh enterprises that availed loans, 1.17 lakh enterprises have outstanding loans for the period of 2006-07. Of the units having loan outstanding with institutional sources like banks and financial institutions, sickness was about 29.40 percent in registered MSMEs.

(Ministry of Micro, Small and Medium Enterprises, 2006-07)

For the enterprises falling under the category sick/incipient sick and not working satisfactorily, reasons or causes are:

**Table 7: Sickness in MSMEs: Causes**

<b>Reason for sickness/incipient sickness</b>	<b>Proportion of sick/incipient sick units (%)</b>
Lack of demand	41.94
Shortage of working capital	20.49
Non-availability of raw materials	5.11
Power shortage	5.71
Labour problems	5.64
Marketing problems	11.48
Equipment problems	3.17
Management problems	6.46

#### 3.5.2.1 Criteria for and Measure of Sickness

Information on sickness and incipient sickness was collected during Fourth Census of MSMEs (2006-07). In order to measure incipient sickness, continuous decline in gross output for three consecutive years was identified as a suitable indicator, whereas for measuring sickness, the latest definition given by Kohli Committee was used. Thus, the following criteria were adapted to identify sick/incipient sick units in the Fourth Census:

- (i) Continuous decline in gross output compared to the previous two financial years
- (ii) Delay in repayment of loan, taken from institutional sources, for more than 12 months
- (iii) Erosion in net worth to the extent of 50 per cent of the net worth during the previous accounting year

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.

### 3.5.3 Revival of sick MSMEs: Role of Banks

The evaluation of banks, while considering sick enterprises for revival, is very often influenced by a conflict of interest, as stakeholders. 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 percent for March 2012 of which 7.8 percent were put under nursing, which came down to 5.1 percent sick units in March 2013, and further only 1.8 percent 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.

The nursing process, largely similar for most banks, can be documented as follows:

**TABLE 8: Stages in the Nursing Process of Sick MSMEs**

	<b>NATURE OF CONCESSION</b>	<b>MEDIUM ENTERPRISES</b>	<b>MICRO AND SMALL ENTERPRISES</b>
1.	Interest on fresh and existing (renewed) working capital	Prevailing BPLR or 1% below the applicable rate which ever is lower.	1.5 % below the prevailing BPLR or 1.5% below the applicable rate which ever is lower.
2.	Interest on existing Term Loan	Reduction by a maximum of 2 % from the applicable rate	Reduction by a maximum of 2 % (3% for Micro Enterprises) from the applicable rate.
3.	Interest on fresh Rehabilitation Term Loan (RTL). (For Small manufacturing units for start up expenses and margin for working capital).	Prevailing BPLR or 1% below the applicable rate which ever is lower.	1.5 % below the prevailing BPLR or 1.5% below the applicable rate or as prescribed by SIDBI/NABARD where refinance is obtained, which ever is the least.

4.	Interest on Contingency Loan Assistance to meet escalations in capital expenditure under the rehabilitation scheme.	Not applicable.	At the concessional rate allowed for working capital assistance.
5.	Interest on Working Capital Term Loan (WCTL).	1 % below the prevailing BPLR or 1% below the applicable rate which ever is lower.	1.5 % to 3 % below the prevailing BPLR or 1% to 2% below the applicable rate whichever is lower.
6.	Interest on Funded Interest Term Loan (FITL).	2 % below the prevailing BPLR or 1% below the applicable rate whichever is lower.	NIL for a period of three years at the discretion of the bank.
7.	Repayment period for Funded Interest Term Loan.	Normally 3 to 5 years (Can be prolonged to 6 to 7 years in exceptional cases). As far as possible should get precedence over, or is spread over a shorter duration than the repayment of institutional loans.	To be repaid within 3 years from the date of commencement of implementation of rehabilitation Programme.
8.	Repayment period for Funded Term Loan (FTL).	The repayment period for restructured debts may extend up to a maximum period of 10 years, but the interest concession will be available only for a period of 7 years being the outer limit for rehabilitation.	Should not normally exceed 7 years from the date of restructuring and 15 years from the date of first disbursement of original loan. For Micro Enterprises, the said period may be 5

			and 7 years respectively. Staggered or ballooning repayment may also be permitted so that the instalments are aligned to the cash flows.
9.	Repayment period for Working Capital Term Loan (WCTL).	- do -	- do -
10.	Waiver of Penal Interest	Waiver of Penal Interest from the beginning of the accounting year in which the unit started incurring cash losses continuously.	Waiver of Penal Interest from the date of account becoming NPA or started incurring cash losses whichever is earlier.

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

### 3.5.4 Contribution of Laws and Regulatory Norms to Exit

Around 94 percent 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).

**Table 9: MSMEs - Nature of Organisation**

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

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. This acts as a disincentive to undertake an MSME in the first place for as long as an entrepreneur possesses within his personal assets the finances to pay off the enterprise's dues, he is culpable and will not be considered an insolvent; this involves a huge financial risk that may deter many potential entrepreneurs.

These laws have largely remained static in terms of determining entrepreneurial liability 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. These may very well result in his subsequent imprisonment. The focus of any proceedings undertaken is recovery of statutory dues (such as third-party obligations of the enterprise), rather than an attempt at revival of the enterprise. (Prime Minister's Task Force on Micro, Small and Medium Enterprises Report, 2010).

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

#### **3.5.4.1 Limited Liability Partnership Act, 2008**

The Minister of SSIs and Agro and Rural Industries had announced a Promotional Package for Micro and Small Enterprises on 27 February 2007 in the Lok Sabha, wherein he had committed to "enact a law on limited liability partnerships covering, among others, micro, small and medium enterprises with a view, *inter alia*, to facilitating infusion of equity and venture capital funding in these enterprises". Thus, the LLP model presents an alternative corporate business form that gives the benefits of limited liability of a company and the flexibility of a partnership. An LLP is a separate legal entity and is liable to the full extent of its assets; however, the liability of the partners is limited to their agreed contribution in the LLP. Further, no partner is liable on account of the independent or unauthorised actions of other partners; thus, individual partners are shielded from joint liability created by another partner's wrongful business decisions or misconduct (Anand G., 2009).

The ease of compliance, taxation laws, and registration process make these viable options for micro entrepreneurs to limit their personal liability. Freed from the deterrence imparted by uncertain financial liabilities and potential bankruptcy, individuals are bound to be more enterprising towards undertaking ventures in the MSME sector, allowing the sector to realise its optimum growth potential. However, steps must be taken to ensure the availability of information channels to micro enterprises, the most vulnerable of the MSMEs.

#### ***3.5.4.2 Procedure for Resolving Insolvency***

The procedure for resolving insolvency in India is marked by inefficiency and inordinate delays. According to data collected by Doing Business, resolving insolvency takes 4.3 years on average and costs 9.0 percent of the debtor's estate, with the most likely outcome being that the company will be sold as piecemeal sale. Globally, India stands at 137 in the ranking of 189 economies on the ease of resolving insolvency.

#### **3.5.5 Rehabilitation of Sick Enterprises**

Procedure for rehabilitation of sick enterprises:

1. Timely and adequate assistance to MSEs and rehabilitation effort should begin on a proactive basis when early signs of sickness are detected. This stage would be termed as 'handholding stage' as defined below. This will ensure intervention by banks immediately after detecting early symptoms of sickness so that sickness can be arrested at an early stage. An account is deemed to have reached the 'handholding stage'; if any of the following events are triggered:
  - a. There is delay in commencement of commercial production by more than six months for reasons beyond the control of the promoters
  - b. The company incurs losses for two years or cash loss for one year, beyond the accepted timeframe
  - c. The capacity utilisation is less than 50 percent of the projected level in terms of quantity or the sales are less than 50 percent of the projected level in terms of value during a year
2. The bank branches should take timely remedial action which includes an enquiry into the operations of the unit and proper scrutiny of accounts, providing guidance/counselling services, timely financial assistance as per established need and also helping the unit to sort out difficulties which are non-financial in nature, or require assistance from other

agencies. In order to ensure timeliness for banks for taking remedial action/measures in 'handholding stage', the handholding support to such units should be undertaken within a maximum period of two months of identification of such units.

3. The decision on viability of the unit should be taken at the earliest but not later than 3 months of becoming sick under any circumstances.

The following procedure should be adopted by the banks before declaring any unit as unviable:

- a. A unit should be declared unviable only if the viability status is evidenced by a viability study. However, it may not be feasible to conduct viability study in very small units and will only increase paperwork. As such for micro (manufacturing) enterprises, having investment in plant and machinery up to INR 5 lakh and micro (service) enterprises having investment in equipment up to INR 2 lakh, the Branch Manager may take a decision on viability and record the same, along with the justification.
  - b. The declaration of the unit as unviable, as evidenced by the viability study, should have the approval of the next higher authority/ present sanctioning authority for both micro and small units. In case such a unit is declared unviable, an opportunity should be given to the unit to present the case before the next higher authority. The modalities for presenting the case to the next higher authority may be worked out by the banks in terms of their Board approved policies in this regard.
  - c. The next higher authority should take such decision only after giving an opportunity to the promoters of the unit to present their case.
  - d. For sick units declared unviable, with credit facilities of INR 1 crore and above, a Committee approach may be adopted. A Committee comprising of senior official of the bank may examine such proposals. A Committee approach will improve the quality of decision as collective wisdom of the members shall be utilised, especially while taking decision on rehabilitation proposals.
  - e. Decision of the above higher authority should be informed to the promoters in writing. The above process should be completed in a time bound manner not later than three months.
4. The banks may, however, take decision in cases of malfeasance or fraud without following the above procedure.
  5. Banks may decide on the relief and concessions for rehabilitation of viable/potentially viable units based on their own Board approved policies.
  6. The banks are to put in place a Non-discretionary One Time Settlement scheme for recovery of non-performing loans for the MSE sector, duly approved by the Board of Directors.

(Reserve Bank of India, 2013)

As discussed above, there is no prescribed procedure for exit of MSMEs. "There is a need to facilitate start-ups and evolve a time-bound exit mechanism; that being said, the Ministry of MSME has assured of amending the MSMED Act, 2006 to facilitate the inclusion of a viable method for exit of MSMEs.

(Ministry of Micro Small and Medium Enterprise, Year unknown)

### **3.6 Exit: Analysis of Regulatory Norms**

#### **Rehabilitation and Resolving Insolvency Measures to be Aimed at Revival**

It has been observed that most rehabilitation efforts or resolution of insolvency are largely aimed at satisfying the statutory obligations (such as fulfillment of liabilities towards third parties) of the enterprise. The focus does not lie on revival of the firm itself. 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 percent for March 2012 of which 7.8 percent were put under nursing, which came down to 5.1 percent sick units in March, 2013, and further only 1.8 percent were put under nursing. Even the Ease of Doing Business Index recognises that the most likely outcome of insolvency resolution in India is that the "company will be sold as a piecemeal sale". Thus, policy attitude is in need of modification so as to lead resolution efforts towards revival, not exit.

#### **Legal Framework for Exit**

Contrary to the yearlong time frame allowed under section 25 of the MSMED Act, 2006, there has been no definite legal procedure. This allows for arbitrariness on part of banks when resolving insolvency and finalising exit proceeding. A statutory framework, focused on facilitating revival (or at least easy exit) of MSMEs is imperative.

The regulatory framework in India, along all aspects that constitute an MSME's life cycle—entry, continuance and exit—having been evaluated, it is imperative to now understand what the effects of such regulations are on the general business environment, and on the ease with which MSMEs can establish and maintain themselves. Further, the study cannot preclude a critical view of the Indian regulatory scenario by placing it in a global context. Hereafter, the study therefore proceeds to an international view of where the Indian business environment stands, with respect to micro, small and medium enterprises in particular.

## Section V: International Comparison

In this section, an analysis of India's performance along several parameters that contribute to the larger business environment will be conducted. Further, in an attempt to identify best practices in terms of providing policy and institutional support to the MSME sector, it becomes relevant to place India in a global perspective. This international comparison has been conducted along two dimensions:

- An analysis of the Ease of Doing Business Index 2014 has been conducted so as to enable a critical and reformatory view of the existing business environment in India, and its subsequent impact on the performance of MSMEs
- Given the developing nature of all the nations in the group and their comparability with India along socio-cultural-economic lines, the performance of India, along the Index, has been juxtaposed against that of China, the Russian Federation and Bangladesh.

### 5.1 How Does the Ease of Doing Business (EoDB) Index Work?

The Doing Business 2015 Report (DB15) presents results for two aggregate measures: the distance to frontier score and the ease of doing business ranking (which is based, for the first time in the DB 15, on the former).

The ease of doing business ranking (henceforth, "Ranking") compares economies with one another in terms of the stringency of regulatory norms. It is a measure of the extent to which regulatory norms lend themselves to a business environment—conducive or otherwise. The distance to frontier score (henceforth, "Score"), meanwhile, benchmarks the economies with respect to the regulatory best practice, showing the absolute distance to the best performance on each *Doing Business Indicator*. To illustrate, Canada and New Zealand have the smallest number of procedures required to set up a business (1) and hence, it is they who establish the frontier at 1. Significantly, when compared across years, the Score shows how much the regulatory environment for local entrepreneurs in an economy has changed over time in absolute terms, while the Ranking can only show how much the regulatory environment has changed relative to that in other economies. (World Bank, Doing Business Rankings, 2014)

A composite of the two results in the Ease of Doing Business Index (henceforth referred to as "Index"); a high ranking on the Ease of Doing Business Index means the regulatory environment is more conducive to the starting and operation of a local firm. The rankings are determined by

sorting the aggregate distance to frontier scores on ten parameters, each consisting of several indicators, giving equal weight to each; the parameters being:

1. Starting a business
2. Dealing with construction permits
3. Getting electricity
4. Registering properly
5. Getting credit
6. Protecting minority investors
7. Paying taxes
8. Trading across borders
9. Enforcing contracts
10. Resolving insolvency

(World Bank Doing Business Rankings, 2014)

In the context of MSMEs, it becomes very important to take note of the fact that *Doing Business*, as a holistic, comprehensive measure sheds light on how easy or difficult it is for a local entrepreneur to open and run a small to medium-size business when complying with relevant regulations. It measures and tracks changes in regulations affecting the aforementioned 11 areas in the life cycle of a business. The data not only highlights the extent of obstacles to doing business, it also helps identify the source of those obstacles, supporting policy makers in designing regulatory reform.<sup>8</sup>

(World Bank, Doing Business India Profile, 2014)

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<sup>8</sup> **The Doing Business methodology has limitations which must be duly recognised and acknowledged. Other areas important to business—such as an economy’s proximity to large markets, the quality of its infrastructure services (other than those related to trading across borders and getting electricity), the security of property from theft and looting, the transparency of government procurement, macroeconomic conditions or the underlying strength of institutions—are not directly studied by Doing Business. The indicators refer to a specific type of business, generally a local limited liability company operating in the largest business city. Because standard assumptions are used in the data collection, comparisons and benchmarks are valid across economies.**

**While this ranking tells much about the business environment in an economy, it does not tell the whole story. The ranking on the ease of doing business, and the underlying indicators, do not measure all aspects of the business environment that matter to firms and investors or that affect the competitiveness of the economy. Still, a high ranking does mean that the government has created a regulatory environment conducive to operating a business.**

## 5.2 Where Does India Stand?

India's DB 2014 rank stood at 140 while DB 2015 lies at 142, the change in rank being two rank points to India's detriment. Meanwhile, the distance to frontier (DTF, in terms of percentage points) saw a shift from 52.78 (DB 2014) to 53.97 (DB 2015), showing a marginally positive development of 1.19 percentage points.

To get a quantified overview of the business environment in India, it is interesting to note that on a scale of 0 (worst performance) to 100 (depicting the frontier), India stands at a score of 53.97, which is marginally below the South Asian Regional Average (54.56). As against comparator economies<sup>9</sup>, India lies far below China and Russia, each with Rank 90 and 62, their scores along 'business environment' parameter being 62.58 and 66.66, respectively. As against Bangladesh, India fares positively, with the former having the rank and score of 173 and 46.84, respectively.

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<sup>9</sup> Owing to their comparability along socio-cultural, developmental and income-grouping lines.

Figure 1.3 Rankings on *Doing Business* topics - India  
(Scale: Rank 189 center, Rank 1 outer edge)

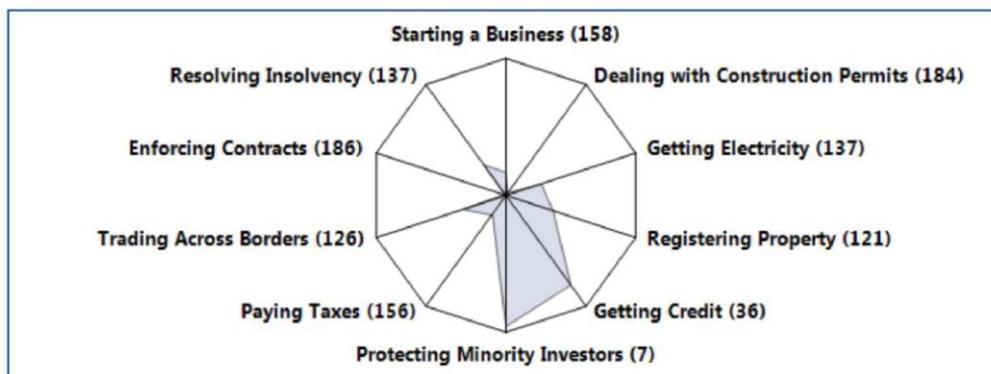
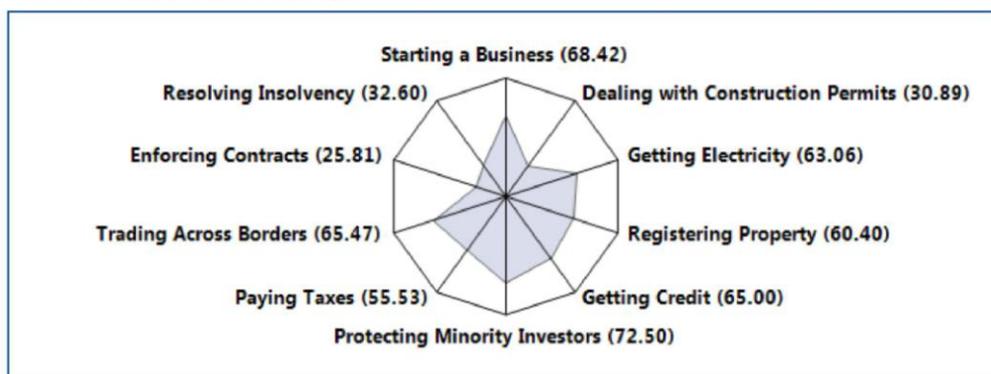


Figure 1.4 Distance to frontier scores on *Doing Business* topics - India  
(Scale: Score 0 center, Score 100 outer edge)



Note: The rankings are benchmarked to June 2014 and based on the average of each economy's distance to frontier (DTF) scores for the 10 topics included in this year's aggregate ranking. The distance to frontier score benchmarks economies with respect to regulatory practice, showing the absolute distance to the best performance in each *Doing Business* indicator. An economy's distance to frontier score is indicated on a scale from 0 to 100, where 0 represents the worst performance and 100 the frontier. For the economies for which the data cover 2 cities, scores are a population-weighted average for the 2 cities.  
Source: *Doing Business* database.

Figure 2: India's Ranks on *Doing Business* & Distance to Frontier Scores  
(*Doing Business*, 2015)

Having placed India in a regional and global context in terms of the overall business environment, it becomes imperative to study how it fares along the several parameters that constitute the Index.

### 5.3 India: Why does it Stand Where it Stands on the Index?

Hereunder, the DB Index Rank for India has been broken down into its constituent components, in an attempt to understand which factors play a contributory role—and to what extent—in determining the present-day regulatory environment of India, which has been witnessed to not be very amenable to doing business despite the developments documented under Section IV of the paper.

The calculation of scores for India, for all intents and purposes associated with the DB Index, is done on the basis of collated data from the cities of Delhi and Mumbai, population-based weights assigned to the two being 53 and 47, respectively.

**Table 10: Doing Business Parameters: India 2014 v. India 2015.**

DB TOPIC/ PARAMETER	DB RANK 2015/2014 ALONG THE TOPIC	DISTANCE TO FRONTIER SCORES 2015/2014
Starting a Business	158/ 156 (-2)	68.4/ 65.54 (+2.88)
Dealing with Construction Permits	184/183 (-1)	30.89/ 29.70 (+1.19)
Getting Electricity	137/ 134 (-3)	63.06/ 62.55 (+0.51)
Registering Properly	121/115 (-6)	60.40/ 60.40 (-)
Getting Credit	36/ 30 (-6)	65.00/ 65.00 (-)
Protecting Minority Investors	7/ 21 (+14)	72.50/ 65.83 (+6.67)
Paying Taxes	156/ 154 (-2)	55.53/ 55.64 (-0.11)
Trading Across Borders	126/ 122 (-4)	65.47/ 64.89 (+0.58)
Enforcing Contracts	186/ 18 (-)	25.81/ 25.81 (-)
Resolving Insolvency	137/ 135 (-2)	32.60/ 32.43 (+0.17)

(Source: Doing Business, 2015)

We see that in terms relative to other nations, as indicated by the differential in the DB 2014 and DB 2015 Ranks, India has fared poorly. 'Protecting Minority Investors' is the only parameter along which it has gained a substantial 14 rank points. However, the Rank differential simply indicates performance relative to other economies. A yardstick more suited to gauging India's performance along the regulatory norms guiding business environment, in absolute terms, is the DTF score. Here, India presents a more promising picture. Starting a business, dealing with construction permits, getting electricity, trading across borders and resolving insolvency have all become easier to negotiate. Being associated with all stages of the growth of an MSME—entry, continuance as well as exit—these developments have contributed to a more amenable business environment, and can be traced and documented as follows Doing Business, World Bank, 2014):

### DB 2008

- Getting Credit: India's private credit bureau started to provide credit information on firms. India also strengthened its secured transactions system by launching a unified and

geographically centralised collateral registry that covers security interests granted by companies, can be searched by debtor name and encompasses the entire country.

- Trading Across Borders: It was made easier by introducing ICEGATE—an electronic data interchange system making it possible to lodge customs declarations through the Internet and facilitating the operation of a risk management system, an electronic payment system and an electronic manifest system that allows shipping lines to submit their cargo manifest in advance.

#### **DB 2009**

- Trading Across Borders: India reduced the time for exporting by implementing an electronic data interchange system.

#### **DB 2010**

- Resolving Insolvency: India made resolving insolvency easier by increasing the effectiveness of processes and thereby reducing the time required.

#### **DB 2011**

- Starting a Business: India eased business start-up by establishing an online VAT registration system and replacing the physical stamp previously required with an online version.
- Paying Taxes: The administrative burden of paying taxes was reduced by abolishing the fringe benefit tax and improving electronic payment.

#### **DB 2012**

- Paying Taxes: India eased the administrative burden of paying taxes for firms by introducing mandatory electronic filing and payment for value added tax.

#### **DB 2013**

- Dealing with Construction Permits: India reduced the time required to obtain a building permit by establishing strict time limits for preconstruction approvals.

## DB 2015

- Starting a Business: India made starting a business easier by considerably reducing the registration fees, but also made it more difficult by introducing a requirement to file a declaration before the commencement of business operations. These changes apply to both Delhi and Mumbai.
- Protecting Minority Investors: India strengthened minority investor protections by requiring greater disclosure of conflicts of interest by board members, increasing the remedies available in case of prejudicial related-party transactions and introducing additional safeguards for shareholders of privately held companies. This reform also applies to both Delhi and Mumbai.
- Getting Electricity: In India the utility in Mumbai made getting electricity less costly by reducing the security deposit for a new connection.

To delve deeper into the status of regulatory and legal norms affecting the climate of business in India, these DB topics can further be broken down into processes and practicalities associated with the establishment and maintenance of an MSME. Further, performance along these sub-parameters can be viewed relative to that of comparable economies as well as best-performing nations, globally.

### 5.4 Doing Business Parameters: The Indian Perspective

Hereunder, the major parameters/ topics that constitute the ease of doing business index have been listed and an analysis of how the Indian policy and regulation framework fares along the criterion has been conducted.

#### Parameter 1: Starting a Business

The ease of starting a business is measured by the DB Index by taking account of:

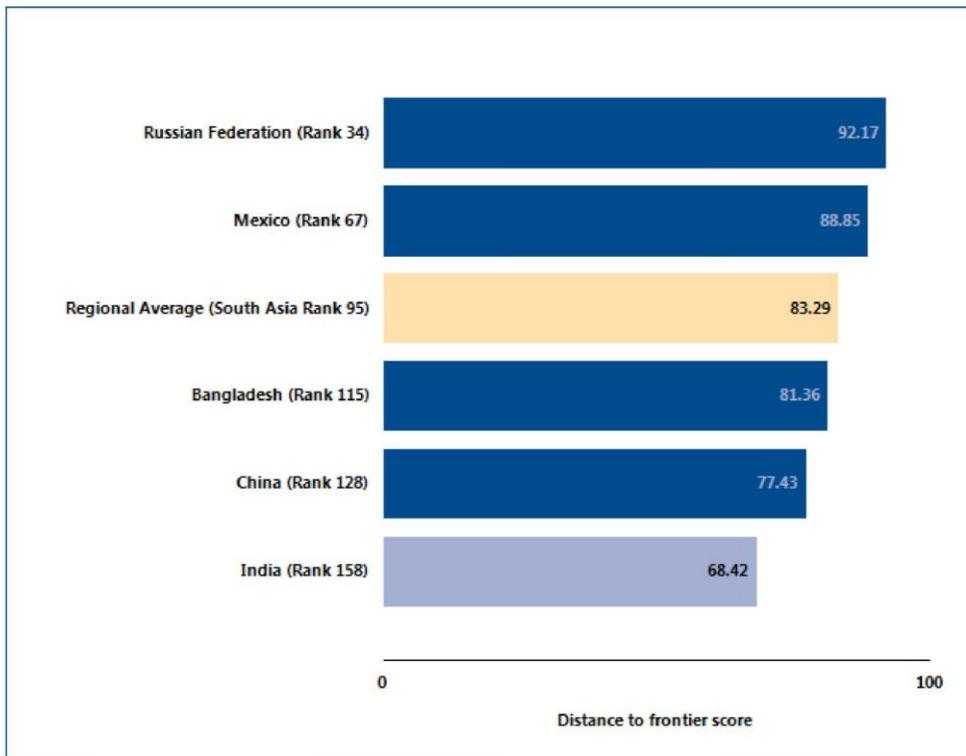
- The number of procedures required to legally start and operate a company. This in turn includes: pre-registration (name verification or reservation and notarisation, for instance), registration in the economy's largest business city<sup>10</sup> and post-registration (for example, company seal or a social security number in case of certain countries).

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<sup>10</sup> In case of countries with population exceeding a 100 million, a weighted average of the two largest cities is taken. In case of India, these are Mumbai and Delhi, as previously mentioned in the paper.

- The time required to complete each procedure, expressed in calendar days. Calculations hereunder do not factor in the time spent gathering information and procedures that can be fully completed online are recorded as only half a day. Procedure is deemed to be complete once the final document is received by the applicant (MSME owner) and no prior contact or association with the concerned officials is assumed.
- Another sub-parameter lies in the cost required to complete each procedure and it is expressed as a percentage of income per capita. This cost is inclusive of only official costs and not bribes; professional fees also stands excluded, unless the services they correspond to are mandated by law.
- The final factor is the paid-in minimum capital, also expressed as a percentage of income per capita—it refers simply to the capital deposited in a bank or with a notary either prior to, or within three months of, registration.

India stands at 158<sup>th</sup> rank (with a DTF score of 68.42) on the ease of starting a business parameter. All comparable economies, as also the South Asian Regional Average, stands above India. The Russian Federation stands at rank 34 (with DTF being 92.17), China at 128 (77.43), Bangladesh at 115 (81.36) and the South Asia rank is 95 (83.29).



Source: Doing Business database.

**Figure 3: How Indian and Comparator Economies Rank on Ease of Starting Business (Doing Business, 2015)**

In India, starting a business requires 11.9 procedures, takes 28.4 days, costs 12.2 percent of income per capita and requires paid-in minimum capital of 111.2 percent of per capita income. (Doing Business 2015 India Report, 2014).

## **Parameter 2: Dealing with Construction Permits**

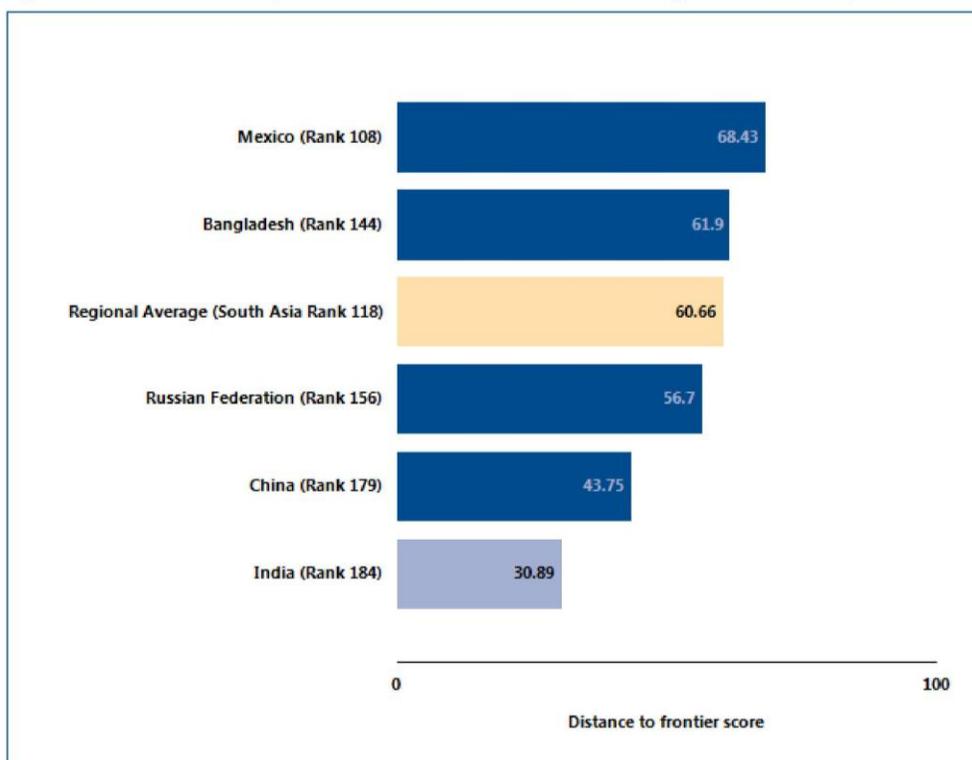
The Doing Business Report has appropriately identified that “regulation of construction is critical to protect the public. But it needs to be efficient, to avoid excessive constraints on a sector that plays an important part in every economy. Where complying with building regulations is excessively costly in time and money, many builders opt out. They may pay bribes to pass inspections or simply build illegally, leading to hazardous construction that puts public safety at risk. Where compliance is simple, straightforward and inexpensive, everyone is better off.”

This parameter measures the following:

- The number of procedures to legally build a warehouse. The processes involved extend to: submitting all relevant documents and obtaining all necessary clearances, licenses, permits and certificates; submitting all required notifications and receiving all necessary inspections; obtaining utility connections for water and sewerage; registering the warehouse after its completion (if required for use as collateral or for transfer of the warehouse).
- Time required, in calendar days, to complete each procedure. This does not include the time spent gathering information and procedure is deemed to be complete only when the final document is received; no prior association with authorities is presumed.
- Finally, the cost required to complete each procedure is factored in as a percentage of warehouse value; hereunder, only official costs are added, to the exclusion of bribes.

To comply with the formalities to build a warehouse in India, an MSME owner must go through 25.4 procedures, 185.9 days and costs as high as 28.2 percent of the warehouse value.

India stands at a dismal 184 (of 189 economies), with a DTF score of 30.89. Russia stands at 156 (56.7), China at 179 (43.75), Bangladesh at 144 (61.9) and the South Asian Regional Average at 118 (60.66); India, thereby, being the worst performer amongst these comparators.



Source: *Doing Business* database.

**Figure 4: How India and Comparator Economies Rank on Ease of Dealing with Construction Permits (Doing Business, 2015)**

The estimated cost of constructing a warehouse, factoring in the procedure applicable in Mumbai and Delhi, stands at a staggering INR 4,496,273; presumably, this facility of building their own warehouse cannot be availed by many MSME owners, given the extent to which it is financially demanding.

### Parameter 3: Registering Property

Ensuring formal property rights has been identified as fundamental by *Doing Business*; effective administration of land being part of that. If formal property transfer is too costly or complicated, formal titles might go informal again. The most important aspect of registration of property for MSMEs lies in the fact that where property is informal or poorly administered, it has little chance of being accepted as collateral for loans—limiting access to finance, a challenge that already weighs heavy on MSME owners, as formerly discussed.

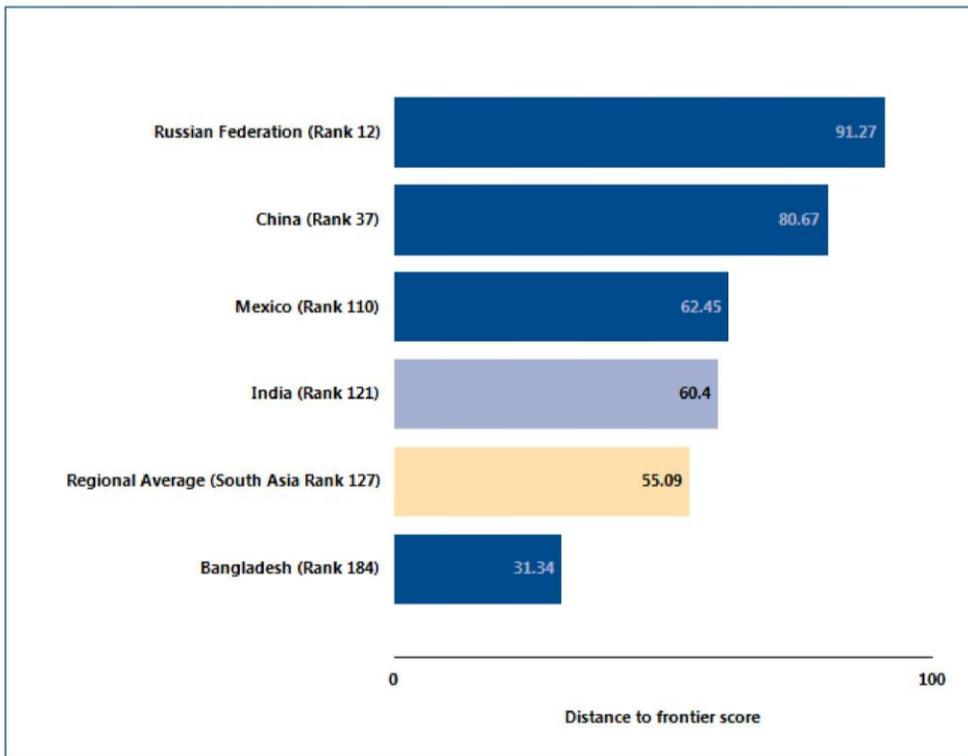
The parameter involves the following components:

- The number of procedures required to legally transfer title on immovable property. These include: pre-registration (for instance, checking for liens, notarising sales agreement, paying

property transfer taxes), registration in the economy’s largest business city and post-registration (for example, filing title with the municipality).

- Time required to complete each procedure, in calendar days, whereby time spent gathering information is not included. Again, procedure is considered completed once the final document is received by the applicant and no prior contact with officials is presumed.
- The cost required to complete each procedure is expressed as a percentage of property value. Only official costs are factored in and no bribes, value added or capital gains taxes included.

Completing a property transfer in India involves seven procedures, takes 47 days and costs 7 percent of the property value. Globally, India stands at 121 in the ranking of 189 economies on the ease of registering property, its DTF score being 60.4. This is as against China’s rank 37 (80.67), the Russian Federation’s standing at 12 (91.27), Bangladesh’s 184<sup>th</sup> position (31.34) and the South Asian Regional average which lies at 127 (55.09).



Source: Doing Business database.

**FIGURE 5: HOW INDIA AND COMPARATOR ECONOMIES RANK ON THE EASE OF REGISTERING PROPERTY (DOING BUSINESS 2015)**

## Parameter 4: Getting Credit

Two types of frameworks can facilitate access to credit and improve its allocation: credit information systems and borrowers and lenders in collateral and bankruptcy laws. Credit information systems enable lenders' rights to view a potential borrower's financial history (positive or negative)—valuable information to consider when assessing risk. And they permit borrowers to establish a good credit history that will allow easier access to credit. Sound collateral laws enable businesses to use their assets, especially movable property, as security to generate capital—while strong creditors' rights have been associated with higher ratios of private sector credit to GDP (Doing Business India Profile, 2014).

The 'getting credit' indicators measure the following:

- Strength of legal rights index (0-12)<sup>11</sup>; hereunder, the rights of borrowers and lenders through collateral laws are taken into account. Also, the protection of secured creditors' rights through bankruptcy laws is measured.
- Depth of credit information index (0-8)<sup>12</sup>; the scope and accessibility of credit information distributed by credit bureaus and credit registries is measured.
- Credit bureau coverage, expressed as a percentage of adults, measures the number of individuals and firms listed in the largest credit bureau.
- Credit registry coverage calculates the number of individuals and firms listed in the credit registry as a percentage of adult population.

The pertinent question here is as to how well do the credit information system and collateral and bankruptcy laws in India facilitate access to credit? The economy has a score of seven on the depth of credit information index and a score of six on the strength of legal rights index. Higher scores indicate more credit information and stronger legal rights for borrowers and lenders.

Globally, India stands at 36 (DTF score: 65) in the ranking of 189 economies on the ease of getting credit; the highest amongst all comparable economies, indicating how well regulations and institutions in India support lending and borrowing. China stands at rank 71 (50), the Russian Federation at 61 (55), Bangladesh at 131 (30) and the South Asian Regional Average performance is 97 (41.88).

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<sup>11</sup> **Data collected to assess the overall legal framework for secured transactions and the functioning of the collateral registry.**

<sup>12</sup> **Data collected on accessing borrowers' credit information online and availability of credit scores.**

How strong legal rights are for borrowers and lenders are determined by the economy scores along the legal rights index: India (6), China (4), Russia (4), Bangladesh (6). Higher scores indicate that collateral and bankruptcy laws are better designed to facilitate access to credit.

The depth of credit information index, meanwhile, indicates how much credit information is shared and how widely: India (7), China (6), Russia (7), Bangladesh (0). Higher scores indicate the availability of more credit information, from either a credit registry or a credit bureau, to facilitate lending decisions. If the credit bureau or registry is not operational or covers less than 5 percent of the adult population, the total score on the depth of credit information index is 0.

### **Parameter 5: Paying Taxes**

While taxes are essential, the level of tax rates needs to be carefully chosen—and needless complexity in tax rules avoided. Firms in economies that rank better on the ease of paying taxes in the *Doing Business* study tend to perceive both tax rates and tax administration as less of an obstacle to business according to the World Bank Enterprise Survey research (Doing Business India Profile 2014).

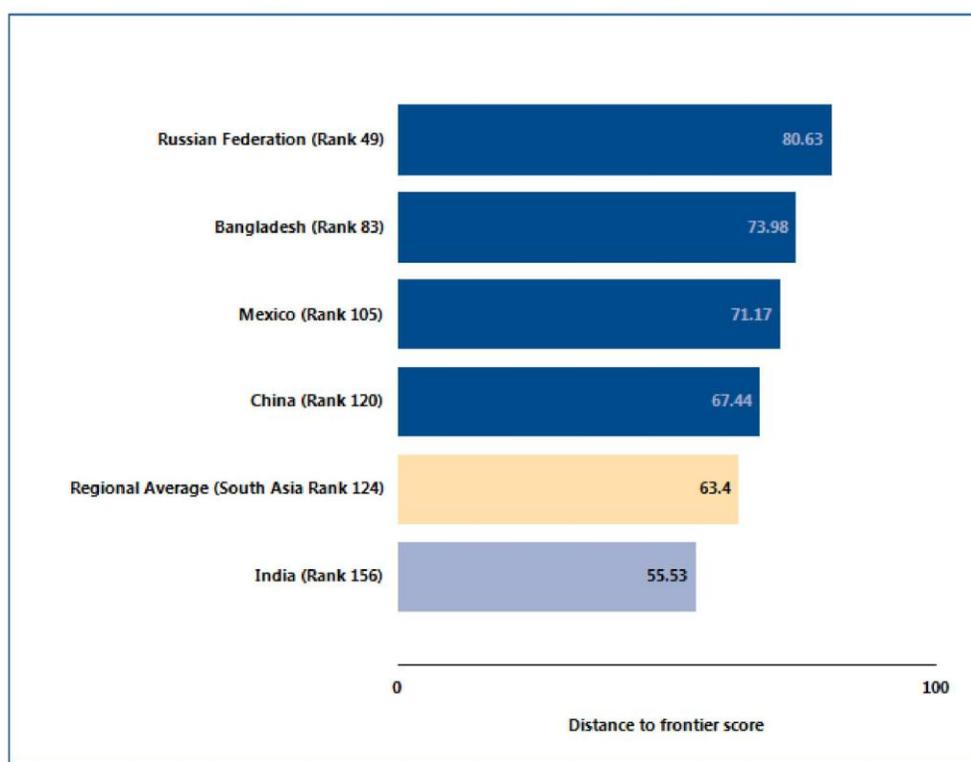
The approach that *Doing Business* takes towards computing for the purposes of this parameter is as follows. Using a case scenario, it measures the taxes and mandatory contributions that a medium-size company must pay in a given year as well as the administrative burden of paying taxes and contributions. Information is also compiled on the frequency of filing and payments as well as time taken to comply with tax laws.

The 'Paying Taxes' parameter consists of the following indicators:

- Tax payments for a manufacturing company in 2013, in calculating which the number per year has been adjusted for electronic and joint filing and payment. It includes the total number of taxes and contributions paid, including consumption taxes (value added tax, sales tax or goods & services tax). The method and frequency of filing are also factored in.
- Time required to comply with three major taxes, in terms of hours per year, is factored in. This computation includes: collecting information and computing the tax payable; completing tax return forms, filing with proper agencies; arranging payment or withholding; preparing separate tax accounting books, if required.
- Total tax rate, expressed as a percentage of profit before all taxes. The calculation of this total tax rate accounts for profit/corporate income tax; social contributions and labour taxes

paid by the employer; property and property transfer taxes; dividend, capital gains and financial transactions taxes; finally, waste collection, vehicle, road and other taxes.

On an average, firms in India make 33 tax payments annually, spend 243 hours a year filing, preparing and paying taxes, and the total tax payment amounts to 61.7 percent of profit. Globally, India stands at 156h position along the 'Paying Taxes' parameter, with a DTF score of 55.53. It ranks the lowest amongst comparable economies, as can be observed from the diagrammatic representation given below:



Source: Doing Business database.

**FIGURE 6: HOW INDIA AND COMPARATOR ECONOMIES RANK ON EASE OF PAING TAXES (DOING BUSINESS 2015)**

### Parameter 6: Trading Across Borders

In today's globalised world, making trade between economies easier is increasingly important for business. Excessive document requirements, burdensome customs procedures, inefficient port operations and inadequate infrastructure all lead to extra costs and delays for exporters and importers, stifling trade potential. Research shows that exporters in developing countries

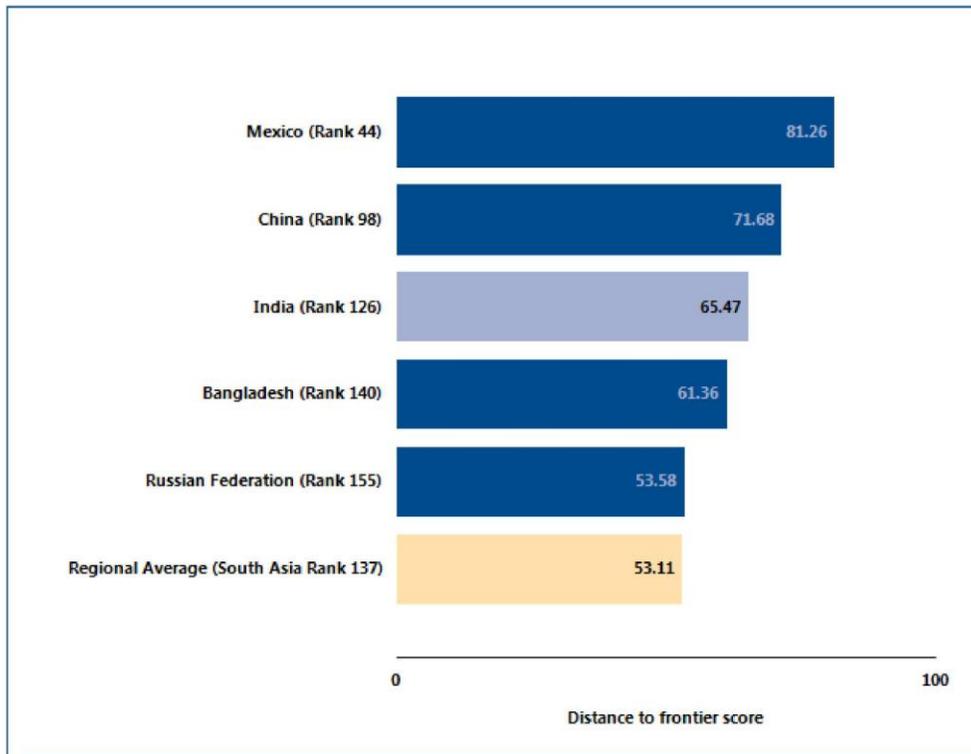
gain more from a 10 percent drop in their trading costs than from a similar reduction in the tariffs applied to their products in global markets (Doing Business India Profile, 2014).

To understand the standing of any economy along this parameter, it becomes imperative to measure the time and cost associated with exporting and importing a standard shipment of goods by sea transport, and the number of documents necessary to complete the transaction.

The 'Trading Across Borders' parameter measures the following:

- The number of documents required to import and export, including bank documents, customs clearance documents, port and terminal handling documents and also, transport documents.
- Number of days required to export and import. This computation takes account of obtaining, filling out and submitting all the documents; inland transport and handling; customs clearance and inspections; port and terminal handling; sea transport time stands excluded.
- Cost required to export and import, in terms of USD per container, including costs involved in all documentation, inland transport and handling, customs clearance and inspections and finally, port and terminal handling; hereunder, only official costs are factored in, bribes stand excluded.

In India, exporting a standard container of goods requires seven documents, takes 17.1 days and costs USD 1332. Importing the same container of goods requires 10 documents, takes 21.1 days and costs USD 1462. Globally, India stands at 126 in the ranking of 189 economies on the ease of trading across borders, its standing with respect to comparable economies being as follows:



Source: Doing Business database.

**FIGURE 7: HOW INDIA AND COMPARATOR ECONOMIES RANK ON EASE OF TRADING ACROSS BORDERS (DOING BUSINESS 2015)**

### Parameter 7: Resolving Insolvency

The significance of this measure lies in the fact that a robust bankruptcy system functions as a filter, ensuring the survival of economically efficient companies and reallocating the resources of inefficient ones. Fast and cheap insolvency proceedings result in the speedy return of businesses to normal operation and increase returns to creditors. By improving the expectations of creditors and debtors about the outcome of insolvency proceedings, well-functioning insolvency systems can facilitate access to finance, save more viable businesses and thereby improve growth and sustainability in the economy overall (Doing Business Report India Profile, 2014).

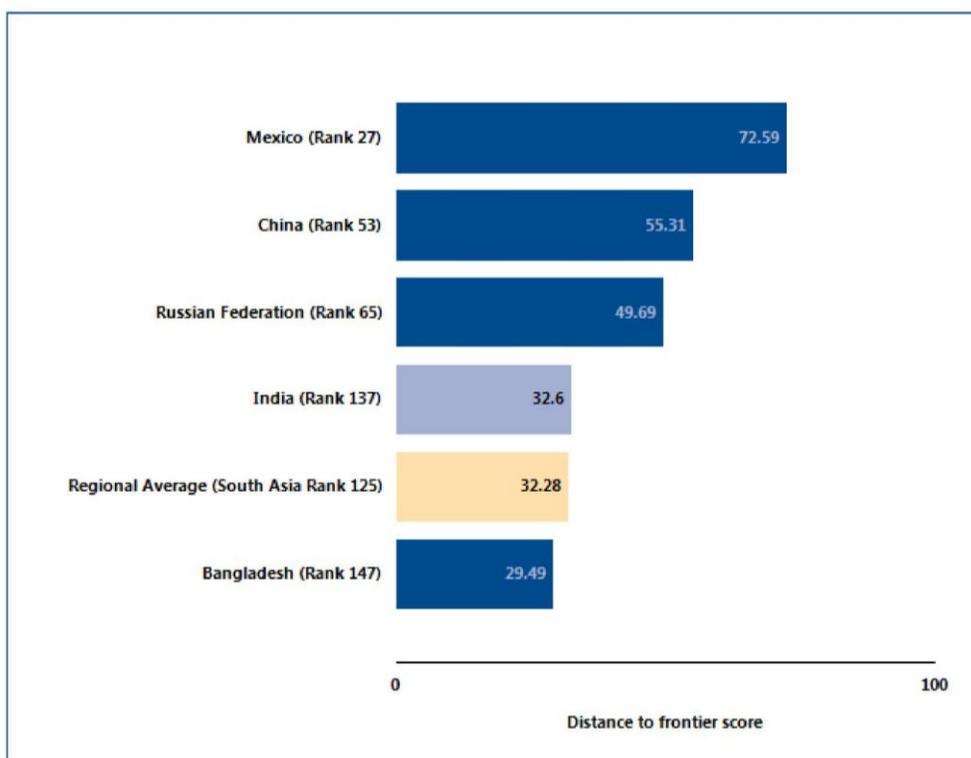
The 'Resolving Insolvency' indicators measure the following:

- Time required to cover debt, measured in calendar years; appeals and requests for extension are included.

- Cost required to recover debt, expressed as a percentage of the debtor's estate. This cost includes court fees, fees of insolvency administrators, lawyers' fees, assessors' and auctioneers' fees and other related fees.
- The outcome of the insolvency resolution process is also factored in; that is, whether the business continues operating as a going concern or business assets are sold piecemeal.
- Recovery rate for creditors measures the cents on the dollar recovered by secured creditors.
- Strength of insolvency framework index (0-16) puts forth the sum of the scores of four component indices: commencement of proceedings index (0-3), management of debtor's assets index (0-6), re-organisation of proceedings index (0-3) and creditor participation index (0-4).

In India, resolving insolvency takes 4.3 years on average and costs 9.0 percent of the debtor's estate, with the most likely outcome being that the company will be sold as piecemeal sale. India scores 2.0 out of 3 points on the commencement of proceedings index, 3.0 out of 6 points on the management of debtor's assets index, 0.0 out of 3 points on the reorganisation proceedings index, and 1.0 out of 4 points on the creditor participation index. India's total score on the strength of insolvency framework index is 6.0 out of 16.

Globally, India stands at 137 in the ranking of 189 economies on the ease of resolving insolvency, with a DTF score of 32.6. The performance of other comparator economies can be documented as follows:



Source: Doing Business database.

FIGURE 8: DISTANCE TO FRONTIER SCORES (DOING BUSINESS 2015)

## Other Parameters

### ***Parameter 8: Getting Electricity***

Obtaining an electricity connection is essential to enable a business to conduct its most basic operations. In many economies the connection process is complicated by the multiple laws and regulations involved—covering service quality, general safety, technical standards, procurement practices and internal wiring installations. (Doing Business India Report, 2014)

India stands at 137<sup>th</sup> position with a DTF score of 63.03; amongst the comparable economies, it lies behind only China (Rank: 124, DTF: 66.35). Russia stands at 143 (60.89), Bangladesh at 188 (17.32) and the South Asian Region at 122 (62.47).

### ***Parameter 9: Protecting Minority Investors***

Protecting minority investors matters for the ability of companies to raise the capital they need to grow, innovate, diversify and compete. Effective regulations define related-party transactions precisely, promote clear and efficient disclosure requirements, require shareholder participation

in major decisions of the company and set detailed standards of accountability for company insiders (Doing Business India Profile, 2014).

The parameter is composed of several indices: extent of disclosure index, extent of director liability index, ease of shareholder suits index, extent of shareholder rights index, extent of corporate transparency index and finally, strength of investor protection index.

How strong minority investor protections are against self-dealing in India, is indicated by the fact that the economy ranks 7<sup>th</sup> amongst 189 countries along the parameter (DTF score: 72.5), with a score of 7.3 on the strength of minority investor protection index; a higher score indicates stronger protections.

Along this parameter, India is placed higher up than all comparable economies: China being at 132<sup>nd</sup> rank (45), Russia at 100 (50.83), Bangladesh at 43 (60.83) and the South Asian Regional position being 78<sup>th</sup> (52.5).

### ***Parameter 10: Enforcing Contracts***

Effective commercial dispute resolution has many benefits. Courts are essential for entrepreneurs because they interpret the rules of the market and protect economic rights. Efficient and transparent courts encourage new business relationships because businesses know they can rely on the courts if a new customer fails to pay. Speedy trials are essential for small enterprises, which may lack the resources to stay in business while awaiting the outcome of a long court dispute (Doing Business Report India Profile, 2014). The parameter includes indicators such as: number of procedures to enforce a contract through courts, time required to complete procedures and the cost required to complete procedures, expressed as a percentage of the claim.

In India, commercial dispute resolution or the enforcement of a contract takes 1420 days, costs 39.6 percent of the value of the claim and requires 46 procedures.

In terms of rankings, India stands at 186<sup>th</sup> position (DTF score: 25.81) in terms of the ease of enforcing contracts, the only comparator economy lower down being Bangladesh with a rank of 188 and with its DTF score being 20.82. China occupies the 35<sup>th</sup> position (DTF score: 68.21), Russia stands at 14<sup>th</sup> position (75.85) and the South Asian Regional average lies at 148<sup>th</sup> position (40.95).

The regulatory framework for small-scale business ventures in India and their largely detrimental impact on the business environment for MSMEs having been understood, the paper now seeks to suggest measures—at the policy and implementation level. This has been done in an attempt to mitigate the extent to which MSMEs have been adversely affected, by re-aligning policy in a manner that facilitates their growth.

## Section VI: Policy Recommendations

The study documented and assessed the regulatory framework—both, statutory and procedural—surrounding the business climate in India, with particular and detailed reference to MSMEs. Using this assessment, policy recommendations have been made that, if implemented, will hopefully mitigate the detrimental impact of faulty, or simply redundant, policy measures on MSMEs—their entry, operation and comfortable, structured exit.

### 1. Drawing Up a Distinction Between Micro, Small and Medium Enterprises at a Policy Level

A challenge faced by the sector from a policy perspective, and which cannot be readily quantified, lies in the fact that Micro, Small and Medium enterprises are often lumped together—in making budgetary allocations, devising policy measures and in the subsequent application and implementation of policies so drafted. The distinction between them is not merely academic; it comes with variations in their requirements and, therefore, holds practical value. Micro, Small and Medium enterprises, for instance, have different finance needs. Micro enterprises primarily rely on debt for both early and growth-stage financing; micro and small services enterprises primarily transact in cash and tend to keep minimal records. Finally, manufacturing enterprises and those with order-driven services tend to need more finance because of longer working capital cycle and higher capital expenditure (International Finance Corporation, Year Unknown). These different requirements can naturally not be catered to and addressed when they are not even recognised. Legally, the same laws are not applicable to them for micro and small enterprises do not qualify, statistically, to fall in the ambit of the same laws as medium enterprises. By lumping them together—at an institutional level, and hence psychologically—these requirements are often ignored. It is recommended that government departments (either ministries or sub-functionaries within a ministry) for the three should be kept separate, with each being specialised to cater to the demands of its assigned segment.

### 2. Starting a Business: Minimisation of Procedural Compliances Required

In India, starting a business requires 11.9 procedures, takes 28.4 days, costs 12.2 percent of income per capita and requires paid-in minimum capital of 111.2 percent of per capita income.

India stands at 158<sup>th</sup> rank (with a DTF score of 68.42) on the ease of starting a business parameter; this is lower than the South Asian Regional Average and also, all three comparable economies in question. The procedure can readily be simplified by simply making a few alterations in the manner of compliance; for instance:

### **3. Separate Filing of Entrepreneurs' Memorandum for the Same Enterprise Involved with Manufacturing and Rendering of Services can be Removed**

- a. Online or e-filing of documents/ payments (such as the Director Identification Number, for instance), though more efficient, should always be accompanied by an alternative option of physical filing for those who may not be comfortable with online compliance of such obligations.
- b. Single Window Clearance for No-Objection Certificates is a viable option. For instance, in case of acquiring construction permits, NOCs from the sewerage, tree and drainage departments can easily be acquired through a single-window system.

### **4. Better Monitoring Mechanism with Respect to Finance for MSMEs**

The RBI has taken several measures towards streamlining the flow of finance, from public as well as private sector banks, to the MSME sector. In response to these directive measures, there has been a corresponding and steady increase in the flow of such finances. However, when placed against the debt gap and credit requirements of the sector, this increase proves insufficient. Better monitoring of the flow of these finances is hereby suggested as a potential remedy to this problem.

The status of the loan should be available to be tracked online, for higher bank authorities and applicants alike. This will serve as an incentive for banks to maintain efficiency in the process and will aid the maintenance of accountability and transparency.

### **5. Simplification of Labour Regulatory Framework**

Currently, 44 legislations (only central; the number does not include state legislations) provide for labour regulations. Most of these are seen to be inapplicable to micro and small enterprises. Even for medium enterprises, the regulatory framework is scattered across all these statutes, making compliance a challenge. In terms of quality, this legislation is marked by unnecessary complexity and redundancy. In keeping with the view of the Confederation of Indian Industries (CII), the following statutes are suggested to be amended, and measures to be put in place, so as to simplify the existing framework:

- The Factories Act, 1948
- The Employees Provident Funds and Miscellaneous Provisions Act, 1952
- The Employees State Insurance Act, 1948
- Definition of wage
- The Industrial Disputes Act, 1947

- The Contract Labour (Regulation and Abolition) Act, 1970
- The Industrial Employment (Stand Order) Act, 1946

The detailed recommendations, adopted from those put forth by the CII, have been discussed in 'Annexure B' to the paper.

## **6. Inclusive Manner of Checking Compliance with Laws**

In an attempt to check the corruption, red-tapism and bureaucratic attitude associated with inspections undertaken by the government, an alternative compliance-enforcement mechanism is recommended. Hereby, all stakeholders' interests will be duly represented while conducting inspections. For instance, compliance with health and safety norms in restaurant should not be conducted by a government official alone. The protection of the MSME owner's interests should be ensured with the inclusion of an independent expert on such norms.

## **7. Taxation: Need for Simpler Procedure and Non-Ambiguity in Laws**

While taxes are essential, the level of tax rates needs to be carefully chosen, and needless complexity in tax rules avoided. On an average, firms in India make 33 tax payments annually; spend 243 hours a year filing, preparing and paying taxes; and the total tax payment amounts to 61.7 percent of profit. Globally, India stands at 156th position along the 'Paying Taxes' parameter, with a DTF score of 55.53. It ranks the lowest amongst comparator economies.

The possibility of introduction of the Goods and Services Tax (GST), for instance, is a step in the direction of simplifying procedure. GST is a comprehensive tax levy on manufacture, sale and consumption of goods and services at a national level. Through a tax credit mechanism, this tax is collected on value-added goods and services at each stage of sale or purchase in the supply chain. The system allows the set-off of GST paid on the procurement of goods and services against the GST which is payable on the supply of goods or services. However, the end consumer bears this tax as he is the last person in the supply chain. Experts say that GST is likely to improve tax collections and boost India's economic development by breaking tax barriers between States and integrating India through a uniform tax rate

Needless to say, its introduction will also bring about a reduction in the procedure currently associated with paying different forms of indirect taxes separately.

Further, the ambiguity in the definition of SSIs for the purposes of the I-T Act, 1961, needs clarification on part of the CBDT, so that benefits and exemptions granted thereunder can reach MSMEs.

## **8. Addressing Lack of Awareness**

The government, particularly when it claims to be welfare-oriented, cannot take the plea of 'Right to Information' and thereby put the onus on MSME owners to seek information about various schemes and benefits. It must take on the duty to inform upon itself, for the deficiency lies not in the existence of schemes, but on their implementation. Incentive to implement can only be achieved in the ultimate beneficiaries are aware of policies and are in a position to make a forceful claim for their operationalisation.

## **9. Legal Framework for an Exit Scheme**

In defiance of the yearlong time frame allowed under Section 25 of the MSMED Act, 2006, there has been no definite legal procedure to provide for a structured winding-up scheme to facilitate easy exit of MSMEs. This allows for arbitrariness on part of banks when resolving insolvency and finalising exit proceedings. A statutory framework, focused on facilitating revival (or at least easy exit) of MSMEs is imperative.

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