

# **CHALLENGES FACED BY MICRO, SMALL AND MEDIUM ENTERPRISE (MSME) SECTOR IN INDIA**

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## **ABSTRACT**

*A major obstacle to the growth of the vital Indian micro, small and medium enterprises (MSME) sector is its lack of adequate access to finance. This paper examines the major issues in the financing of MSMEs in the Indian context, such as the information asymmetry facing banks and the efficacy of measures such as credit flow for MSMEs; whether transaction lending would be adequate to address the information issues or would lending have to be based on a relationship with the MSME, using both 'hard' and 'soft' information; and whether the size and origin of the bank affect the availability of credit to MSMEs. Some aspects are elevated in the paper, such as the role and importance of the credit flow to MSME sector for the economic growth and development and the role that banks can play in developing the MSME sector in India.*

***Keywords: Economic Development, Employment, Financing, Government, MSME***

## **I. INTRODUCTION**

Micro, Small and Medium Enterprises' (MSME) contribution in the development of world economy has been significant, both in terms of contribution to GDP and creation of employment opportunities. Many studies show that economic growth of any country is closely associated with SME development and there exists a positive relationship between the relative size of the MSME sector and economic growth. Also some evidences reveal that the contribution of formal MSMEs in high-income countries amount to approx. 50 percent of GDP on an average. Today small and medium enterprises account for nearly 35 percent of the gross value of output in manufacturing sector and 43 percent of the total exports. This sector is one of the most success stories of the modern India. Currently MSMEs account for 95% of total industrial units and 46 % of the industrial production. MSMEs are the biggest employment providers in the country having almost 6 corers of the population depend on them for their livelihood. The survival of MSME is of vital importance to the people. In accordance with the provision of Micro, Small & Medium Enterprises Development (MSMED) Act 2006, the Micro, Small & Medium Enterprises (MSME) are classified as shown in table 1. The limit for investment in plant and machinery/equipment for manufacturing/service enterprises:

**Table 1: Finance for SME sector as per MSME act 2006**

Classification	Investment ceiling for plant, Machinery or Equipment's	
	Manufacturing Enterprises	Service Enterprises
Micro	Up to Rs. 25 lakh	Up to Rs. 10 lakh
Small	Above Rs. 25 lakh & up to Rs. 5 crore	Above Rs. 10 lakh & up to Rs. 2 crore
Medium	Above Rs. 5 Crore an up to Rs. 10 crore	Above Rs. 2 crore & up to Rs. 5 crore

**Note:** Besides this government of India has also reserved 836 items for small scale production and 409 items for exclusive purchase from small scale industry (means small industrial units having investment on fixed assets not exceeding Rs.1 lakhs).

## II. LITERATURE REVIEW

Indian government has given high priority to SME sector on account of the important role it plays in balanced and sustainable economic growth. Though SMEs are considered as a priority sector in our country, they continue to face problems related to credit flow. In a study titled 'Credit Flow of SMEs in India' conducted by Samta Chaudhary and Shweta Ahalawat (2014), the importance of SMEs and its various socio-economic contribution like employment generation, fostering new entrepreneurship, providing volume to the industry base and contribution to national output and exports of our country was identified. On this background, the study further highlighted hurdles faced by SME sector and analyzed existing credit flow.

Ms. Jahnavi K. Dubal in his paper on Financing of SME Firms in India (2015) had examined the major issues in the financing of SMEs in the Indian context, such as the information asymmetry facing banks and the efficacy of measures such as credit scoring for SMEs; whether transaction lending would be adequate to address the information issues or would lending have to be based on a relationship with the SME, using both 'hard' and 'soft' information; and whether the size and origin of the bank affect the availability of credit to SMEs.

According to study conducted by Das (2007), it is argued that the improvement in the quality of financial information is noted to be an important requirement for increasing the flow of credit to SMEs because the quality of decisions also influences decisions on loan finance.

Morris et al. (2001) argue that the organizational structure of Indian banks and their processes have taken them far from task orientation and also have created a specific bias against small loan portfolios.

## III. ROLE AND IMPORTANCE OF MSMEs IN ECONOMIC DEVELOPMENT

Small and medium enterprises have been the backbone of self-sustainable industrial development. Small and medium enterprises represents an indigenous model of economic development, which emphasized high contribution to domestic production, significant export earnings, low investment requirements, employment generation, effective contribution to foreign exchange earning of the nation with low import intensive operations.

The contribution of Small Scale Industries (SSIs) which comprise more or less of the same MSME game of companies has been remarkable in the industrial development of the country. It has a share of 40% in the

industrial production with 35% of the total manufacturing related exports of the country are directly accounted for by this sector. In terms of employment generated, this sector again attracting attention next only to agriculture. MSME are less capital intensive and suit the Indian economic environment with scarce resources and large population base. In addition, it is highly and has a scope for labour intensive for building upon the traditional skill and knowledge. Overall, the small industry sector has done quite well and has enabled the country to achieve considerable industrial growth and diversification

**Table2: Contribution of manufacturing output of MSME inGDP**

Year	Gross Value Of Output of MSME Manufacturing Sector	Share of MSME sector in total GDP (%)			Share of MSME Manufacturing output in total Manufacturing Output (%)
		Manufacturing Sector MSME	Services Sector MSME	Total	
2008-09	1375589	7.52	28.60	36.12	40.79
2009-10	1488352	7.45	28.60	36.05	39.63
2010-11	1653622	7.39	29.30	36.69	38.50
2011-12	1788584	7.27	30.70	37.97	37.47
2012-13	1809976	7.04	30.50	37.54	37.33

**Source:** MSME Annual Report 2014-15

The above table highlights the percentage share of MSME sector in GDP of India and also shows the output of the MSME manufacturing output to the total manufacturing sector output for a period of 5 years from 2008-09 to 2012-13. It may be observed that the percentage share of manufacturing sector is less as compared to that of services sector; which indicates that the MSMEs are more into the service industry. There has been declining trend of percentage share of manufacturing sector's contribution to the GDP; this could be because of the problems faced such as lack of proper and timely credit flow, technological limitations, inefficient marketing of the products, and unavailability of skilled labour. Although the MSME manufacturing sector's outputs have been increasing, but as a percentage of total manufacturing sector it shows a declining trend. The contribution of services sector in total GDP is rapidly increasing as there is high demand from the foreign consumers thus leading to increase in exports of the country. This is mainly contributing the fact that India has a large pool of low cost, and educated workers in the country.

### **Performance of the MSME sector**

Small and Medium Enterprises (SMEs) in India have seen exponential growth over the last decade. According to the latest reports by the Ministry of Micro, Small and Medium Enterprises, India currently has more than 48 million MSMEs. These MSMEs contribute more than 45% of India's industrial output, 40% of the country's total exports and create 1.3 million jobs every year. Yet, these MSMEs continue to struggle on multiple accounts. While some are challenged by credit and finance issues, others are struggling to cope with stringent regulatory environments.

Indian SMEs have grown at a stable pace of 4.5% in the last 5 years. According to the latest Annual Report

issued by the Ministry of Micro, Small and Medium Enterprises, there are over 6,000 products, ranging from traditional to high-tech, which are being manufactured by the MSME sector for domestic as well as international markets.

**Table 3: Performance of MSME, employment and investments**

Year	Total Working Enterprises (in Lakh)	Employment (in Lakh)	Market Value of Fixed Assets (Rs. in Crore)
2008-09	393.70	880.84	977,114.72
2009-10	410.80	921.79	1,038,546.08
2010-11	428.73	965.15	1,105,934.09
2011-12	447.64	1,011.69	1,182,757.64
2012-13	447.54	1,061.40	1,268,763.67
2013-14	488.46	1,114.29	1,363,700.54

**Source:** MSME Annual Report 2014-15

The above table shows an increase in the number of MSME enterprises, no of people employed and the market value amount of the investments made in plant & machinery and equipment. This is on account of encouragement from government and support by the Ministry of Micro, Small and Medium Enterprises. It means that MSMEs are looked in a positive way for overall economic development.

## MSMEs IN INDIA: CHALLENGES AND OPPORTUNITIES

The MSME Sector contributes in multiple ways towards the economy. Being a highly unorganised sector with fragmented nature of reach, the sector has always been a laggard in enjoying the full flow of Government policies and financing company's empathy and understanding. In order to understand the obstacles and probable steps to be taken to exploit the opportunities offered by MSMEs, lets discuss the details of the working dynamics of MSMEs as under:

### 1. Dearth of easy finance and credit instruments

Ease of credit access and quick finance is the most critical growth driver for any MSME. Most Indian MSMEs start out with minimal capital, which eventually stalls their growth after a certain point. Easy credit access for SMEs therefore becomes a very important factor for national growth as well. The lack of easy credit tends to stagnate the growth of MSMEs, which in turn affecting generic growth in terms of GDP, import, export and employment. Unavailability of credit at the right time can also affect business growth at many seals leading to a lot of small businesses shutting shop due to inadequate margins.

Some major problems that approximately 80% MSME Entrepreneurs face on a day-to-day basis while trying to obtain credit assistance for their business operations:

- i. Complex collaterals required to obtain term loans
- ii. High transaction costs in imports/exports
- iii. Private Equity Funding is difficult to obtain
- iv. Banks offer high rates for term loans
- v. Private equity (PE) dilutes control in the company

- vi. Un-standardised project appraisal system for term loans
- vii. Cumbersome procedures and delay in fund disbursement

## 2. Complicated Regulatory Policies for Starting a Business

India is ranked at 130<sup>th</sup> position out of 189 countries who participated in the World Bank's Ease of Doing Business Ranking primarily due to unfavourable business climate for its enterprises, especially the MSMEs. Indian MSMEs are weighed down by inflexible and complicated regulatory policies like taxation, dealing with construction permits, registering property, enforcing contract, resolving insolvency, etc. Owing to this prohibitive business climate, many innovative entrepreneurs are not able to enter the markets or sustain a business.

The following points show a breakdown of how inflexible regulatory policies affect the functioning of MSMEs

- i. Absence of a common regulatory body
- ii. Complicated procedures of setting up business
- iii. No special schemes for start-ups
- iv. Complex book keeping regulations

## 3. Unavailability of modern, affordable technology

In an increasingly complex and competitive economic landscape, the need to align people, processes and technology is stronger than ever. Latest technology can help enterprises reduce cost and time taken to innovate and offer sophisticated products and services. This helps SMEs differentiate from peers, optimize cost structures and most importantly compete on a global level.

However, SMEs in India face struggles on account of accessing and using the latest technological advancements. While knowledge, access and funds continue to hamper implementation of technology, absence of an ecosystem that enables technology transfer and interaction with experts is a critical reason of limited adoption.

The below mentioned are the key reasons why MSMEs fail to adopt latest technology to innovate and transform their businesses. The absence of a common platform for interaction with technology providers continues to be the most critical challenge faced by MSMEs in this area.

- i. Limited interaction between tech providers and seekers
- ii. Absence of ecosystem for technology transfer
- iii. Access to modern technology is expensive
- iv. Minimal knowledge about upcoming technologies
- v. Unavailability of e-Governance systems
- vi. Lack of effective information systems
- vii. Lack of funds to support Innovation and R&D

## 4. Lack of basic infrastructure facilities

Adequate and modern infrastructure powers the steady growth of a nation's economy. The absence of proper infrastructure can cause serious problems to an enterprise's daily business operations of manufacturing, consumption, and distribution of goods and services. Poor infrastructure affects businesses at every level and ends up being a deterrent to healthy growth.

The following reasons highlight some of the key infrastructural issues that cause a hindrance to normal business operations in an MSME. The biggest challenge continues to be the lack of electricity resources:

- i. Inadequate supply of water
- ii. Lack of facilities like Tool Rooms
- iii. Insufficient methods of industrial waste management
- iv. Inadequate cluster infra reducing competitiveness
- v. Lack of reliable electricity resources
- vi. No minimum price for power fixed for MSME
- vii. Volatility in prices of basic fuels

## 5. Absence of exclusive marketing platforms and distribution networks

With consumer habits changing rapidly and increased competition from both local and global brands, market dynamics and customer loyalties are in a state of flux. While offering best-in-class products and services, enterprises also need to improve the quality of customer interaction at each opportunity. Enhancing customer engagement is not a matter of choice anymore and to succeed, SMEs need market intelligence, tools and well-trained workforces to respond to these external pressures.

The below mentioned are the key reasons why domestic MSMEs in India are unable to approach marketing and distribution effectively.

- i. Lack of monetary support/schemes
- ii. Limited knowledge about digital marketing
- iii. Limited expertise in new-age marketing
- iv. Unaware of technology for marketing
- v. Not enough trade fairs and buyer-seller meets
- vi. Losing to large competitors due to lack of networks

## 6. Inflexible labour laws and availability of affordable skilled labour

Indian MSMEs employ 40% of the country's workforce, making them the employment powerhouse of the country. However, India today faces the big challenge of out-dated labour laws that are still in use. Bigger organizations like Maruti too have faced labour problems in the recent past. This leaves many MSMEs struggling with problems of culture and scale and not being able to meet their workforce demands. A labour law reform overhaul is required to regulate large influx of workforce which will enter the working landscape.

The following points highlight some of the key issues that enterprises face related to workforce:

- i. Retaining talent due lack of ability to pay
- ii. Low productivity of labourers
- iii. Common minimum wage policies
- iv. Lack of skilled workers

Nonetheless, the sentiments towards Micro, Small & Medium Enterprises is growing positive, putting them back in the spotlight. There is an expectation that their growth would be much faster over the next few years. However, the companies which would emerge winners would need to find a way around to leverage their strengths and remain ahead of intense competition. The use of technology to develop a competitive advantage would be key defining point to look out for. Having access to the right talent, adequate sources of funding will

develop a 'value proposition' which embeds itself into the journeys of improving customers experience and benefit for the country as a whole. This has to be supported by a defined framework and deft handling of the challenges of MSMEs in India.

## IV. RECOMMENDATIONS

Some of the suggested framework to help minimise the challenges faced by MSMEs in their growth:

### 1. Introduction of easy financing and credit tools

In order to compete with large scale enterprises and other global counterparts, it is important that they are provided easy and affordable funding opportunities to obtain credit. With limited working capital, key for MSMEs is low cost finance that is available from Public Sector Banks (PSBs). In order to retain growth for MSMEs, the government must work towards establishing an environment that simplifies access to finance and creates transparency in how banks and credit agencies decide sanction credit funding terms. The measures taken by the government should be such that it is easy for MSMEs to obtain a term loan from banks without high emphasis on collaterals and complex paper work and at reduced interest rates. The measures should include standard project appraisal system in banks, reduce transaction costs in imports/exports, encourage for cluster financing by creating MSME hubs and insurance coverage to Banks advances towards MSME.

### 2. Developing a supporting legal and regulatory framework

An effective legal and regulatory framework promotes competition by avoiding overly restrictive licensing requirements and allows international and regional banks with better MSME lending tools to enter the market. Competition among financial sector players can be promoted further by introducing technological platforms in key areas, facilitating a variety of financial products and services, driving down the costs of financial access, and reaching previously untapped markets. Evolvement of companies' law and enactment of Bankruptcy legislation will have a highly positive impact on MSMEs and lenders

### 3. Access to Modern Affordable Technology

MSMEs have a unique problem to solve – while they are required to adhere to global standards and ensure compliance to regulations, they mostly have limited understanding (and budgets) for technology. This surely needs to change and Indian MSMEs need to evolve as aggressive users of technology. From being an enabler of productivity and quality, technology must be used for transformation and as a key influencer of competitive advantage. MSMEs expect the Government to take necessary steps to provide modern technology at cheaper and subsidized cost, enable ecosystem to facilitate technology transfer, create a platform for technology providers and technology seekers. The Government needs to create and collate public information and systems towards technological base.

### 4. Strengthening the financial infrastructure

Establishing a solid financial infrastructure (auditing and accounting standards, credit registries/bureaus, collateral, and insolvency regimes) should be a priority in financial development. The aim should be to develop a comprehensive credit reporting system that covers both personal and commercial credit information, and help lenders better manage credit risk and extend access to credit. Some countries, such as India, have introduced MSME rating agencies as an additional institution designed to provide more information to prospective lenders. Moreover, a well-functioning collateral regime characterized by a wide range of allowable collaterals

(immovable and movables), the establishment of clear priority rankings of claims over collateral, efficient collateral registries making priority interests publicly known, and effective enforcement of collateral in the case of default can further enhance risk acceptability of MSME customers for financial institutions. Training Institutions for financiers' specific training in small credit and MSMEs financing requirement should be set up by every PSBs.

## 5. Effective government support mechanisms

In all cases, government interventions should be carefully designed and better evaluated with a view to accurately measure their achievements in terms of outreach and leverage. Partial credit guarantee schemes should remain an important form of intervention. Key guiding principles on such schemes should contain guidelines on eligibility criteria, coverage ratios, scalable credit approval mechanism, fees, payment rules, use of collateral/down-payment, and equity ratios, among other parameters.

## 6. Access to Marketing Platforms and Networks

The need for enterprises to increase market coverage, improve operational efficiencies and enhance customer engagement is imperative. However, this requires readiness on two accounts – the company and government regulation and policies including SME special programs, initiatives and funds.

## 7. Introducing Labour Law Reforms

The last few years have seen an exponential growth in the inflow of workers into the MSME sector; this says a lot about the potential MSMEs hold for national development. The presence of flexible labour laws therefore becomes increasingly critical in today's environment. Labour laws provisions such as standardized wages, social security, and job safety ensure that the workforce is protected and delivers its highest output. The MSMEs require government-led initiatives and schemes for competency and skill development to ensure SMEs don't have under-skilled workers.

## RAY OF HOPE

- i. Make in India Initiative by Government of India
- ii. E-Governance push Government of India
- iii. Improvement in Interactive platform of Inorganic Funding
- iv. Option of online marketplace through e-retailers
- v. Budgetary allocation for funding MSMEs through SIDBI and other funds
- vi. Government skill development initiative is trying to provide vocational training facilities to maximum.
- vii. Introduction of Bankruptcy Law

## V. CONCLUSION

Micro, Small and Medium Enterprises (MSMEs) contribute to economic development in various ways such as creating employment opportunities for rural and urban population, providing goods & services at affordable costs by offering innovative solutions and sustainable development to the economy as a whole.

The MSMEs continue to struggle on multiple accounts. While some are challenged by credit and finance issues, others are struggling to cope with stringent regulatory environments. The role and importance of MSME sector in the vital growth of Indian economy has been discussed in the paper. The problems MSMEs face which also

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become the reason for slow paced growth of this sector have been detailed in the paper. At the end, this paper has tried to offer some suggestions to overcome those challenges and offer a ray of hope for the MSME sector in India.

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