

EXIM BANK: RESEARCH BRIEF

Strategic Development of MSMEs: Comparison of Policy Framework and Institutional Support Systems in India and Select Countries



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INTRODUCTION

The role of MSMEs in developing and emerging economies is undisputed and is well recognized. Contributing significantly to the employment generation, poverty alleviation and rural development, MSMEs are considered to be the engine of growth, the world over. MSMEs stimulate innovative ideas / business methods, and entrepreneurial skills; they are flexible and can adapt quickly to changing market demand and supply situations; help in diversifying economic activity, and make a significant contribution to industrial development and exports. Thus, it is not surprising that the establishment and promotion of MSMEs across the globe has assumed strategic importance.

DEFINITION OF MSMEs IN INDIA

Earlier, industrial units in India, based on investment ceiling on the installed plants and machinery, were classified as small scale, and large scale units in broad terms. Within small-scale sector, there were sub-classifications such as ancillary units, tiny units, women enterprises, and small scale services and business units. The medium scale units were not earlier defined in India. However, following the enactment of Micro, Small and Medium Enterprises Development

(MSMED) Act, 2006, enterprises in India are being broadly classified into micro units, small units, medium units and large units.

PERFORMANCE OF MSMEs IN INDIA

The MSME sector contributes about 45 per cent of the manufacturing output and 40 per cent of the total exports of the country. The sector is estimated to employ about 70 million persons in over 30 million units throughout the country. There are over 6000 products ranging from traditional to high-tech items, which are being manufactured by the MSMEs in India. Analysis of performance of MSMEs in India reveals that MSMEs have performed well over the years.

The latest available data on exports by MSME sector of India is for the year 2007-08, as per the Annual Report (2011-12) of Ministry of MSMEs. In the year 2007-08, the value of exports by MSME sector was ₹ 202,017 crore, a growth of little over 10%, over the export level recorded in the previous year.

According to the Fourth All-India Census of Micro-Small and Medium Enterprises (reference period 2006-07), the size of the registered MSMEs was estimated to be 15.64 lakh units. This comprises of 67% of manufacturing enterprises and 33% of services

enterprises. About 45% of the units were located in rural areas. Of the total working enterprises (15.52 lakh units), the proportion of micro, small and medium enterprises were 94.94%, 4.89%, and 0.17% respectively. About 90% of the registered enterprises in the MSME sector were proprietary concerns, about 4% were partnership firms, and about 3% were running as private companies and the balance were owned by public limited companies, cooperatives, trust etc. Share of women enterprises in total was around 14%. According to the Census, the export value of these 15.52 lakh registered working units was ₹ 76,334 crores, which works out to 13.3% of India's total exports.

MSMEs: STRATEGIES FOR DEVELOPMENT – LEARNING FROM EXPERIENCES

Redefine the ceiling limit of medium enterprises

The MSME sector in India, with some exceptions, is characterized by low technology levels, which act as a handicap in the emerging global market. Although MSMEs play an important role in India's economic growth, be it in terms of its contribution to manufacturing value-added, exports or employment generation, not many units have ability to access technological expertise or mobilize resources for in-house innovation. Also, the cap on plant and machinery for the purpose of classifying the units as MSMEs does not encourage Indian MSMEs to move up the value chain.

It may be observed that some countries (such as EU and China) have positioned the ceiling on investment for medium enterprises at high level, encouraging capital intensiveness,

Definition of MSMEs in India		
Size of Enterprise	Manufacturing Sector	Service Sector
	Investment in plant and machinery (in ₹ million)	
Micro	< 2.5	< 1
Small	2.5 – 50	1 – 20
Medium	50 – 100	20 – 50

Country	Definition of SMEs (medium enterprises)		
	Ceiling on No. of employees	Ceiling on Turnover (US \$ million)	Ceiling on Investment (US \$ million)
India	-	-	2.0
Mexico	250	3.5	-
Brazil	250	-	-
Jamaica	50	1.73	-
Laos PDR	99	0.25	0.15
South Africa	200	6.67	2.50
Kenya	100	9.65	-
China	2000	47.67	63.56
Taiwan	200	-	2.70
Japan	300	-	3.62
Vietnam	300	-	0.5
Indonesia	100	-	-
Pakistan	250	2.75	0.3
South Korea	300	-	8.0
Malaysia	150	8.20	-
Philippines	200	-	2.3
Thailand	200	-	6.48
Singapore	200	-	12.00
Israel	100	-	-
Bangladesh	99	-	1.22
UAE	250	68.00	-
EU	250	66.76	57.40
MIGA	300	15	15
OECD	250	66.76	57.40

Source: Exim Research;

India: Ministry of MSME; Companion note for MSME Country Indicators, IFC and World Bank for the countries : China, Philippines, Vietnam, Singapore, Brazil, Laos PDR, Kenya; Japan: SME Agency, METI, Japan; Malaysia: SME Corp. Malaysia; Pakistan: Small and Medium Enterprises Development Authority; South Korea: Small and Medium Business Administration, South Korea Republic; Taiwan: Small and Medium Enterprise Administration (SMEA) of the Ministry of Economic Affairs; Jamaica: Ministry of Industry, Investment and Commerce (MIIC); Mexico: SMEs in Mexico, OECD; UAE: Mohammed Bin Rashid Establishment for SME development; Thailand: Ministry of Industry, Thailand; South Africa: Annual Review of Small Business in South Africa, Department of Trade and Industry; Bangladesh: National Manufacturing Policy 2010; EU: European Commission; MIGA: World Bank; OECD: OECD

technology upgradation, quality improvement, export orientation and employment generation. Considering the above, the ceiling on capital investment for medium enterprises in India may be increased, at least to an extent of US \$ 10 million to US \$ 12 million. The hike in investment ceiling for medium enterprises would encourage higher investments for technology absorption, quality upgradation, and export orientation.

Cluster Development Approach

It is recognized that MSMEs can achieve high levels of competitiveness if they work in a cluster environment ensuring complementarities,

common facilities, collective activities including collective sourcing and marketing. MSMEs can also achieve efficiency through collective innovations. However, it is pertinent to upgrade the clusters through strengthening of linkages and creation of value chain. These can be achieved through promotion of linkages among firms, strengthening the local position within the value chains, building cluster-specific skill centers to build a cluster-specific labour force, strengthening the linkages with the local suppliers, and facilitating greater level of interactions among the stake-holders of clusters. Even State Governments have to play a major role to promote linkages within the clusters.

Need for Focused Technology/R&D Institution for MSMEs

India has established a range of dedicated institutions to provide diverse support services to MSMEs, such as finance, credit guarantee, credit rating, and entrepreneurship development. There are also few technology-oriented institutions supporting the R&D activities in general, including those of MSMEs. However, there may be a need for a focused institution encouraging technology development and R&D activities in MSME sector in a coordinated manner. The proposed institution may identify thrust areas for research, new areas for technology application, opportunities for commercialization of R&D, and hand-holding of MSMEs in their R&D intensification.

Increasing MSMEs' Access to Finance

The availability of external finance for MSMEs is an issue of great importance to policy makers around the world. An added issue would be the availability of lending infrastructure in a country to fund MSMEs including the funding models and technology that best suit the SMEs in the country. This infrastructure may also include the regulatory framework (such as directed lending), commercial and bankruptcy laws that affect creditor rights and prudential norms, availability of specialist agencies for sharing of credit information, credit rating, and credit guarantee of SME financing. Most of these aspects are covered in India's institutional and policy framework for SME sector. However, there has been no directed lending to support the export activities of MSME sector.

Export Credit Support to MSME Sector

Export credit is not a part of mandatory priority sector lending for domestic commercial banks; while foreign banks are set with a 12% sub-target for export credit under the mandatory priority sector lending. Share of export credit, though growing in absolute terms, has been falling down in terms of its share in Net Bank Credit (NBC), over the years – from a level of 9.8% as of end-March 2000 to 4.2% as of end December 2011.

MSMEs are estimated to be contributing about 40% of India's total exports. Hence

they require enhanced level of export credit support. A Working Group constituted by the RBI (July 2008) for fixing a target export credit for MSME sector has delineated that commercial banks have extended around 38% of their total export credit to MSME sector. The Working Group further suggested that 50% of export credit of commercial banks to be provided to MSME sector as a desired target level. The export credit as a share of NBC was 4.2% as of end December 2011. Assuming that the desired level (50% of export credit to MSME sector) has been achieved by now, export credit share to MSME sector should have been around 2.1% of NBC.

The share of export credit to MSMEs should be doubled (4.2% of NBC) to support the export credit needs of MSME sector. It is suggested that RBI may consider fixing a mandatory target of 4.2% of NBC as export credit to MSME sector, under the overall priority sector target of 40%, and for foreign banks under the 12% mandated export credit target. This measure will also help improve the overall export credit to around 8.5% of NBC, if non-MSME sector is continued to get support at the same level.

Assessing non-financial parameters of MSMEs

Banks and financial institutions are generally adopting conventional lending structure and norms for MSME financing. Traditional method of credit assessment based on past financials may not be the most appropriate method of assessing credit needs of the MSME sector. The screening methodology of financing institutions needs to consider non-financial parameters and management competencies, while evaluating loan proposals from MSME units.

One such non-financial parameter is the technological competency of MSMEs. Government of Korea has instituted Korea Technology Finance Corporation (Kibo) which appraises technological expertise of SMEs thereby enabling the banks to accept technology as collateral for extending financial support. Kibo has also launched a technology guarantee services programme, which covers the losses incurred when borrowers default on loans. Such a policy measure could also be introduced in India.

Developing Mezzanine Financing in India

The market for mezzanine financing in India is not well developed; some form of mezzanine financing is available to the upper strata of enterprises, but not to the lower strata. Thus, a market for mezzanine financing needs to be developed in India, including appropriate financial tools. The Working Group, constituted under the chairmanship of Dr. K. C. Chakrabarty, the then Chairman and Managing Director, Punjab National Bank, to suggest measures improving credit flow to the SME sector, has also suggested for examining the feasibility of bringing in additional capital through alternative routes, such as equity, mezzanine/venture financing.

Access to alternate sources of capital

Alternative sources of capital like angel funds/risk capital are not available to Indian MSMEs. Access to equity capital is a genuine problem. At present, there is almost negligible flow of equity capital into this sector. Absence of equity capital may pose a serious challenge for development of knowledge-based MSMEs, particularly those that are sought to be promoted by the first-generation entrepreneurs with the requisite expertise and knowledge. Several countries have policies and programmes to stimulate equity capital in the MSME sector. Australian Government has been supporting Venture Capital Limited Partnerships (VCLPs), and Pooled Development Funds (PDFs) with tax incentives for providing equity capital to growing SME sector in Australia. Italian Private Equity and Venture Capital Association, and the Italian Business Angels Network are supported by Government of Italy for providing necessary funds, equity seed capital and start-up financing to new SME ventures. Though not as advanced as developed markets in terms of depth and liquidity, Thailand has established a Market for Alternative Investment (MAI) to enable access to capital for smaller companies. MAI serves as a much needed avenue to facilitate equity financing in Thailand SMEs.

India also needs to develop programme that would support SMEs to access alternate sources of capital. There was a felt need for developing a dedicated stock exchange for the SME sector so that SMEs can access capital markets easily, quickly and at lower costs.

Such dedicated SME exchange is expected to provide better, focused and cost effective service to the SME sector.

Promoting Entrepreneurship

Improvements in skill formation and learning mechanisms in MSME sector have a substantial impact on productivity and value addition. The task of promoting skills and entrepreneurship development cut across wide range of policy areas, institutional boundaries, both at national and global level. India should institute the skill development and entrepreneurship promotion strategy that should go beyond the public sector and its agencies, encompassing the private sector and its organizations, including academic institutions and non-governmental organizations. MNCs/large enterprises that source their requirements from MSMEs should also be encouraged to take a lead role in infusing enterprise education, skill upgradation, and management induction programmes of SMEs.

Increase the support to enhance export competitiveness of MSMEs

Indian MSMEs have harnessed the opportunities presented by the opening up of the markets, since the establishment of the WTO, and contribute a sizeable percentage to India's export basket. However, the proportional growth in exports by MSMEs that was expected to follow the reduction in tariffs and the dismantling of quantitative restrictions, has not taken place. Country experiences suggest that most of the countries have programmes to harness the export competitiveness of MSME sector. Some countries have innovative programmes that may require adaptation in India. For example: Government of Malaysia, through MATRADE, provides grant support (to an extent of RM 1 million per company/per brand) to Malaysian SMEs to develop and promote Malaysian brands, both in products and services. Government of Malaysia also provides concessional financing (maximum of RM 3 million) through Malaysia Industrial Development Finance (MIDF) to undertake branding/rebranding exercises of SMEs.

Participation in exports provides MSMEs a reliable barometer of its competitiveness and also gives exposure to global trends, new

ideas and designs. The export competitiveness of Indian MSMEs has not improved in proportion to their strengths, because the MSMEs have limited awareness regarding changing dynamics of product safety and standards requirements in the importing countries, or have limited ability to understand the technicalities of these requirements. Hence, efforts are required to create adequate awareness on the regulations that are being implemented globally.

Apart from this, role of packaging in exports has also gained much significance in view of trends in the world markets. The need for better and scientific packaging for exports from MSME sector has been recognized since long back. With a view to acquaint MSME exporters of the latest packaging standards, techniques etc. training programmes on packaging for exports need to be organised in various parts of the country to generate the much needed awareness in the industry and to help educate the entrepreneurs regarding the scientific techniques of packaging.

Promoting Synergy

In most of the countries, there is a tendency of keeping a 'decentralized arrangement' for MSME development, which is the case too in India. It is essential to achieve integration with regard to institutions and programmes, in order to achieve desired outcomes. Thus, the requisite mantra should be 'achieving synergy' in the various programmes and institutions meant for MSME development. This means that when introducing new programmes/institutions synergy should be reinforced with the existing offerings. In all cases, duplication of existing delivery mechanism and institutional support system may be avoided.

Exit Policy for MSMEs

An exit route for non-viable units is necessary to manage industrial sickness in MSME sector. As on March 2011, the number of units identified as potentially viable as a percentage

to total sick MSE units is only around 8%, while the number of units placed under nursing as a proportion to the total number of sick units stood at only around 5%. The remaining units are considered to be unviable sick units.

Business failure in India is viewed as a stigma, which adversely impacts individual creativity and development in the country. Keeping these aspects in mind, many countries have put in place mechanisms to handle insolvencies and bankruptcies for the industrial units, in general. The present exit policy for firms in India is archaic. The existing legislations may have to be toned up so as to provide for efficient liquidation of non-viable businesses.

Strengthening Sub-Contracting Relationships

In general, several Governments have been giving special treatment for MSMEs when it comes to public procurement. However, dealing with Government may be expensive for MSMEs as there are challenges associated with understanding procurement guidelines, and procedural delays. In this context, it may be recognized that the sustainability and growth of MSMEs would largely depend on their capacity to become part of the strategies of larger firms in the global and national arena. This is particularly important for technology oriented MSMEs, which serve as sub-contractors for large enterprises in sectors such as IT, biotech, pharmaceuticals, light engineering, electronics and auto components. Strategies to establish and strengthen linkages between MNCs and Indian MSMEs are critical in this context. MNC-MSME linkages may not be misconceived with the foreign direct investments in MSMEs. MNC-MSME linkage means improving the flow of information about supply opportunities and persuading MNCs to develop 'MSME-friendly' tendering policies. MNCs may also be encouraged to assist MSMEs to upgrade them to meet the quality standards that may be required by them. Government may consider working with MNCs, donor organizations, and other such intermediaries to develop capacity

building programmes for MSMEs, and facilitate backward linkages and other positive spillover benefits.

IN SUM

Institutional framework and policy specifications are important factors in helping the evolution and success of SMEs across the globe. Many countries have a range of programmes in diverse areas of SME development, viz., financing, technology, innovation, managerial ability, market information, and developmental assistance, aimed at improving the working environment for SMEs.

In the context of India, MSME development requires a cross-cutting strategy that touches upon many areas, which can help the sector to improve and create a niche for itself in the Indian economy. Gaining from the experiences of other countries, India needs to suitably adapt its approach, policies and programmes for MSME development, and implement a set of measures to enhance the potential of this sector.

The contents of the publication are based on information available with Export-Import Bank of India and on primary and desk research through published information of various agencies. Due care has been taken to ensure that the information provided in the publication is correct. However, Export-Import Bank of India accepts no responsibility for the authenticity, accuracy or completeness of such information

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