


MSMEs

## Unlocking the Dynamism of MSMEs and Start-Ups for Industrial Transformation

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This policy brief is based on the presentation and discussion of the Plenary Session, *Unlocking the Dynamism of MSMEs and Start-Ups for Industrial Transformation* in the National Conference, “Towards Industrial Transformation of India: Building an Inclusive, Sustainable and Competitive Manufacturing Sector to Realize the 2047 Vision”, organized by the Institute for Studies in Industrial Development, New Delhi, October 4-6, 2023. The session was chaired by **Mr Ram Mohan Mishra**, Chairman, Meghalaya Investment Promotion Board and formerly Development Commissioner, Ministry of MSMEs, Government of India. The distinguished panelists include **Prof M H Bala Subrahmanya**, Indian Institute of Science, Bengaluru; **Prof Keshab Das**, Kalinga Institute of Industrial Technology (KIIT) University, Bhubaneswar; **Prof R Nagaraj**, formerly Indira Gandhi Institute of Development Research (IGIDR); **Dr Radhicka Kapoor**, Indian Council for Research on International Economic Relations (ICRIER); and **Mr Mukesh Gulati**, Executive Director, Foundation for MSME Clusters (FMC). The YouTube link of the policy roundtable is available here. 

In India, around 63.9 million firms are categorized as micro, small and medium enterprises (MSMEs) as per an estimate based on the 73<sup>rd</sup> round survey of unincorporated non-agricultural enterprises conducted by the NSSO in 2015-16. Apart from being pivotal in value chains, they contribute significantly to the gross domestic product, employment, and export of the country. The industrial landscape of MSMEs in the country is very complex and heterogeneous in terms of products and services, size, operation, ownership, linkages, and market access. Furthermore, the majority of MSMEs are in the informal sector which restricts their accessibility to government policy support initiatives. These firms are engaged in the production of over 6,000 products. The sector faces challenges for its growth and survival primarily in terms of low financial accessibility, low productivity, obsolete technologies, lack of demand, lack of skilled workforce, and low awareness, among many others. The criticality of these challenges varies across sectors and over time.

### ***Firm landscape in India is dominated by smaller firms***

Among the 63.9 million MSMEs, around 99.47% are micro enterprises, around 0.52% are small enterprises, and merely around 0.01% are medium enterprises. As per an estimate based on a combined dataset of unincorporated non-agricultural enterprises and formal enterprises from the Annual Survey of Industries, more than 95% of enterprises have less than 5 workers. After dropping the own account enterprises from the combined dataset of enterprises, over 90% of enterprises operate with less than 10 workers. Thus, the industrial landscape in the country is dominated by the smaller firms.

### ***MSMEs' definition dis-incentivize small firms to grow large***

Many studies in the Indian, as well as global context, show government support is critical for the survival and growth of the MSME sector.

In general, government support measures are based on primarily the size of the firms. Presently, Indian MSMEs are defined in terms of composite criteria of investment in plant and machinery including equipment, and turnover excluding export. Firms fear losing access to government support if they cross the limits of criteria for MSMEs. It acts as a disincentive for them to grow.

### ***The functioning of MSME clusters is complex and dynamic***

The functioning of large firms and MSME clusters are different. The design of a large firm is the agglomeration of different small firms (that is, production department, marketing department, finance department, sales department, purchase department, and so on) being controlled by a single authority, the CEO. A cluster is a group of different independent small enterprises engaged in activities that are similar to different departments of a large firm. Being not controlled by a single authority, a cluster functions based on organic relations among different independent enterprises meeting the needs of each other through making them partners in their collective growth. This relationship is more complex, interdependent, and dynamic. The clusters are formed locally to cater to business opportunities by utilizing strategic and comparatively advantageous local resources. Therefore, one MSME cluster is different from another even though they are primarily engaged in similar kinds of activities. The complexity and dynamism of MSME clusters require a micro and localized approach to address their concerns.

### ***Localized institutional support is critical for the survival and growth of the sector***

Some Asian countries like Japan, Malaysia, and Thailand have developed incentive systems around the idea of one-village-one-product, or one-Tambon-one-product to promote their rural products in the global markets. To promote the local rural economy through e-commerce, China is providing 5G high-speed internet connectivity in remote rural areas and has enabled village entrepreneurs to have access to national and global markets

through the Taobao online retail platform. Rural producers of both goods and services can sell their products and services without the presence of any intermediaries and are getting a good price for their products and services.

In India too, state intervention has played a significant role in enhancing the competitiveness and survival of MSMEs. For example, the state government's improved business support infrastructure in the Morbi ceramic cluster in Gujarat through investment in buildings and roads, and faster connection of the cluster to the Mundra Port has enabled enterprises in the Morbi clusters to compete with Chinese firms in terms of production and export. In the Athani cluster in Karnataka, massive investment in product innovation with the intervention of local NGOs and support from Central Leather Research Institute has resulted in bringing out more than 600 designs of boots and 'Kolhapuri' chappals leading to selling not only in the domestic market but also in the foreign markets. In the Sujni quilt cluster in Gujarat, with a huge base of power loom units, the MSME Ministry's common facility center has helped enterprises to enhance their performance. These successful examples of localized government policy intervention highlight the criticality of local institutional support for the growth of the MSME sector.

## **Major Impediments in the Growth of the MSME Sector**

### ***Poor Official Statistics about the MSME Sector***

In 2024, the availability of the latest MSME census is for 2006-07. The latest NSO survey of unincorporated enterprises, on which most of the MSME statistics are based, is for 2015-16. There is no data on product-wise export from the MSME sector at least since 2008-09. To date, merely 25-30% of enterprises have registered on the Udyam registration portal which gives some statistics about registered MSMEs. The majority of the firms operate in the informal sector. Similar to the MSME sector, official statistics about artisan and craft products are also in a poor state.

Due to the data limitations, there is little or no information about how MSMEs graduate across categories or sizes (that is, growth of a firm from micro enterprise to large enterprise). Because of disincentive to grow and other constraints, the majority of firms remain in the same MSME category for a long time. However, a few of them graduate over time and transform themselves from micro enterprise to small enterprise, small enterprise to medium enterprise, and medium enterprise to large enterprise. Such small dynamic transformative enterprises need more policy attention due to their changing growth requirements. The lack of reliable official statistics makes it difficult to identify and support such enterprises.

### ***The Indian startup ecosystem is in the evolving phase***

India has the third-largest ecosystem in the world. This database is debatable because we have only statistics for the number of startups that have been established and we do not know how many startups are operating at any particular point of time. As per some studies, about 90% of tech startups died in the very first five years, about 50% in the very first year and another 40% in the subsequent four years. Further, none of the six major startup ecosystems in Bangalore, NCR Delhi, Bombay, Hyderabad, Pune, and Chennai have attained maturity. The four phases of growth of the startup ecosystem are infancy, evolving, maturity, and self-sustainable. All the six major startup ecosystems are only in the evolving stage. Our startup ecosystems are yet to give a signal of maturity and self-sustainability.

### ***MSMEs lack skilled people and high-quality management professionals***

MSME sector, particularly the manufacturing enterprises lack skilled persons which severely hinders their progress and prosperity. Courses on diploma and graduation in technology have greater orientation towards larger firms. Further, MSMEs also struggle to get high-quality management professionals. Universities and colleges are essentially churning out managers or MBAs for large firms. There are no such programs for either

small enterprises or MSME clusters. Business schools simply produce management graduates based on whatever business model or management education model that has emerged in the West and mostly directed towards the Fortune 500 companies or the large firms while the challenges and constraints faced by the MSMEs are distinctly different from the problems faced by the MNC sector. Thus, MSMEs are not able to get high-quality management personnel.

### ***Lack of physical infrastructure***

The physical infrastructure of clusters like road, rail, air, and port connectivity is necessary for the availability of raw materials and supply of products and services. It reduces the logistic costs of firms. The availability of an uninterrupted and cheap energy supply boosts the firm performance. Government support for physical infrastructure in the Morbi ceramic cluster has revived the cluster and enhanced its competitiveness globally. However, in most industrial clusters, physical infrastructure is practically frozen in the pre-reform period. Very little improvement in it has happened during the last few decades. Changes in nomenclatures and rebranding of State support have done little to promote MSMEs.

### ***Low productivity and informality in the MSME sector are interlinked***

The low productivity of MSMEs is one of their major problems, among many. The sector is dominated by smaller firms, that is, micro enterprises which are highly heterogeneous, and diverse and operate mostly in the informal sector. Given the low productivity, MSMEs lack the potential to grow and expand. It acts as a disincentive for them to formalize. For them, there are few benefits of formalizing than the cost of regulatory compliance. Thus, the low productivity of MSMEs is linked to their high informality.

### ***Declining financial support to the MSME sector***

Low financial availability or high cost of credit is still a major impediment to the growth of the MSME sector despite many policy initiatives. In reality, credit problems

to the MSME sector increased from 2010-11 to 2015-16 as per estimates from an unincorporated enterprise survey conducted by NSSO. An ISID study based on a primary survey of around 271 firms located in UP and NCR in 2019-20 also highlights that MSMEs' credit problems have further worsened. Although banks follow guidelines of priority sector lending for the MSME sector, they have a higher preference for relatively larger firms in the MSME sector indicating higher credit problems for relatively smaller firms. RBI statistics also indicate a decline in financial support to the MSME sector. The average loan size under the much celebrated MUDRA scheme, started in 2015-16, has also gone up suggesting these are more of the relatively larger of the small firms that have been taking these loans.

### ***Lower internationalization and penetration in the global value chains***

Though the MSME sector contributes around 50% of the total exports of the country, the number of MSME exporters is pretty negligible. A significant number of them are intermittent exporters. The majority of them are non-perennial exporters. They enter the export market only when it is favorable to them, otherwise not. Further, as per some statistics, about 80% of international trade is accounted for by the global value chains of MNCs. It indicates lower internationalization and lower penetration of Indian MSMEs in the global value chains.

## **Policy Suggestions to Unlock Potential of the MSME Sector**

### ***Conducting annual surveys of MSMEs and preparing a longitudinal database for the sector***

To assess the complexity and dynamism of the growth of the MSME sector, there is a need for an annual survey of MSMEs, similar to the Annual Survey of Industries, and to prepare a longitudinal database of the sector. A nationwide network of District Industry Centers can be mobilized for this purpose. Along with covering both manufacturing and service enterprises separately, it should

also include information related to entry and exit, products, selling destination, workforce, formality, awareness, and digitalization among many others.

### ***Preparing cluster grid database for MSMEs***

In addition to conducting the annual survey of MSMEs, there is a need to prepare a Cluster Grid Database for the MSME Sector. It will be a kind of interactive database for the MSMEs and MSME clusters which may be used by policymakers and scholars for assessing their growth, viability, and financial health. It may be used for appropriate and timely policy intervention.

### ***Splitting micro enterprises among sub-groups***

More than 99% of the MSMEs are micro enterprises while less than 1% represent small and medium enterprises (SMEs). Operating mainly in the informal sector, the majority of them are very small and operate primarily with the objective of subsistence. These enterprises are highly heterogeneous, complex, and localized. Further, among micro enterprises, a small fraction is formal and transformative towards larger firms. Therefore, there is a need to split micro enterprises among different sub-categories so that relevant policies can be designed for each sub-category to foster the growth of the MSME sector as a whole.

### ***Skilling youth through collaboration***

MSMEs lack a skilled workforce and trained professionals. A collaboration between MSME associations and ITIs should be promoted and an appropriate syllabus for diploma/certificate courses should be designed to train youth, including both students and existing laborers to skill and reskill them. To increase the availability of high-quality management personnel, an exclusive PG program on MSME management should be rolled out by MBA Colleges, Universities, and Institutes.

### ***Encouraging technological innovations through linking MSMEs and engineering institutions***

MSMEs, in general, do not fully recognize the significance of innovation. Being dominated by informal and micro enterprises, the majority of MSMEs innovate and adopt by and large Jugaad technologies. To promote and foster technological innovations in the MSME sector, MSMEs/industry associations should link with engineering institutions. Engineering graduate students should be encouraged through their projects and assignments as part of their course/curriculum activities. It will be mutually beneficial as academia gets live problems and industry gets cost-effective solutions. Peenya Industrial Estate and IISc model has already set an example for it.

### ***Setting up more entrepreneurial universities***

Since all six major startup ecosystems are in the evolving stage, there is a need to foster and strengthen their growth. Encouraging and setting up more entrepreneurial universities can be an effective step in this direction to give a signal to the global market. As an example, lessons may be taken from the entrepreneurial university ecosystem of IIT Madras – Research Park and Center for Innovation of IIT Madras. Similar initiatives may be taken in other IITs, NITs, IISERs, IISc, and universities/institutes of national importance.

### ***Encouraging returning entrepreneurship***

Returning entrepreneurship plays a very significant role in the entrepreneurial activities in the country. Returning entrepreneurship refers to Indians who have gone abroad to any part of the developed world either for higher education or employment for a minimum period of two years and they would have come back now. They are significantly different from domestic entrepreneurs because they possess superior knowledge capital, superior social capital in the international context, superior financial capital, superior manager skills, and entrepreneurial skills. Due to these advantages, they tend to be involved in truly innovative projects with the global market as

the target. In China, they have an exclusive science research park to promote returning Chinese entrepreneurs. Therefore, there is a need to encourage returning entrepreneurs in the country by providing a conducive ecosystem for them.

### ***Promoting the FDI-MSME ecosystem for the internationalization of MSMEs***

In India, the number of MSME exporters is very negligible. The majority of them are intermittent and non-perennial exporters. In other emerging economies and even developed countries, the percentage of MSME exporters varies from 10-35%. There is a need to encourage at least 10% of our manufacturing MSMEs to enter the international market. In general, manufacturing MSMEs enter the export Market because of their local MNC customers. FDI-MSME ecosystem should be explicitly encouraged in our country. Thus it will also foster penetration in the global value chains by the Indian MSMEs.

### ***Need for well-designed local-level state promotion efforts***

MSMEs clusters are diverse and localized in nature. MSMEs clusters engaged in similar activities may face different constraints and challenges. Therefore, state support should be localized and context-specific. The significant positive impact of localized government support in the case of Morbi ceramic cluster, Athani leather cluster, Tirupur garments cluster, and Sijni quilt cluster are a few examples in India. Therefore, there is a need for well-designed local-level State promotion efforts to strengthen the entrepreneurial ecosystem for MSMEs in the country.

### ***Machines and equipment should be input and product-specific for each unit/cluster***

The emergence of MSME clusters is primarily based on their strategic local resources and strategic competitive advantage. Even for similar products, the quality and features of natural resources also vary due to geographical conditions. Therefore, it requires variations in the Machines and equipment of each MSME unit/cluster

should also be input and product-specific. It also indicates the need for hyper-local technological solutions in some cases to foster the growth of local MSMEs. To support locally required technological innovations, their providers should also be incentivized.

### ***Strengthening industry associations for local solutions***

Since MSMEs' challenges are localized and contextual, it might be difficult to get relevant and timely solutions for their problems. There is a need to strengthen Industry Associations to bring out local solutions, build linkages between large and small firms, enhance awareness, and generate social capital to support their business activities.

### ***Enhancing access to financial products***

Given the declining financial flow to the MSME sector or increasing credit problems of the sector despite many policy initiatives by the government, there is a need to find alternative solutions to address the credit gap in the sector. MSMEs have very limited access to the financial market. Insurance services availability to micro and small enterprises is very dismal. There is a need to enhance access to equity, angel funding, impact funding, and insurance services for the MSME sector. CSR funding can also be directed towards supporting micro enterprises.

### ***Use of artificial intelligence in monitoring the financial health of a firm and providing timely support for its survival***

One of the major reasons for the low preference for relatively smaller firms in providing credit by banks is the higher risk of becoming non-performing assets (NPAs). A loan becomes an NPA if the interest or principal remains overdue for a period of 90 days. Banks may use artificial intelligence to monitor the financial health of a firm and provide timely support for their survival. With appropriate regulations, artificial intelligence may be used for this purpose. There is a strong need for designing such technology-based modules in the banking system to reduce the risk of NPAs in the MSME sector. It will also

help in the timely identification of financially vulnerable units before their transformation into sick units.

### ***Creating business infrastructure for MSMEs***

Business infrastructure for MSMEs is poor, except in a few cases. The majority of MSME clusters have good roads, rail/air/port linkages, uninterrupted power supply, facility centers, etc. Further, last-mile connectivity of MSMEs/clusters should be strengthened through boosting infrastructure support at the ground level. It will reduce their logistic cost significantly. Creating appropriate business infrastructure for the MSME cluster by considering their local needs may enhance their productivity, competitiveness, and overall performance.

### ***Creating a knowledge-sharing hub for MSME entrepreneurs***

Majority of the micro enterprises, particularly tiny industries, are own account enterprises. Some of them have successfully grown over time despite lesser odds for their survival. A knowledge-sharing hub can be created for such entrepreneurs to share their knowledge and train young entrepreneurs.

## **Conclusions**

Given their significant role in industrial production, GDP, export, employment generation, and promoting regional development, the growth of MSMEs is crucial for the industrial transformation of the Indian economy. Being represented by largely smaller firms, the MSME sector is highly heterogeneous, complex, and dynamic. The lack of official statistics hinders developing a clear understanding about the sector. Despite many policy initiatives, the sector faces challenges for its growth and survival primarily in terms of low financial accessibility, low productivity, obsolete technologies, lack of demand, lack of skilled workforce, and low awareness, among many others.

For unlocking the growth potential of this dynamic sector, a comprehensive policy framework is needed which should include an annual survey of MSMEs, preparing cluster

grid database, splitting micro enterprises from SMEs, ensuring availability of trained and skilled workforce/professionals, fostering collaboration between MSME associations and institutions/colleges/universities, focusing on local technological and policy solutions,

creating and improving infrastructure, promoting last mile connectivity, enhancing financial accessibility and financial products services, and promoting FDI-MSME ecosystem and returning entrepreneurship, among others.

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