Background Note on the Micro, Small and Medium Enterprise Development Act 2006

The micro, small and medium enterprises sector comprises 50% of India's total manufactured exports, 45% of India's industrial employment, and 95% of all industrial units in the country.[1] Despite its importance, the MSME sector has long faced extreme obstacles in accessing finance and markets. Some of these obstacles include inability to access finance and working capital loans from banks, inability to access capital from other sources, mistreatment by larger procurement companies, difficult bureaucratic procedures for registration, and lack of management skills. The increasing availability of cheap foreign imports has further hindered the development of Indian micro, small and medium enterprises. These obstacles have compelled the MSME lobbies and the Government of India to develop government intervention to ensure the continued growth and success of MSMEs.

The Government of India passed in June 2006 an act regarding the Micro, Small, and Medium Enterprises. The Micro, Small and Medium Enterprise Development Act 2006 (MSMEDA) was the product of a consultative process involving over 300 industry associations, government bodies, and multiple stakeholders across India. The Act accomplishes many long-standing goals of the government and stakeholders in the MSME sector.

Accomplishments of the Act

First, the Act establishes the necessary structure for overseeing and regulating the development of MSMEs in India.[2] The entire structure and composition of the National Board for Micro, Small & Medium Enterprises is clarified in the Act. The Board's duties and long-term objectives—managing Cluster development, training entrepreneurs, developing infrastructure, and promoting financial access—is clearly stated in the Act. The Act ensures that diverse representatives from government, industry, financial, and civil society interests sit on the Board and Advisory Committees.

Second, the Act decisively defines the MSMEs by the level of by Plant and Machinery (P&M) investment.[3] This eliminates any lingering confusion over the category to which a business belongs. The categorization also makes allowances for the inherently smaller investments of Service enterprises. The new definition has expanded the P&M limits; now each enterprise level encompasses larger investments than before. The new categorization is as follows:

Micro Manufacturing:	P&M Less than 25 lakhs	Micro Service:	P&M Less than 10 lakhs
Small Manufacturing:	Less than 5 crore	Small Service:	Less than 2 crore
Medium Manufacturing:	Less than 10 crore	Medium Service:	Less than 5 crore

Third, the MSMED Act simplifies the registration process for new MSMEs.[4] The previous time-consuming process has been replaced by a simpler Filing of Memoranda. The previous system discouraged many enterprises from formalizing; it is hoped that this simpler process will encourage the formalization of previously informal enterprises. The new process should relieve the

---

[1] http://www.wasmeinfo.org/pdf/Presentation%20by%20Dr%20J%20S%20Juneja.ppt
[2] MSME Development Act 2006, Section 3.
[3] Section 7 (1).
[4] Section 8.

administrative burden of the District Industry Centres (DICs) so that they may focus on encouraging MSME growth.

Fourth, the Act substantially increases the penalties for late payments.[5] One major constraint on MSMEs has been a lack of working capital; often this lack of capital stems from the tendency of many larger companies to delay payments to smaller suppliers. The Act aims to impose more stringent deadlines for such companies to ensure a smoother cash flow to MSMEs.

Fifth, the Act sets the agenda for specific policies that it will create and implement in the future. One such policy is a Procurement Preference Policy, which will guide government bodies on how much of their supplies should be purchased from MSMEs.[6] Another future policy is Close of Business, or Exit Policy, which will regulate the liquidation of sick or weak units.[7] Sick units have become a major problem in India, so this policy aims to absolve many of these units.

Discussion Points

There are several lingering debates regarding the Act and the future goals of the Government of India in developing the MSME sectors. Out of these debates have come more proposals for the Government's consideration.

First, the expansion of the P&M limits expands the priority sector. Banks have to lend up to 40% of their portfolio to the priority sector, but many banks already picked the safest borrowers, which are often larger companies with better financial statements and documentation. The expansion, while adjusting for the increasing economic power of India's businesses and inflation, has an adverse effect on the most vulnerable of India's small businesses. In effect, the new inclusion of *larger* medium enterprises effectively crowds out the smallest enterprises from priority lending. The Indian Federation of Tiny Enterprises (IFTE) proposes that tiny, small, and medium enterprises each have their own separate priority packages so that the tiniest are not crowded out by the biggest.[8]

Second, Indian businesses with net worth of less then 10 crore cannot access the stock market, and therefore cannot access capital easily. Larger businesses that can access capital markets can bargain with banks for interest rates lower than the Prime Lending Rates (PLR). MSMEs without alternative access to finance are often forced to borrow at rates higher than the PLR. The Federation of Small and Medium Enterprises (FOSMI) proposes that banks cannot lend higher than PLR to MSMEs.[9]

Third, the Act notes the need for Procurement Preference Policies, but such policies are not specified yet. The Federation of Association of Cottage & Small Industries (FACSI) proposes that separate preference policies be instituted for micro or small (as opposed to medium) enterprises, to guarantee their products will be procured by government and state bodies.[10] Many women's organizations argue that of the preference policies granted to MSMEs, a specific portion of those preference quotas should go to women-run enterprises.

Fourth, there are vigorous legal debates regarding the upcoming Closure of Business (CoB) policy. Such debates typically argue either that an expedient closure process can ensure that inefficient investment is redirected to more efficient businesses, or, on the other hand, that CoB should remain restricted to prevent mismanagement and irresponsible business practices. There are also debates on who takes priority in CoB cases (owners, shareholders, employees, etc).

---

[5] MSMEDA, Sections 14-24.
[6] MSMEDA, Section 11.
[7] MSMEDA, Section 25.
[8] http://www.csmworld.org/public/PDF/ifte.pdf
[9] http://www.csmworld.org/public/PDF/fosmi.pdf
[10] http://www.csmworld.org/public/PDF/facsi.pdf

Fifth, the Act lacks substantial labor policy. While some stakeholders propose that the Act should include provisions for more flexible employment policies,[11] many others also argue that the Act should regulate or encourage better labor practices such as minimum wages, employee benefits, and stable employment environments.[12]

Sixth, the 11th Five Year Plan which passed last year stated that the government will promote female entrepreneurs. However, no such provisions are made in this MSME Development Act. Some organizations, such as the Centre for Social Movements (CSM), assert that women entrepreneurs face multiple obstacles to finance, market, and information access, and therefore, the government and the MSME Development Act should be involved in helping remove these obstacles. One example is through reshaping the Procurement Preference Policies, while another policy could be the creation of Special Economic Zones (SEZs) that include shared facilities for female employees/ businesswomen, such as daycare or crèche. To address information gaps the government could examine the potential of establishing one window interfaces so that entrepreneurs with many obligations (including men) have one access point to receive information and direct questions.

Conclusion

The Act marks a milestone in the development of India's MSME sector. The forum for discussing the MSME development now exists; now all stakeholders are encouraged to, and indeed responsible for, continuing the dialogue created by the Development Act.

The Small Enterprise Finance Centre (SEFC), a research centre at the Institute for Financial Management and Research (IFMR), researches small enterprises' formal finance access and examines obstacles preventing the development of the small enterprise sector. Examining the implications and impact of the MSME Development Act is thus an important activity for the Centre; SEFC also hopes to work with stakeholders on how to improve and implement the Act and the government's future policies on MSMEs.

Jessica Wade, Research Associate
Small Enterprise Finance Centre

[11] http://www.csmworld.org/public/PDF/fosmi.pdf
[12] http://www.ilo.org/dyn/empent/empent.Portal?p_prog=S&p_subprog=JQ