India’s micro firms face a credit squeeze

In a way, the government has excluded the entire non-formal sector from the new definition and is telling firms to either formalise or perish. **(Photo: Raj K Raj/Hindustan Times)**

- The Centre has reclassified the definition of what constitutes a small and micro enterprise. Will it help or hurt them?
- When the limits are increased so drastically, we are providing a large inlet of firms that were otherwise not considered small or medium. This is bound to crowd out the smaller players

BENGALURU : Amid the farm sector debate, a recent notification by the government of India on the Micro Small and Medium Enterprises (MSME) went largely unnoticed. These circulars were issued in light of the announcements made by Finance Minister Nirmala Sitharaman on the reclassification of what could be considered under the category of MSMEs.

In doing so, the notifications may address the issues pertaining to small and medium enterprises, but completely leave aside the concerns of the micro enterprises. This, of course, provides a trigger to ask some fundamental questions about the nature of the Indian economy: Why do small firms stay small in India and often never acquire the necessary scale to improve productivity levels? What are the legal and regulatory hoops that a small firm has to jump through? And might it help if government policy on micro and unincorporated enterprises is distinctly different from all incorporated entities?

With the new notifications, the definition of MSMEs has moved beyond a pure investment criterion to a dual criterion of investment and turnover. Based on the investment criteria, what used to be the upper end in the definition of a medium enterprise—a firm with an investment of ₹100 million (in plant, machinery or equipment)—is now defined as a small enterprise. A firm having an investment of up to ₹500 million would now become the newly defined 'medium' enterprise.

But the most important category of firms, which require particular attention, may be the micro enterprises. Given the preponderance of extremely small firms in the Indian economy, a micro enterprise would now cover a whole range of enterprises, from the roadside pakodawalla to a firm that has an investment of up to ₹10 million (the limit used to be ₹1 million or ₹2.5 million, depending on whether the company was involved in services or manufacturing sector activity, respectively).

On the face of it, the policy objective looks laudable—it facilitates the growth of smaller enterprises to larger sizes without the fear of losing privileges because of growth. But do the benefits still hold on closer scrutiny? When the limits are increased so drastically, we are providing a large inlet of firms that were otherwise considered large to come into the category of small and medium enterprises and a very small growth outlet. It is very unlikely that a firm at the upper end of the extant limit of ₹100 million would overnight grow to a ₹500 million firm, but an erstwhile firm having an investment ₹500 million and already in the open market is now entering the protected environment of a "growing" firm.

It is not only eligible for loans through the banking system under existing targets for the priority sector, but can also participate in the government procurement system which is reserved for MSMEs. This is bound to crowd out the smaller players. Of course, the fittest have to survive and the weak have to be squeezed out. The quest for formalisation and efficiency takes us there.

Small is big

The 73rd round of the National Sample Survey (NSS) estimated the total number of unincorporated, non-agricultural enterprises to be around 63.4 million and these were employing 111.27 million persons, a large number of them being run solely by the entrepreneur.

The own account enterprises—that did not hire external labour on a regular basis—were 53.3 million. Of these enterprises, 96% were sole proprietaries and about 2% were partnerships, the rest being trusts and other forms of associations. Of the total number of own account firms, around 69% of the enterprises did not have any form of registration. Thus, we are talking of a fairly large number of establishments, livelihoods, and families which depend on these livelihoods.

Now, here's the issue. Apart from the new definition of MSMEs which the government has come up with, the Reserve Bank of India (RBI) and the banking system have their own internal definitions on who qualifies for certain types of credit.

In the case of microfinance, the RBI has indicated that a loan of less than ₹125,000 which is lent by a specialised institution registered as a Non-Banking Finance Company-Microfinance Institution (NBFCMFI) would be considered as microfinance (subject to some other conditions being met). In the case of Small Finance Banks (SFB), the RBI has indicated that 50% of the portfolio should consist of account sizes of less than ₹2.5 million, thereby, providing its definition of “small" as ₹2.5 million in an SFB.

MUDRA has provided its definition of what micro-units are by breaking up the loan limits up to ₹50,000 as Shishu, ₹500,000 as Kishore and ₹1 million as Tarun.

As far as the priority sector lending norms are concerned, the RBI requires the banks to lend 40% of their Adjusted Net Bank Credit (ANBC) to listed sectors that are notified, of which MSME forms a part. For the purposes of the targets, there is a hard target of 7.5% of ANBC to be achieved by lending to micro enterprises. A hard target would imply penalties on non-achievement of the targets, unlike a soft target for, say, weaker sections where there are no penal clauses.

The definition of what constitutes a micro enterprise is now pegged to the notification issued by the government of India on 26 June, 2020. This definition is in conformity with the rather liberal revised investment and turnover sizes discussed above. In this case, a micro-enterprise is one which could have an investment of up to ₹10 million (or a turnover of ₹50 million), a far-removed limit from the other markers and definitions discussed above.

Register or perish

While we have argued that these limits would crowd out the smaller loans, let us park that argument for a while and look at how these will be operationalised. The limits on investments and turnovers are broad specifications, but the eligibility for being a recognised enterprise that is entitled to these benefits would require a registration under the Udyam registration portal.

From the NSS data, we find that 69% of the informal sector enterprises do not have any form of registration anywhere. While the portal in a different form has been in existence from September 2015, the total registrations in the portal as of June 2020 was about 16% of the enterprises estimated by the NSS.

So, there is a big gap of people who are already falling through the cracks. Now, a further rub: The requirement is that not only should every enterprise register on the Udyam portal, even those who have registered will have to re-register in order to be recognised as an enterprise to qualify for a loan under the priority sector lending norms.

The registration process involves some documentation which most likely the informal sector would not have: a PAN Card, a GST Registration number, and an Aadhaar number which is mandatory. There could be one identification and unique number based on the registration and all activities would be mapped to one of these identity documents and de-duplicated. Unless the enterprise/entrepreneur is registered on this portal, she is not recognised for the purposes of priority sector lending norms.

In a way, with the RBI outsourcing the definition of a micro enterprise to a gazette notification and that notification imposing additional layers of compliance, the entire informal sector would now be excluded from the discourse. Or they would be excluded at least until the neighbourhood pakodawalla goes to the portal and uploads his documents.

Let us assume that this is also achievable. There is a further rub: The portal explicitly excludes wholesale and retail traders from the classification and, thus, from registering. Again, NSS data tells us that of the 63.4 million unincorporated entities, 19.96 million entities are classified as involved in trade. That is the largest chunk of micro enterprises. So, they are effectively left out of the definition, registration, credit facility and procurement processes.

We go in circles

So, theoretically, an MFI can lend to these micro-enterprises. And loan to an MFI is reckoned as a priority sector loan, provided that the end use is established via the definition and process criteria, which takes us back to the Udyam Portal! If you are an SFB—an MFI in your past avatar—it is unlikely that the portfolio you specialise in would qualify under the Udyam portal registration.

In a way, the government has excluded the entire non-formal sector from the new definition and is telling firms to either formalise or perish. The first step towards formalisation is an Aadhaar number which throws out a one-time password (OTP). The next step is mapping the Aadhaar number with all the enterprises (formal or informal) on the Udyam portal and then seeking other details such as PAN and GST.

So, welcome to the new Assam and the new National Register of (Corporate) Citizens for informal enterprises, where India UnInc becomes India UnWelcome.

Now, the pakodawalla outside the office of a news channel has created an enterprise, but cannot scale up unless he gets the documentation props. He is seen as inherently risky and now the banks do not even get regulatory forbearance for lending to him under the new priority sector lending norms.

So, he has to stay put without scaling up due to entry barriers in the rationed credit market. Was this the intent of the FM? I would like to grant her the benefit of the doubt and say that possibly she did not realise what would be done to please her. Data collection and Aadhaar linking is an obsession of this government and you should not blame anybody for attempting to do that. The enthusiasm of this government in collecting and linking data is only matched by its reluctance to share any data with anybody.

The way forward

So, is there a viable way to protect small firms? What can be done now?

The RBI can have a mind of its own and define micro enterprises according to the parameters it has established for MFIs and SFBs for the purposes of classification of priority sector norms. Peg it to Mudra norms if they really need to outsource!

Otherwise, the government can create a new category of nano enterprises and pat itself on the back.

This could be for unincorporated enterprises who have an investment of up to ₹1 million and a turnover of up to ₹2.5 million and this amount could be the lower end of micro enterprises. The registration requirement for informal enterprises up to this limit could be exempt and a Udyam registration could be made mandatory on breaching this limit.

Or, one more option is to just fall back on a Mudra registration which could be initiated without the requirement of any elaborate documentation. Much like banks have a minimal Know Your Customer (KYC) norm for a no-frills account, these nano enterprise registrations could come without any strings (or frills). Pegging it with Mudra-type conditionalities will ensure that the informal sector would be alive and kicking.

Unfortunately, none of the above may ultimately be considered. In our enthusiasm to formalise and collect data, the state will not give up on any of the conditionalities. This would mean that the loan books would move upwards toward larger firms, and the small and informal sector will be completely squeezed out.

After all, the pakodawallas have to be formalised; they need to be released from the clutches of informal moneylenders and be made a part of start-up India and made to stand up for India. But that will happen only after a venture fund makes a substantial investment in the business of the pakodawalla. Till then, we can wait in anticipation of Godot.

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