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WORKING PAPER: NEED FOR DEVELOPING A NEW TAXONOMY FOR MSME- CASE FOR NANO ENTERPRISES

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APRIL 13, 2022

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Chapter 1: Introduction

A significant part of the Indian industrial landscape is made of micro, small and medium enterprises (MSME). MSMEs contribute about 45% to manufacturing output, more than 40% of exports, over 28% of the GDP while creating employment for about 11.1 crore people, which in terms of volume stands next to the agricultural sector (Reserve Bank of India, 2019). By fostering entrepreneurship and generating significant employment opportunities at relatively lower capital costs than industries, MSMEs play a crucial role in economic development (MSME Annual Report, 2021).

A key feature about the MSMEs as an industrial and policy category is the heterogeneity in terms of their sizes, products and services delivered, access to finance channels, and marketing and technology deployed. These characteristics differ not just across the categories but vary greatly within each of the categories. Businesses and firms depend on conducive public policies for their sustenance and growth indeed. This need is particularly acute amongst smaller firms. The policy intervention for smaller firms requires different provisions and tools, and therefore for several decades, a need was being felt to focus on these firms specifically. Keeping this in mind, the government in 2005 evolved a legal framework for the *Micro, Small, and Medium Enterprises Development (MSMED) Act* 2006. The legislation added 'services' as part of enterprises (earlier only manufacturing units were considered such) and categorized these enterprises distinctly through classification based on the investments in plant and machinery or equipment.

Table 1: Old classification of MSMEs

Classification	**Manufacturing Enterprises (Investment in plant & machinery)**	**Services Enterprises (Investment in equipment)**
Micro	Less than INR 25 Lakh	Less than INR 10 Lakh
Small	Less than INR 5 crores	Less than INR 2 crores
Medium	Less than INR 10 crores	Less than INR 5 crores

Source MSMED Act 2006

In July 2020, the government revised the classification of MSMEs, in addition to collapsing the distinction between enterprises involved in the services and manufacturing sector. But more importantly, the government revised the micro-small-medium enterprises classification category, basing it on the annual turnover and investment in plant and machinery or equipment. The July amendment suggested the following classification:

(a) Micro: enterprises with less than INR 1 crore investment in plant and machinery and having an annual turnover less than INR 10 crores.
(b) Small: enterprises with INR 1-5 crore investment in plant and machinery and having an annual turnover less than INR 50 crores.
(c) Medium: enterprises with more than INR 50 crores investment in plant and machinery and having annual turnover up to INR 250 crores.

These categorizations pose a serious problem. In the MSME group, microenterprises are disproportionally represented. For instance, in 2006-07, of the total 15.64 lakh MSMEs 95% units were micro, 4.8% small and merely 0.17% were medium (4th All India Census of MSMEs, 2007). This number has only become even starker. According to the 2020-21 annual report of the Ministry of Micro, Small and Medium Enterprises, out of a total of 633.88 lakh enterprises, micro sector with 630.52 lakh estimated enterprises accounts for more than 99% of total estimated number of MSMEs. Small sector with 3.31 lakh and medium sector with 0.05 lakh estimated MSMEs accounted for 0.52% and 0.01% of total estimated MSMEs, respectively. At the same time, the per unit value added by micro-enterprises falls short significantly even though micro-enterprises are also the largest employment provider in the MSMEs. It indicates that micro-enterprises hold the potential to contribute proportionate value to the economy if policies are tailored to serve their interests.

This level of lop-sidedness in classification is rather unusual in any policy discourse. The exceedingly high concentration of microenterprises in the MSME ecosystem casts several questions on the proposed benefits of the policies and schemes otherwise aimed for this segment. In fact, despite the large volume, microenterprises are not able to adequately reap the benefits of government schemes and policies. In fact, it has been observed that economic stimulus packages announced by the government from time to time failed to reach enterprises in the micro-category (Parliament of India, 2021).

One wonders if the policy can cater to this segment fairly. There is a need to consider whether micro units need separate policy attention on financial aspects, regulations, and other relevant policy dimensions. There may indeed be a demand to create a separate ministry exclusively focusing on issues and concerns related to micro-enterprises (Need for a separate ministry focusing on micro-enterprises with dedicated policy support: CIA, 2021). This study takes these considerations seriously and argues that such a demand for a separate policy approach is indeed defensible. A closer look into the micro category reveals heterogeneity among units in terms of size, finances, capacity, employment, etc.

Of these classifications, based on our research, we believe that the very small enterprises deserve a special policy category and treatment. These enterprises can be called nano enterprises. These are small shops providing goods and services, operating hyper-locally, and catering to neighborhood areas. For instance, a local grocery store, saloons, small eateries and restaurants, auto garages, and laundry shops can be termed nano-enterprises. Lying at the bottom of the microenterprise category, and having a turnover of a few lakh rupees with negligible investment in equipment, nano-enterprises face different challenges from their micro-small-medium enterprise counterparts. They operate on a meager working capital often borrowed from family and friends. Lack of resources and skills impedes their growth and scaling.

These are survivalist enterprises and are often invisible from policy radar. At present, these nano-enterprise clusters are often eclipsed in the scheme designs. They are in dire need of policy impetus, distinctly from the other micro-businesses.

This need has become even more pressing after the Covid-19 pandemic. The lockdowns severely disrupted the day-to-day operations of these enterprises. Lower aggregate demand and uncertainty across the consumption spectrum forced these enterprises either to scale down or shut down permanently (Kearney and CII, 2021).

In the rest of the paper, in Section 2, we offer a brief excursion to the literature in this field, including the historical evolution of these units. In Section 3, the paper will detail out what are nano-enterprises and offer a more useful taxonomy of MSMEs for India. Policy reforms follow.

Overview of the Policy and Literature

Historically, the industrial sector in India was fairly developed, with a substantial part of it contributed by the cottage industry and handicraft. This was even noted in the Report of Industrial Commission (1916-1918), which observed (Holland, 1918), "*At a time when the West of Europe, the birthplace of modern industrial system, was inhabited by uncivilised tribes, India was famous for the wealth of her rulers and for high artistic skill of her craftsmen. And even at a much later period, when the merchant adventurers from the west made their first appearance in India, the industrial development of this country was at any rate, not inferior to that of the more advanced European nations*." The colonial economic and trade policies that extracted raw material from India and dumped them as manufactured industrial goods back in India, destroyed handicrafts and small-scale cottage/rural industry. It severely damaged not only cottage industry but crippled the Indian economy (Majumdar, 2012).

That is why until very late, there was no formal attempt even to define, support, and develop indigenous small-scale industries at the national level. It was only in the National Planning Committee (NPC) set up by Indian National Congress in 1938 that K. T. Shah, then General Secretary of the NPC suggested the following definition for small and rural industries (Shah, 1940), "*A Small Scale or Cottage Industry may be defined to be an enterprise or series of operations carried on by a workman skilled in the craft on his own responsibility, the finished product of which he markets himself. He works in his own home with his own tools and materials and provides his own labour or at most the labour of such members of his family as are able to assist. These workers work mostly by hand labour and personal skill, with little or no aid from modern power-driven machinery and in accordance with traditional technique. Such supplementary energy as is provided by an animal power may add to the economy and efficiency of the industry. He works, finally, for a market in the immediate neighborhood, that is to say, in response to known demand with reference to quality as well as quantity.*"

However, this definition was inadequate, subjective, and overlapping. Therefore, Jawaharlal Nehru suggested another more objective definition and categorization of industries based on usage of mechanical power and employment criteria (Nehru, 1940). His classification suggested that:

Cottage Industries *may be those which have:*

(a) No mechanical power and no hired labor

(b) No mechanical power and hired labor under 10 persons

They may also be with:

(c) No mechanical power but hired labor of over 10 persons

(d) Mechanical power under 10 B.H.P. but no hired labor

Small Scale Industries *may be (c) and (d) as in cottage industries and also those with.*

(e) Mechanical power under 10 B.H.P. and hired labor.

Large Scale Industries *will generally with*

(f) Mechanical power over 10 B.H.P. and hired labor

After the independence, the immediate focus was to revive and develop cottage and small industries. In pursuant to this an Industrial Conference was arranged in December 1947. In this conference, small scale industries were divided into:

1. Those which are auxiliary to large-scale industries.
2. Those which are engaged in the supply of repair service.
3. Those which are engaged in the manufacture of finished goods

In 1950 the first official definition of small-scale industries was using two parameters, namely - capital invested and the number of employees. This definition was modified from time to time. The following table offers a useful summary.

Table 2:Classifications of small firms in India since independence

Year	Parameters			Comment
	Employment	**Investment**	**Any other**	
1951	<50 workers	NA	If using power	Essentially SSI sector meant those units which fell outside the scope of the Industries Act 1951
	<100 workers	NA	If not using power	
1955	<50	<INR 5 Lakh	Using power	
	<100	<INR 5 Lakh	Not using power	
1960	NA	< INR 5 Lakh	NA	Employment and power criteria discontinued
1966	NA	<INR 7.5 Lakh	NA	On the recommendations of Small-Scale Industries Board
1977	NA	< INR 10 Lakh and < INR 15 Lakh for ancillaries	NA	
1977 - Tiny Industries		<INR 1 Lakh	Located in rural areas and small towns	New sector - "Tiny" was created for the first time.
1980	NA	<INR 20 lakh and <INR 25 Lakh for ancillaries Tiny - INR < 2 Lakh		
1985	NA	<INR 35 lakh and <INR 45 Lakh for ancillaries Tiny - INR < 2 Lakh		
1985 - SSSE		INR 2 Lakh		The new concept of Small-Scale Service Establishment

				(SSSE) introduced.
1991	NA	<INR 60 lakh and <INR 75 Lakh for ancillaries Tiny - INR < 5 Lakh SSSBE - INR < 5 Lakh		SSSE was suspended and Small-Scale Service Business Enterprise (SSSBE) was introduced.
1997	NA	<INR 3 crore and <INR 3 crore Lakh for ancillaries Tiny - INR <25 Lakh SSSBE - INR < 5 Lakh	Location criteria discontinued.	
1999		<INR 1 crore and <INR 1 crore Lakh for ancillaries Tiny - INR <25 Lakh SSSBE - INR < 5 Lakh		For the first time downward revision in the investment criteria.
2001	NA	Only SSSBE increased to INR < 10 Lakh		

Source: Respective Five-Year Plans and Economic Surveys

In the initial decades of the post-independence period, industrial policies had a certain degree of focus on small-scale industrial units. These units were considered as a primary driver of growth for rural and semi-urban areas. The definitional focus underlines that they were also important for the employment generation of unskilled and semi-skilled workers. However, with the progress of time, the policy focus is shifted to investment in plant and machinery and value addition. Small-scale and tiny industries with their inherent limitations did not have adequate means or resources to attract investment and scale-up operations. As a result, small-scale enterprises dominated in numbers but their capacity to influence policy matters started fading away.

Surely, the cut off limits has been revised from time to time to accommodate the changes in the price indices, emerging needs of the industry for additional investments in machinery/ laboratory equipment, pollution control equipment, modernization, technology up-gradation, products standardization, etc. but there has been no concerted effort to segregate these units creatively.

There was a notable effort through the Industrial Policy Resolution 1977 that targeted the effective promotion of cottage and small industries that were widely dispersed in small villages and towns which led to the creation of a new category called 'tiny industries'. But this was not a rigorous design of classification and failed to deliver desirable results.

During 1948-1990 the objective was to increase employment opportunities and equitable distribution of national income. After the structural adjustment program in 1991, the focus was shifted from ‘industries’ to ‘enterprises’ and global capital began to flow in. During 1991-1999, government priority was to make the MSMEs more competitive in the face of liberalization. Naturally, a significant portion of this capital was attracted by medium and large enterprises and small-scale enterprises remained at the periphery. 1999 onward, the objective has been the development and promotion of the sector by addressing challenges relating to credit, infrastructure, marketing, and technology. But by and large, for the most part of the policy, stimulus package, economic incentives, tax breaks, or reliefs are designed as common across MSMEs bringing them under one umbrella.

These policy interventions benefited the medium and small enterprises significantly. In effect, this also gave a rise to the creamy layer phenomenon in the MSMEs where enterprises at the upper echelon continue to reap the benefits while lower strata continue to starve. Overall, the nano-enterprises remained ignored. This inequality is quite visible in terms of access to capital, technology, and marketing. On one hand number of nano-enterprises continues to increase significantly but availability, accessibility, and affordability of resources either remained the same or declined to make them more vulnerable.

Chapter 2: Characteristics of Nano Enterprises

There is no universal set of parameters that distinguishes nano enterprises from the other three, although some general patterns are consistent. For instance, these are typically unorganized sector enterprises established through their own funds as they lack access to institutional funding. They neither have managerial bandwidth nor do they have established channels for marketing. These enterprises are generally centered around a single traditional technology (Reserve Bank of India, 2019). For example, a traditional salon shop does not have access to capital to upgrade equipment and offer additional services or a scrap shop uses analog weighing machines over several years. These enterprises are mainly *demand-driven businesses* instead of R&D-type innovation-driven. In fact, nano-enterprises typically do not invest in R&D and lack strategies (even desire) for growth. On the competitive side, however, these enterprises face fierce competition from their peers as most of them produce or sell the same goods and services within a smaller geographical area. In urban areas, nano enterprises are often seen benefiting from the agglomeration effect. Cities offer agglomeration economies that attract nano-entrepreneurs, and in turn, benefit them.

Scholars have also noted that informal operations and heterogeneity are key features of nano enterprises. According to National Commission for Enterprises in Unorganized Sector (NCEUS) report 2007, more than 94% of MSMEs are unregistered, with a large number established in the informal or unorganized sector. In this universe of informal MSMEs 'nano' segment predominantly consists of own account enterprises, i.e., where there are no hired workers and are run by self with or without the help of unpaid family members. Further, this sector is highly heterogeneous in terms of the size of the enterprises, variety of products and services produced the levels of technology employed.

All of the above crystallize two takeaways. Firstly, there is a dire need to separate nano-enterprise as a category distinct from MSME. This will help the development of policy designs that specifically target nano-enterprises. Secondly, despite this need, there have been no serious efforts to create a legal category of nano-enterprises. Absent a legal definition, the policy discussion remains only theoretical.

Proposed Definition

We propose that the new legal category of nano-enterprises should continue to focus on measurable and similar characteristics that the government is used to considering. This will be technically feasible and given the electoral importance of people working in the MSME sector, will also be politically palatable. Further, accounting models overwhelmingly indicate that, barring a few niche start-up industries, turnover can be an appropriate proxy for a range of firm's characteristics, including employment, size, health, and finances.

Interestingly, the recent GST reforms offer us some ideas. The annual turnover of an enterprise can be ascertained through returns filed under Goods and Services Tax (GST). Besides accounting data and other tools can be used to triangulate the annual turnover of an enterprise. Similarly, the investment in equipment is also not hard to find. Thus, finding a new limit on annual turnover to classify nano-enterprises appears the most appropriate way to go. This limit should capture those enterprises which we think can be classified as nano-enterprises and should not include those which ought not to fall in this category.

We propose to use INR 25 lakh as the cut-off point for annual turnover. Enterprises engaged in manufacturing, services, or trade with an annual aggregate turnover not more than INR 25 Lakh and investment in equipment not more than INR 2.5 lakh should be taken out of the microenterprise segment and be categorized as a separate nano-enterprise.

The guiding principle here is two-fold. *Firstly,* this limit of INR 25 Lakh is derived from the government's own view about the very-small enterprises reflected in their GST deliberations. We therefore simply borrow the cut-off point from the government's categorization of enterprises in their GST framework. We simply ask the question, who does the government exempt from filing the GST. Aren't these the very people who the government thinks need support? *Secondly,* based on the government's findings (deliberated in the GST Council Meetings) as well as extensive data that deAsra and other such organizations in this sector have accumulated, a vast number of enterprises within the microenterprise category do not have annual revenues more than INR 25 lakhs, even though this is 0.25% of the cut-off limit for microenterprises. The GST Council meeting suggested that around 60% of businesses and 70% of service providers have turnover below INR

25 lakhs.

The effective GST exemption limit at present stands at INR 20 Lakh. i.e., any business with an annual turnover of less than INR 20 lakh is exempted from filing GST. This limit was an outcome of political consensus among various states. Earlier, the proposed limit was INR 25 lakhs, but smaller states as well as the large but industrially backward states were not amenable to this limit, as they feared a loss of revenue. After many deliberations in the GST Council meeting, the limit was brought down from INR 25 lakhs to INR 20 lakhs.

We propose to keep INR 25 lakhs (and not INR 20 Lakh) as the threshold limit for the classification of nano-entrepreneurs because the threshold limit of INR 25 lakh was the original exemption limit mentioned under the Goods and Services Tax. Also, it was this figure of INR 25 Lakh that was discussed during the GST Council meetings, and the data that came out during those meetings pertained to this figure (this threshold captures 60% businesses, 70% service providers and which contribute only 2% of overall tax. In other words, tax exemption below this threshold indicates that the cost of tax collection outweighs potential tax revenue. It also suggests that the government's intent is indeed to provide relief to these very small businesses and service providers that we are categorizing as nano-enterprises.

While we think investment in equipment for nano enterprises might be a difficult parameter to draw meaningful conclusions from, we have still retained the value at 10% of the annual revenue, namely, INR 2.5 Lakh. Given the variety of nano enterprises – such as beauty salons, grocery stores, tailoring shops, canteen/tiffin centers/eateries dry cleaners, motor garage shops, mechanics, home-based entrepreneurs such as women selling sarees from home, retail clothes the investment parameter will vary significantly. However, the 1:10 ratio between the values of investment and turnover applicable for micro-enterprises is retained here for simplicity.

Chapter 3: Conclusion

The umbrella policies for MSMEs are not able to serve the interest of smaller and vulnerable stakeholders. The volume, heterogeneity, and sector-specific characteristics of nano enterprises vary greatly which constrains policymakers to formulate a comprehensive policy under the existing classification of MSMEs. The advent of e-commerce and rapid change in the technology landscape requires a reframing of regulations facilitating nano-enterprises, which may suffer at the hands of multinational companies and e-commerce platforms. Undoubtedly nano enterprises represent the most vulnerable segment. These were the major victims of both demonetization and the sudden lockdown to contain the Covid-19 pandemic. These enterprises are hugely consequential for the marginalized sections of society. Despite supporting a large proportion of the workforce, they lack a lobby to voice their concerns simply because of a fragmented structure. Thus, the foremost need is to recognize, define and carefully create a policy structure enabling nano enterprises to sustain and grow.

The new classification we believe will aid in the development of nano-specific policies that may have better efficacy. Organizations such as deAsra Foundation, Global Alliance for Mass Entrepreneurship (GAME) are working to facilitate and empower nano-entrepreneurs While the efforts of many organizations and scholars are noteworthy, there has not been detailed scrutiny regarding the classification scheme of MSMEs. This paper is a step in this direction.

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