

# MSMEs: Digitization and Challenges

Vipin Kumar

## Abstract

*Micro, Small and Medium Enterprise (MSME) sector has emerged as a very prominent sector of the Indian economy, contributing significantly, to Gross Domestic Product (GDP), merchandise exports, employment and inclusive growth of the country. Throughout the period, the government has undertaken several policy measures related to finance, infrastructure, risk mitigation etc. to precipitate MSMEs growth. With the government initiatives, such as, digital India and the boom in digital payment, post demonetization, the overall technological adoption, in doing business, has improved in the country. However, there are critical issues such as digital-illiteracy; inefficient telecom infrastructure, irregular electricity and the predominance of large informal enterprises, which can nettlesome MSMEs sector to reap off the benefits of digitization in the country. In this article, I have explained the relevance of digitization for MSMEs and the possible challenges which could manacle its growth prospects, in detail.*

**Key words:** Digitization, MSMEs

## Introduction and Background

Micro, Small and Medium Enterprises Development (MSMED) Act, 2006 which was notified on October 2, 2006, defined the three tiers of micro, small and medium enterprises and set investment limits.<sup>1</sup> The Micro, Small and Medium Enterprises (MSMEs) Sector plays a very definitive role in the Indian Economy. India has about 63 million MSMEs<sup>2</sup> and it is the largest employment providing sector after the agriculture<sup>3</sup>. The sector constitutes a very significant share in Gross Domestic Product (GDP), Exports and Employment generation of the country. As per the Central Statistics Office (CSO) estimates, the Share of MSME Gross Value Added (GVA) in total GVA during 2016-17 was 31.8%. According to the Directorate General of Commercial Intelligence and Statistics (DGCIS) the Share of MSME related Products in total merchandise Export from India during 2018-19 was 48.10%. The survey conducted by NSSO reveals that the estimated number of workers indulged in unincorporated non-agriculture MSMEs, during 2015-16, was around 11.10 crore<sup>4</sup>. Therefore, it is a very important sector from the perspective of government, private players, civil societies and everyone who is working for the development of the country. A study conducted by Research Gate in March 2017 on the 'Performance of the MSMEs sector in India', suggest that in MSMEs, total working enterprises, employment and market value of fixed assets has grown at CAGR of 4.39%, 4.75%, and 6.64% respectively<sup>5</sup>. Several policy measures have been undertaken over several decades, but recently, the revision in the definition of the MSMEs, support and the development in the ecosystem and capacity building of the enterprises, facilitating the formal credit through MUDRA scheme and the general push towards the promoting access to credit for MSMEs are the big drivers towards their growth. The Government of India (GoI) has introduced "Credit Guarantee Fund Trust for Micro and Small Enterprises" (CGTMSE) to make available collateral-free credit to the micro and small merchants in the country. The number and amount of

<sup>1</sup> (Ministry of Law and Justice, 2006)<https://samadhaan.msme.gov.in/WriteReadData/DocumentFile/MSMED2006act.pdf>

<sup>2</sup> (Government of India (Ministry of Micro, Small and Medium Enterprises), 2018-19)<https://msme.gov.in/sites/default/files/Annualrprt.pdf>

<sup>3</sup> (United News of India, 2018, p. MSME is second largest employment after agriculture: President)<http://www.uniindia.com/msme-sector-is-second-largest-employment-provider-after-agriculture-president/india/news/1272584.html>

<sup>4</sup> (Press Information Bureau, 2019, p. MSME Sector Contributes Significantly to Indian Economy)<https://pib.gov.in/Pressreleaseshare.aspx?PRID=1579757>

<sup>5</sup> (SMB, 2017, p. Performance of the MSMEs sector in India)<https://yourstory.com/smbstory/performance-of-the-msmes-sector-in-india>

Guarantees approved under the CGTMSE during 2017-18 is 19065.91 cr. and 30168.57 cr. during 2018-19<sup>6</sup>. The recent U.K. Sinha expert committee on MSMEs also pointed out the need to focus on market facilitation and ease of doing business for MSMEs and a lot of policy measures in that direction are recommended<sup>7</sup>.

So, the trust on digital India and cashless economy by the government and the society is the need of hour. The potential for digital payment in the micro merchant and micro enterprise segment by way of creating digital footprints of these informal businesses, transaction histories and therefore helping them included in the formal mainstream, banking sector and access to credit and other financial services, is immense.

India's Micro, Small, and Medium Enterprises (MSMEs) base is the second largest in the world, after China<sup>8</sup>. It provides a wide range of goods & services – ranging from traditional to more technically advanced items. Given the combined force of government of India's latest 'Make in India' push and large FDI inflows, the Indian MSMEs sector is poised for rapid growth and integration with major global value chains.

### Why Digitization is important

Micro, small and Medium Enterprises (SME) form the backbone of the Indian economy and contribute immensely to the Country's GDP. Combined with the suitable policy structure, technology up gradation and regulatory measures, this sector can contribute even more. One of the ways that SMEs can grow further is through a digital transformation where business owners are willing to use the latest technology in their daily operations to drive efficiency, accuracy, innovation and reduce turnaround time. With the "Digital India" initiative, combined with the expansion of electronic commerce trade, the digitization in MSMEs sector has improved. However, the adoption is still very low. According to the Google-KPMG 2017 report, 68% of SMEs in India are not using digital mode of operation, and continue to operate with traditional methods and legacy tools<sup>9</sup>.

The findings of the report point out that the MSMEs are still engaged in old practices and there is a lack of digital uptake, which can be due to various reasons such as lack of awareness, lack of skilled labour, insufficient funds, low IT infrastructure, etc. But, there's no denying the fact that digital opens up many avenues for SMEs. As per the report, digital SMEs grow revenues and profits up to twice as fast as offline counterparts, capture greater efficiencies, communicate effectively, reduce lead time, and more. Moreover, by adopting digital practices such as CRM, online payments, selling on e-commerce platforms, the latest machines at manufacturing units, etc., SMEs can meet client expectations and bring in innovation. By improving their IT infrastructure, these micro merchants can reduce losses, improve employee productivity, enter new markets and make their companies agile<sup>10</sup>.

E-Commerce in India is the fastest growing and most efficient channel for commercial transactions. The size of the Indian E-commerce market is expected to reach to US\$200 billion by 2026 from US\$ 48.5 billion as of 2018. This growth has been instigated by cheaper internet and smartphone penetration. Country's E-commerce revenue is expected to grow from US\$ 39 billion in 2017 to US\$ 120 billion in 2020, growing at an annual rate of 51 per cent, the highest in the world<sup>11</sup>. Digitization of MSME sector can provide India access to international market and help in increasing Indian exports. Recently, Punjab industries and Commerce Minister Sunder Sham Arora has signed MoUs with key e-commerce giants Amazon and Flipkart to enable access to new markets for the Punjab-based MSMEs. The minister assured that the MoU will enable B2B linkages with key international markets, including US, Canada, Europe. The incumbent e-commerce player

<sup>6</sup> (Press Information Bureau, 2019) <https://pib.gov.in/Pressreleaseshare.aspx?PRID=1579757>

<sup>7</sup> (IAS Parliament., 2019, pp. U.K. Sinha Committee on MSMEs - Recommendations) <https://www.iasparliament.com/current-affairs/uk-sinha-committee-on-msmes-recommendations>

<sup>8</sup> (Sanjay Tiwari, 2019, p. How structured trade finance solutions help MSME exporters & importers) <https://economictimes.indiatimes.com/small-biz/trade/exports/insights/how-structured-trade-finance-solutions-help-msme-exporters-importers/articleshow/70153295.cms>

<sup>9</sup> <https://www.moneycontrol.com/news/business/heres-why-smes-should-go-digital-to-grow-their-businesses-4699971.html>

<sup>10</sup> <https://www.moneycontrol.com/news/business/heres-why-smes-should-go-digital-to-grow-their-businesses-4699971.html>

<sup>11</sup> <https://www.export.gov/article?id=India-e-Commerce>

“Flipkart” will facilitate access for MSMEs to new domestic markets, impetus to handloom weavers and small enterprises in the State. To provide this ease to the MSMEs, the Government of Punjab has partnered with HDFC Bank to provide loans to around 700 MSME beneficiaries, amounting to Rs 1,100cr. There is a provision of special pricing for business loans to all industries in the state, under their MoU.

In order to support the SME sector for digital initiatives, the Indian government also has taken several initiatives such as online filing of taxes (GST), a scheme for promotion of innovation, rural industries and entrepreneurship (ASPIRE), MSE-CDP platform, technology development centers providing skilling on cutting edge technology to MSME and more. The strong push from the government and private sector can help SMEs to digitalize, increase its share in GDP and exports. However, there are certain obstacles within the economy which can manacle MSMEs growth through digitization; these problems will be explained further in the discussion.

### Challenges in Digitizing MSMES in India

As per the official estimates, there are about 55.8 million MSMEs in India. Around 80% of the total MSMEs are in the service sector and only 20% are indulged in the manufacturing sector. A large proportion of total MSMEs are unorganized. According to the MSME annual report, 85% of the total MSMEs in India are not registered<sup>12</sup>. As a result their actions are not covered under jurisdiction and many of them face hurdles in financing their business through formal routs.



Source: MSME Annual Report

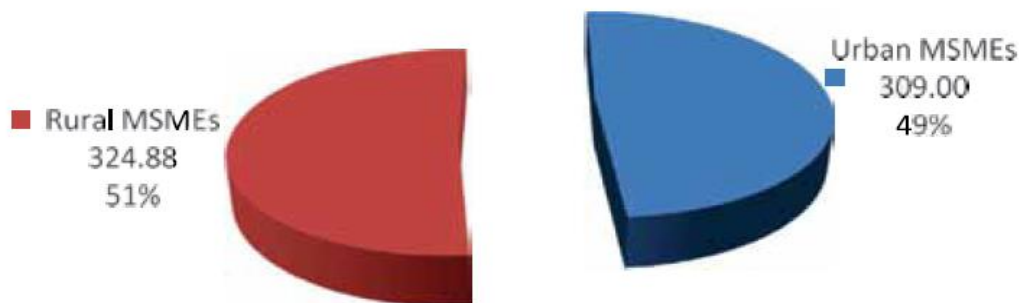
It is important to note that less than 20% of MSMEs are being financed by the formal banking system. This implies more than 80% of the MSME got no form of financing from the formal system<sup>13</sup>. As a result, either they are bound to borrow from the informal sector, paying extensively higher interest rates or end up doing less than their actual capacity, which further reduces their contribution towards GDP. Even in the MSMEs micro and small enterprises are more vulnerable. Micro and small enterprise together constitutes around 95% of the viable debt gap. Which negatively affects the livelihood of the people belongs to the lower income group of the country. The presence of this large number of informal sector in MSME lay down challenges in the digitization of MSME sector in India. So, this is one issue with the growth of MSMEs through digitization.

<sup>12</sup> (Pranbihanga Borpuzari, 2017, pp. MSMEs, India's growth engine, face a Rs 16 lakh crore credit gap)<https://economictimes.indiatimes.com/small-biz/sme-sector/msmes-indias-growth-engine-face-a-rs-16-lakh-crore-credit-gap-msmeday/articleshow/69968156.cms?from=mdr>

<sup>13</sup> (Pranbihanga Borpuzari, 2017)<https://economictimes.indiatimes.com/small-biz/sme-sector/msmes-indias-growth-engine-face-a-rs-16-lakh-crore-credit-gap-msmeday/articleshow/69968156.cms?from=mdr>

In India, MSME is not very cohesive group of industries. There is a huge distinction between the micro industries and the medium industries in India. We have close to 63.05 million micro industries, 0.33 million small industries and only 5000 medium industries<sup>14</sup>. We also need to understand that the largest number in the MSME ecosystem is also dispersed across vast geographical area in the country which includes predominantly rural or semi urban area.

### Percentage Share of Rural and Urban MSMEs in the Country (number in lakh)



Source: MSME Report 2018-19

We need to consider, whereas we are looking at the single payment system and architecture which is going to hit more competitive, we must understand that these numbers that we are actually looking at without realizing or recognizing is a very small number of units within the MSMEs. The reason is, today our telecom sector is under tremendous crisis, along with presence of large inequality in telecom services. In agristic areas, tele-density was 56.87 per cent, at the end of August 2017, whereas in urban areas, it was 173.72 per cent<sup>15</sup>. The network quality is so inferior even in New Delhi which is the capital of India, if you travel from one place to another and if you are in the car and you are talking on your mobile phone, your call will drop not less than 3-4 times. Now consider of going out to a small village in Madhya Pradesh, where you would have a very large number of micro industries. What would be the condition of this telecom system there to sustain digital payment system? One of the greatest tragedy occurred when demonetization took place. Very large number of people didn't have cash and they have no way of getting their economic transactions done because they were just not connected. The problem with the GST today is also the same. When you have to upload your returns, from a very rural kind of a setting it might take you very long hours to do that, because every time connection fails or electricity fails, your time will get into vain. So we need to see when we are pushing this, we have to understand also that in what manner we can really move so that it really becomes attractive.

Before digitization, it is important to understand that what is the cost of using cash and how does it compare with the total transaction cost of digital payments. The reason is, in micro enterprises the margins are very small that every little bit of costs get into it which impacts the profitability. When we make payments with credit cards we need to pay around 2-3% of charges to the service provider which adds to the cost of supplier. There is no existing analysis showing cash versus digital transaction as to how do it impact in terms of the cost per user. That needs to be done.

There is another issue from the government or the regulator's point of view, which is the resolution and management architecture. The moment we get into the digital transaction for micro, small and medium enterprises, the resolution process becomes much complex. So, how do we do the resolution where we have

<sup>14</sup> (Vasundhara Rastogi, 2019, pp. Micro, Small, and Medium Enterprises in India – An Explainer)<https://www.india-briefing.com/news/micro-small-medium-enterprises-india-explainer-17887.html/>

<sup>15</sup> (Vinayak Ramachandra Adkoli, 2019, p. How Telecom Is Transforming Rural India?)<https://electronicsforu.com/technology-trends/tech-focus/telecom-transforming-rural-india>

such large units? When we look MUDRA loan for instance, RBI report raised red flags over rising non-performing assets (NPAs) in loans disbursed under the government's Mudra loan scheme and urged banks to monitor the repayment capacity of borrowers before disbursement<sup>16</sup>. In digital payment case how do we do the resolution for such cases? How do we resolve such issues when we bring a non-banking institution into it?

For the business practices, individuals are taking loans and advances from banks, incurring liabilities in using credit cards, what happen if they default? Currently, sending them into jail seems the only viable option, but sending a person into jail that can pay your money back means that you are not going to get your money back ever. For the resolution of insolvency and bankruptcy, India has insolvency and bankruptcy code. It's a comprehensive code, but so far the rules are concerned, they are prescribed only for corporates and not for the individual sole proprietorship<sup>17</sup>. When we talk about the MSMEs sector, a major share in this sector is not corporate companies but the sole proprietor or partnership firms. So, major shares of MSMEs suddenly are out of this resolution.

According to RBI around 97% of MSMEs are in informal sector. The reason for such a large number is because of easy accessibility and availability of credit without any documentation hassles and mortgages. Lack of comprehensive formal documentation relating to accounts, income and business transactions are the major reasons deterring MSMEs to avail finance<sup>18</sup>. Suddenly, if everything gets digitize these firms will have no place to hide. They will have to show their proper documents and registration proofs otherwise; either it will become an illegal activity if they don't register or they end up getting difficulty in credit. So, when we are creating a digital infrastructure then at the same time we are also exposing these firms for the exploitation. This is another side of that development which is taking place that we need to look at. In order to solve this problem, the Rajasthan Gov. has initiated a very good step. To encourage MSME enterprises the Rajasthan government has said, "Youth setting up new MSMEs will not require any approvals for the first three years". Further, they will be exempted from inspections by government departments during this period<sup>19</sup>. Three years is a good time period for these entrepreneurs to flourish and get the permission which is required.

Another thing that we have to look at, whenever we talk about digitization, data, online payments, etc. this leads us to a larger question of trust. Given the predominance of large informal sector and lack of digital literacy, MSMEs do not have trust either to interact with themselves, create a knowledge system amongst them or to share information amongst them. They don't trust the Internet and the perceived security risks. So, how do we really enable an ecosystem where the clusters could emerge over a period of time? If we are able to create trust element, then the financial system and the market sentiments becomes positive and how the ecosystem operates will become very clear.

## Conclusion

In India, MSMEs can be seen as an engine of economic growth and as a measure for promoting equitable development. Over the period, the sector has shown considerable growth and if the right policy measure is provided, it can surpass agriculture sector and can emerge as the largest employment provider in the

<sup>16</sup> (Economics Times Bureau, 2019, pp. RBI deputy governor red-flags rising stress in Mudra loans) <https://economictimes.indiatimes.com/industry/banking/finance/banking/rbi-red-flags-rising-mudra-bad-loans/articleshow/72238422.cms?from=mdr>

<sup>17</sup> (Singh, 2019, pp. Sole Proprietary Concern not entitled to initiate IBC proceedings, NCLT) <https://www.barandbench.com/news/sole-proprietary-concern-not-entitled-to-initiate-ibc-proceedings-nclt>

<sup>18</sup> (Harendra Behera, 2018, p. How have MSME Sector Credit and Exports Fared?) [https://m.rbi.org.in/Scripts/MSM\\_Mintstreetmemos13.aspx](https://m.rbi.org.in/Scripts/MSM_Mintstreetmemos13.aspx)

<sup>19</sup> (Press Trust of India, 2019, pp. New MSMEs in Rajasthan now require no approvals, no inspections for first 3 years) <https://yourstory.com/smbstory/msme-rajasthan-ashok-gehlot>

country. With the government's initiative to digitize economy, the working environment has transformed from a very traditional kind of structure to more transparent and efficient in many industries. However, the important part is that there is a large universe of MSMEs out there, in which, this small piece of digitization must fit. And unless that universe also grows in the same manner and develops in the same manner that it could sustain this particular move, it would be difficult to get desired outcomes.

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