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Reforms will boost the formal economy

The ecosystem is changing for MSMEs. That should bring scalability and competitiveness to the biggest jobs sector

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Formalisation and, therefore, mainstreaming of micro, small and medium enterprises (MSMEs) has been taking place at a rapid place since demonetisation and the introduction of the Goods and Services Tax. The budget for the next fiscal accelerates this process by incentivising formalisation in such a way that it sets off a cycle of easing access to finance, lowering tax incidence, and encouraging job creation.

With the economy in the process of digesting the two big reforms, capturing data on performance — from the so-called 'digital exhaust' — of the budget initiatives, will ultimately improve access to funding, and job creation among MSMEs.

Change triggers

The reforms processes preceding, and the budget pronouncements seek to change the landscape by triggering three effects:

1. *Increase access to formal finance*: With large corporates now being mandated to go to the corporate bond market for a quarter of their borrowings, and after recapitalisation, public sector banks will have more money to lend. It would be fair to surmise, therefore, that banks will start increasing their exposure to the MSME sector. More so given that competition from mutual and pension funds is set to increase in the corporate bond market, and the regulatory pressure to reduce large corporate exposures.

The proposal to link the Trade Receivables Discounting System (TReDS) platform with the GST Network, and to revamp the online loan sanctioning facility would also improve the MSME sector's access to formal finance.

Traditionally, access to relevant financial data on MSMEs has been a challenge for banks, particularly when funding their working capital requirements. The Government is trying to change this paradigm with the TReDS -GSTN linkage, and by onboarding PSBs and corporates on to the TReDS platform.

The gradual adoption of TReDs has the potential to significantly ease the liquidity woes of MSMEs. Crisil's analysis of the MSMEs it rates shows that average receivables days is as high as 85, despite the MSMED Act 2006 stipulating that they have to be paid within 45 days by the buyer, failing which steep penal interest can be levied.

Also, new advances in technology now allow lenders to use digital transaction trails and rule-based decision-making to underwrite and offer large number of small-ticket loans.

Funding a future The most profitable way AP

For example, technology allows aggregation and analysis of bank statements of MSMEs and helps in analysing cash flows. To take advantage of this digital revolution, the Government has proposed to revamp the online loan sanctioning facility for MSMEs for prompt decision-making.

Giving out more small loans will also improve the diversification quality of the credit portfolios of banks — of course with appropriate risk controls. In this context, the increase in the lending target for the Pradhan Mantri Mudra Yojana to ₹3 lakh crore next fiscal from ₹2.44 lakh crore this fiscal will help.

Further, that the sector would be needing more funds is underscored by the readings of CriSidEx, India's first sentiment index for micro and small enterprises (MSEs), which was developed jointly by Crisil and Sidbi. The index indicated mildly positive sentiment during the October-December 2017 quarter, and a more positive one for January-March 2018.

Tax cuts and incentives

2. *Incentivising sound legal constitution through tax cut*: By reducing the income tax slab of 25 per cent to companies with a turnover of up to ₹250 crore (from ₹50 crore announced in the last year's budget), the Government also aims to boost the investible surplus of MSMEs. The benefit extends to almost 99 per cent of existing companies.

To be sure, this is only a small percentage of the overall 5.1 crore enterprises in the MSME universe, but it will incentivise firms (partnerships and proprietorships) to adopt a more sound legal constitution — and that's positive for formalisation.

3. *Incentivising formal enterprises would create new jobs*: Incentives to formal enterprises extend beyond lower corporate tax rates. The Government has increased its contribution to the employees provident fund to 12 per cent of wages from 8.33 per cent earlier in the case of new employees for the next three years.

Similarly, the benefits under Section 80-JJA of the Income Tax Act have been extended by relaxing the minimum period of employment for new employees to 150 days from 240 days for the footwear and leather sectors as well, besides continuing it for the apparel sector.

All three segments have high labour intensity and therefore, these steps will be beneficial to promoting new jobs.

In sum, using digital trails to improve access to funds, lowering tax rates to increase the investible surplus in the hands of MSMEs, and incentives to employ are just what are needed to ensure faster growth of the formal economy.

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