The Impact of India's Foreign Trade Policy on Small & medium enterprises (MSMEs): Opportunities & Challenges

Table Of Contents

Abstract

Micro, Small, and Medium Enterprises (MSME) play a crucial role in India's economic and social arena with a significant contribution towards output, employment, and growth of the country's exports. The foreign exchange that is earned by these small businesses is transmitted fast in the domestic economy henceforth creating a cycle of local demand, adding to the GDP growth. Therefore, Foreign Trade Policies (FTP) need to be framed keeping in mind the future growth of MSMEs.

This paper analyses the impact foreign trade policies have on MSMEs in India and its prospects. It will also study the policy structure followed in China for MSMEs.
Lastly, the paper sheds light on the amendments that need to be done in India's Foreign Trade Policy to ensure they benefit MSMEs.

Keywords: Micro, Small, and Medium Enterprises (MSMEs), Foreign Trade Policy (FTP), Special Economic Zone (SEZ), Regional Trade Agreements (RTA).

Introduction

Micro, Small, and Medium Enterprises (MSME), also known as the 'backbone of the Indian economy' has emerged as a vibrant and dynamic sector over the last few decades. It contributes significantly to the socio-economic development of the country by encouraging entrepreneurship and generating substantial employment opportunities at comparatively lower capital costs.

Khadi and Village Industries (KVI) are two national heritages of India. One of the most significant aspects of KVI in the Indian economy is that it provides sustainable employment at a meager per capita investment. Another significant industry in the Indian economy is the Coir industry. It is an export-oriented industry and has more significant potential to enhance exports by value addition through technological interventions and diversified products.

The Ministry of Micro, Small & Medium Enterprises imagined a vibrant MSME sector by promoting growth and development, including khadi, village, and coir industries, in cooperation with concerned ministries, state governments, and other stakeholders, through providing support to existing enterprises and encouraging the creation of new enterprises.

India's production environment is mainly dominated by Micro, small, and Medium enterprises, or MSMEs which constitute around 99% of India's total businesses and contribute a massive 50% to the country's total exports (*Bhatia,2022*). However, they are still under-represented in the international market, and their potential to enter or compete in the global markets remains unrecognized as they come across multiple issues related to lack of digital and human infrastructure, inadequate access to credit, low profitability, and lack of awareness.

The objective of the study - This is to understand the impact of India's foreign trade policy on Micro, Small, and Medium enterprises (MSMEs).

Limitations of the study - The presented paper is restricted to some aspects of foreign trade. The data that is stated in this paper is collected from secondary sources, there is a lack of accuracy.

Evolution of the MSME sector in India Post-liberalisation

The new policy for village enterprises laid the framework for government support in the context of liberalization which looked forward to replacing protection with competitiveness to bring about more vitality and growth to small enterprises in the face of foreign competition and an open market. Supportive measures included improving infrastructure, technology, and quality.

On 9th May 2007, following the amendment of Government of India (Allocation of Business) Rules, 1961, the erstwhile Ministry of Small Scale Industries and the Ministry of Agro and Rural Industries were combined to form the Ministry of Micro, Small and Medium Enterprises (MSMEs).

After 14 years since the MSME Development Act came into existence in 2006, a revision in the MSME definition was announced in the Atmnirbhar Bharat Abhiyan Scheme on 13th May 2020. As per the discussion, MSMEs are classified as below -

Size of the Enterprise	Investment and Annual Turnover
Micro	Investments less than Rs. 1 crore Turnover of less than Rs. 5 crores
Small	Investments less than Rs. 10 crores Turnover less than Rs. 50 crores
Medium	Investments less than Rs. 20 crores Turnover less than Rs. 100 crores

Source - *Ministry of Micro Small & Medium Enterprises*

The new definition has the provision of excluding the exports from counting of turnover which will encourage the MSMEs to export more without failing to lose the benefits of an MSME unit(*Ministry of Micro Small & Medium Enterprises, n.d*).

The Gradual Shift Of Msmes From The Informal To The Formal Sector

In India, 99.7% of enterprises are in the unorganized sector (*Kapoor & Kowadkar, 2022*). A significant fraction of these unorganized firms falls in the "micro" category of the MSME sector comprising owner-managed firms, most of which operate with less than five workers.

A major challenge the informal sector faces is that it consists of activities operating outside the regulatory framework that would potentially add value to tax revenue and the Gross Domestic Product but go unaccounted for. A recent estimate suggests that the informal sector still makes up about a third of low and middle-income countries' economic activities (*Kapoor & Kowadkar, 2022*). The main task is to understand why firms choose to operate informally. Formalization entails certain costs as well as benefits for undertaking economic activities. In case, the regulatory structure is complex and imposes extensive costs, it serves as a primary disincentive for firms to register. This is mainly true for smaller firms with a narrow profit margin who find the costs of compliance financially burdensome.

The technology adoption level of Indian unorganized MSMEs is quite low. This may indicate issues related to the availability of requisite skills, resources, and awareness. Further, the technology adoption level amongst manufacturing MSMEs is comparatively lower than service counterparts in the context of India. This means that the manufacturing sector holds greater potential for technological development. Small and unorganized firms need to realize the benefits of formalization and digitalization. The benefits include access to various government subsidies and incentives, enforceable commercial contracts, tax breaks, and access to formal credit channels.

At present, the formal MSME sector is facing various challenges, such as - a lack of strategic management, financial literacy, access to bank credits, technical competency, and labor-related challenges. The government has recently introduced various incentives to resolve the challenges faced by MSMEs.

- Raising and Accelerating MSME Performance (RAMP) Scheme - the program focuses on improving access to market and credit, strengthening institutions and governance at the center and state, improving center-state linkages and partnerships, addressing issues of delayed payments, and greening of MSMEs.
- Credit Guarantee Fund Scheme for Micro and Small Enterprises (CGTMSE) Scheme - it was launched to make available collateral-free credit to the micro and small enterprise sector.
- Interest Subsidy Eligibility Certificate (ISEC) Scheme - under this scheme, implementing agencies can avail of bank loans as per the ISEC issued by the Khadi & Village Industries Commission on payment of only 4 percent of interest and the difference between the actual interest charged by the bank and 4 percent is borne by Khadi & Village Industries Commission as interest subsidy (*Ministry of Micro Small & Medium Enterprises, n.d)*.

Role Of An Effective Foreign Trade Policy In Improving The Msme Sector

The surge in input and fuel costs is worsening matters for the MSME sector. There's a rise in prices of raw materials and MSMEs are finding it difficult to take full advantage of the increase in demand and the new foreign trade policy.

Concentrating on the growth of India's participation in international trade is reflective of the Atmanirbhar Bharat vision. Earning foreign exchange helps reduce the trade deficit and has a direct impact on the GDP. The country has just clocked in a 3-month rise in the unemployment rate, which was at 7.8% in March 2023(*India's unemployment rate rises to a 3-month high of 7.8 pc in March: CMIE,* 2023). The present Foreign Trade Policy is said to not only provide short-term relief from the consequences of the pandemic but also give a strong foothold in our mission to reach a $5 trillion economy by 2025 and $1 trillion through the digital economy.

With the increasing adoption of e-commerce, the floodgates to purchase custom-made goods from anywhere in the world have opened. This merged with low risk and investment gives a significant boost to our MSMEs, which is why the new policy should consider extending necessary support to enable artisans of products, handicrafts, or small exporters of gems and jewelry to take advantage of the global B2C (Bussiness to Consumer) demand. This will result in an increase in employment within the manufacturing sector. With key modifications to incentives and definitions and the implementation of a talent platform, India can compete with the structural change in global trade to emerge as a winning leader. As a result, the country will witness both, short and long-term economic benefits.

Another incentive introduced by the government to increase foreign investment and provide an internationally competitive and hassle-free environment for exports is the Special Economic Zone (SEZ). The policy relating to SEZs, so far contained in the foreign trade policy, was initially implemented through ad hoc amendments to different laws, besides executive orders. To avoid these risks and give a long-term and stable policy framework with minimum regulation, the SEZ Act 2005 was enacted. The Act covers all important legal and regulatory aspects of SEZ development as well as for units operating in SEZs. But the SEZ Act has certain drawbacks, the manufacturing sector has not been able to harness SEZs to generate the desired level of export-based economic advantage. Therefore, the Development of Enterprise and Service Hubs (DESH) Bill was introduced to revive SEZs and develop them into inclusive economic hubs.

Under the DESH Bill, the units will be allowed to manufacture for domestic as well as international markets. The SEZs will facilitate both export-oriented and domestic investment. The move also aimed at making the rules governing special economic zones more WTO-compliant.

India’s Trade Policy Dilemma

The greatest challenge faced by India toward the development of a strong trade policy is its poorly developed manufacturing sector. Although growth was seen after the economic liberalization in 1991, the manufacturing share of the gross domestic product (GDP) has since fallen to 16.2 percent in 2015-2016 compared to what it was in 1989-1990 (16.4 percent)(*Puri, 2017*). Constraints that the manufacturing sector faced included the limited availability of power and land, lack of access to technology, low productivity, the rising cost of labor, and obstacles in doing business(*Puri, 2017*). By far the most serious impediment to the revival of the manufacturing sector is the scarcity of land.

As a result, India’s experience with regional trade agreements has been less than satisfactory because of the lack of competitiveness in its manufacturing sector and the lack of innovation and investment in sectors such as textiles, garments, and pharmaceuticals. This has resulted in a lack of enthusiasm for adopting a more activist trade policy within the government, think tanks, and the trade policy community. For example - the original India-ASEAN trade agreement covered only goods, even though India competes with leading ASEAN members in key manufacturing sectors

such as textiles and automobiles(*Singh, 2016*). The agreement was subsequently expanded to include India's stronger service industries but is not yet fully operational.
The Mercosur agreement excludes textiles, one of India's top export items, which attract import duties of as much as 35%. Vietnam, another top textile exporter, has negotiated an agreement with Russia, while India's negotiations with Moscow are progressing at a really slow pace (*Singh, 2016*).

Joining these regional trade agreements could bring innumerable benefits to India. For instance, an agreement with the EU would help India's apparel exports - the European Union bloc is the world's largest importer of such goods(*Singh, 2016*). It will make the country's goods and services more competitive, forcing the Indian industry to adjust to international standards in technical barriers to trade and sanitary restrictions. The main challenge in India and several other countries is the lack of full understanding of the benefits of trade liberalization, policy paralysis, and lack of political will. To come up with a successful trade policy one needs to have a proper understanding of geopolitics and global economic trends and the ability to negotiate.

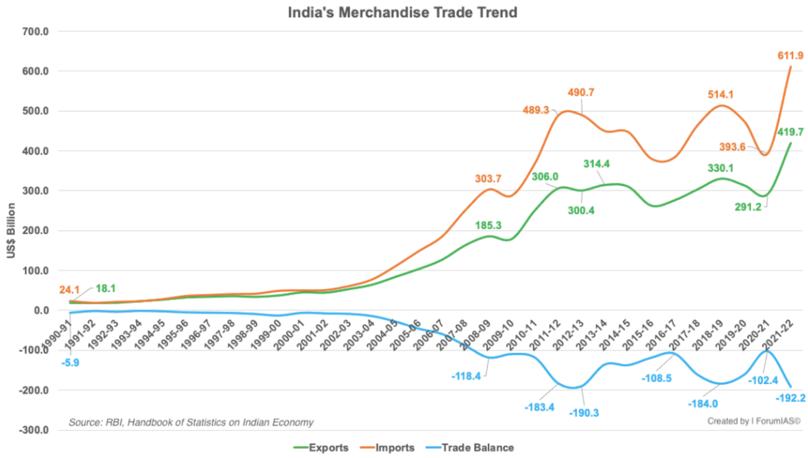
'Amrit Kaal' as defined by Prime Minister Narendra Modi, is the journey of new India for the next 25 years. Where MSMEs will be a major driver of growth. There are 5 key trends that the MSME sector will witness in the coming years that will define the roadmap for Atmanirbhar Bharat -

- The year of Initial Public Offerings (IPOs)
- Digital penetration
- Lending will increase
- Brand building will come into focus
- Import substitution

  The vision of Atmanirbhar Bharat aims at reducing imports and increasing exports.

India's New Foreign Trade Policy

Revisited and notified every five years since the 1991 economic reforms, the foreign trade policy has been the guiding light for all stakeholders. India achieved the highest goods exports in 2021-2022 at US$ 419.7 billion(*Khureja, 2022*). However, there was a significant jump in imports, which also recorded their highest level ever at US$ 611.9 billion. The trade deficit stood at US$192.2 billion(*Khureja, 2022*).



Source: RBI, Handbook of Statistics on India Economy

The government has come up with several initiatives over the years to improve the country's exports. One major step was introducing the 'Production - linked Incentive' (PLI) scheme; the objective is to make domestic manufacturing globally competitive. The PLI scheme has been specifically designed to boost domestic manufacturing and strategic sectors, curb cheaper imports and reduce import bills, improve the cost competitiveness of domestically manufactured goods, and enhance domestic capacity and exports (*PIB Delhi, 2021*). An outlay of Rs.1.97 lakh crore (US$ 26.47 billion) was allocated for the PLI scheme to boost manufacturing across various sectors, increase exports and generate jobs (*Dewan, 2021*).

One of the key objectives of the FTP 2023 is to process re-engineering and automation to facilitate ease of doing business for exporters. The policy emphasizes the use of automated IT systems with risk management systems for various approvals and codifies implementation mechanisms in a paperless, online environment. The approach also reduces fee structure and IT-based schemes to make it easier for MSMEs and others to access export benefits.

India's latest foreign trade policy seeks to handhold MSMEs to build their financial capabilities, set up special zones for e-commerce exports, and develop new mechanisms to support services related to artificial intelligence and the Internet of Things. The March 31 Foreign Trade Policy launch meeting painted an ambition of $2 trillion in exports by 2030, building on the post-covid 19 rebound in exports, which implies a compound annual dollar growth of almost 15% over the next seven years, at a time when world trade is slowing (*Ganguly, 2023*). The world's two largest economies are turning inward.

Case Study: MSME Sector in China

In Contrast, China's SMEs contribute over 60% to the GDP and account for 80% of jobs in China, the number of SMEs in the country is estimated to be over 38 million (*Dewan, 2021*). Compared to 63 million MSMEs in India which contribute 30% to the country's GDP (*Dewan, 2021*).

China has a lot of policy stability, which is a priority to earn the trust of its entrepreneurs and foreign investors. The Chinese government has adopted a series of promotion regulations to support SMEs. They are -

- Financing for SME development - The state set up an SME development fund to encourage donations through tax incentives extended to SMEs.
- SME financing - Incentives, including tax reduction and income tax waivers, are given to SMEs that meet the state-stipulated number of jobs that are expected to be generated each year; SMEs operating in economically underdeveloped areas, and SMEs that employ a specific number of physically challenged people.
- Market access - the government encourages SMEs to expand their markets by enforcing financial policies that allow - imports and exports credit, and export credit insurance. It also ensures that qualified SMEs invest in foreign markets.
- Networking with other enterprises - it promotes specialization and coordination among SMEs so they can pursue collective development of the materials being supplied, production, sales, and technological innovations to help with market expansion.

The Chinese government also introduced the tax deferment policy for MSMEs (including sole proprietorships, partnerships, and individual businesses) in the manufacturing sector. The announcement took effect on November 1, 2021. The following taxes can be deferred under this announcement -

➢ Corporate income tax (CIT), domestic, value-added tax (VAT), domestic consumption tax, and urban construction and maintenance tax paid by MSMEs in the manufacturing sector (*Huld,2022*).

➢ Individual income tax (IIT) is paid by individual businesses, sole proprietors, and partnership enterprises (excluding withholding tax) (*Huld,2022)*.

They decided to replace the inclusive loan repayment extension support tool for micro and small enterprises with inclusive loans for them. Inclusive credit loans were incorporated into the re-lending program for agriculture and small firms. Qualified local banks making inclusive credit loans to MSMEs can apply to the People's Bank of China for low-cost re-lending financial support (*Xinhua, 2021*). They also decided to set up an integrated financing credit service platform network that will be operating at the national level, with a focus on financing services for MSMEs.

India needs to invest in upgrading export infrastructure such as ports, warehouses, quality testing, and certification centers to stay ahead of technology-advanced countries such as China.

Analysis of Internal Trade in India

India is highly integrated internally, with considerable flows of both people and goods. Estimates for interstate trade flows indicate that cross-border exchanges between and within firms amount to at least 54 percent of GDP, implying that interstate trade is 1.7 times larger than international trade(*One Economic India: For Goods and in the Eyes of the Constitution, n.d*). While political borders impede the flow of people, language does not seem to be a demonstrable barrier to the flow of goods.

There is a potential dampener for the finding that trade in goods is high within India. This may be a consequence of the current system of indirect taxes that favors interstate trade over intra-state trade, especially with regards to final consumption items, exempted goods that are input tax credit ineligible. If this analysis is true the GST by ironing out these oddities may normalize interstate trade(*One Economic India: For Goods and in the Eyes of the Constitution, n.d*).

It was also noted that we can quantify not just interstate trade (that is trade between firms), but also intra-firm, trade across states. The latter is, surprisingly large (at least 68 percent of interfirm trade) and is affected by trade costs to a greater extent when compared to interfirm trade(*One Economic India: For Goods and in the Eyes of the Constitution, n.d*). The Constitution favors preserving state sovereignty over one market.

Recommendations

1. India's trade agreements are ill-conceived and not properly negotiated in the sense that they do not fully help in its comparative advantage in the service and manufacturing sector. One of the main reasons for this is that India is facing an infrastructural setback due to inadequate upgraded export infrastructure such as ports, warehouses, and supply chains. The average turnaround time for ships in India is increasing. It's time India starts investing in upgrading export infrastructure to stay ahead of technology-advanced countries. India needs to include modern trade practices such as the digital eco-system which includes easy access to finance, payments, operations, management, and online training programs. Increased B2C (Business to Consumer) exports will allow Indian MSMEs to compete with products and services offered by foreign competitors.

   Some of the e-commerce platforms in India like Amazon and Myntra have started several initiatives to help local entrepreneurs reach the rest of the world with their unique products, by supporting these initiatives the government can ensure that many other

MSMEs can sell their products in international markets, and also provide the local artisans with much needed economic support. Therefore the nation will be able to gain the full economic benefit of trade pacts.

2. India needs to rationalize its duty structure, in the sense it needs to develop a pyramid structure through which it needs to impose the lowest duty on raw materials so that they can be exported after value addition. This in return will encourage MSMEs to produce more to gain a higher price benefit. For example - from November 2017 through March 2018, India raised import duties from zero percent to 60 percent on chickpeas, 50 percent on peas, and 30 percent on lentils, severely impacting U.S pulse exports to India (*Privacy Shield Framework, n.d*). Very high Indian agricultural tariffs are a considerable barrier to U.S. agricultural exports.
3. Various incentives and schemes have been introduced by the Indian government to help MSMEs grow but they haven't been successful in achieving their targets. The main reason for this is the lack of knowledge among the citizens. Awareness campaigns are vital to impart knowledge to the targeted groups. This can be done either through digital platforms or by visiting areas that have limited social media access.
4. One of the strategies used in China that can be implemented in India as well is networking with other enterprises. The model that they follow is that they encourage cooperation between SMEs in a cluster, these clusters allow SMEs to interact with institutions in their surrounding environment. These institutions include businesses and entrepreneurs, industrial associations, banks, R&D institutes, and central and state governments working collaboratively toward achieving the given target.
5. A major hurdle for the MSME sector is the burdensome process of registering with the government. They prefer to remain unregistered to avoid regulatory scrutiny, taxes, and compliance. Smaller firms with narrow profit margins find compliance overhead burdensome. The registration process involves a lot of paperwork and has stringent and complex labor laws. It's time the government educates micro & small entrepreneurs regarding the benefits of formalization, which include government subsidies and incentives, tax breaks, and enforceable commercial contracts, and access to formal credit channels. Only when the current schemes and benefits of being registered are implemented properly and the registration benefits exceed their cost, firms will gradually shift from informal to formal MSMEs.
6. MSMEs are considered the key players in achieving ambitious export targets. However, the rise in input and fuel charges is badly affecting MSMEs. The rise in prices of raw materials along with the shortage of shipping containers and labor are making it difficult for this sector to benefit from the global increase in demand. Subsidies need to be provided to the MSME sector to ensure that they actively take part in export activities. These subsidies will

help bring them align with the larger firm in the market. Faster GST refunds to global services are an urgent requirement for an increase in efficiency.

7. The export benefit that comes under GST is currently outside the domain of Foreign trade policy which has caused discrimination and denial of export benefits to certain classes of exporters. There is a need to bridge the existing gap between the two approaches.

Addressing the economic hardship caused by the pandemic, it is decided that the new Foreign trade policy shall work in a phased manner to address export constraints, review the regulatory and operational framework to reduce transit costs and develop a low-cost operating environment with the help of developed logistics and utility infrastructure.

Conclusion

Trade has contributed to global prosperity, raised standards of living, and contributed to steadily growing real income. It also contributes to inequality. It can have a devastating effect on the manufacturing sector if it is subjected to subsidized products and exchange rate manipulation.

Developments in foreign trade policy confront Indian policymakers with some hard choices. India's ill-conceived trade pacts have resulted in inverted duty structures, high import duties on raw materials, and lower duties on finished goods, which discouraged the production and exports of value-added items. For instance, India - Japan Comprehensive Economic Partnership Agreement (CEPA). India's clinical trials and tests are not automatically recognized in Japan, it takes more than a year to get regulatory approvals(*Singh, 2016*). As a result, India- Japan CEPA has not helped India's pharmaceutical exports despite the huge potential of the Japanese market(*Singh, 2016*).

Liberalization policy played a major role in bringing about market changes and boosting investment in India. The reform brought an increase in the number of small-scale units but the reflection in terms of productivity was missing. The export and the local production witnessed a wide variation. The marginal productivity and marginal revenue were not satisfying as the units could not afford innovation, better technology, and competitiveness.

Given the dynamic and flexible nature of MSMEs, they are considered an essential sector in achieving sustainable development goals (SDGs) set by the United Nations. MSMEs have a huge role to play in the achievement of - Poverty alleviation (Goal 1), Decent Work and Economic Growth (Goal 8), and Industry Innovation and Infrastructure (Goal 9)

At present, there has to be inner consistency and harmony between the objectives of policy and the implementation modalities. It will be an impossible task to increase the share of foreign trade and create millions of jobs by ignoring MSMEs or focusing on a trade policy that isolates India from the major trading arrangements that are globally taking place.

References

Hattiambire, D. (2022, April). *Challenges and Future Prospects for the Indian MSME Sector: A Literature Review*. https://www.researchgate.net/publication/360805089_Challenges_and_Future_Prospects_for_the_Indian_MSME_Sector_A_Literature_Review. Retrieved May 6, 2023, from https://www.researchgate.net/publication/360805089_Challenges_and_Future_Prospects_for_the_Indian_MSME_Sector_A_Literature_Review.

Dewan, N. (2021, February 15). *Taking a cue from China: How India can help SMEs flourish and Prosper*. The Economic Times. Retrieved May 6, 2023, from https://m.economictimes.com/small-biz/sme-sector/taking-a-cue-from-china-how-india-can-help-smes-flourish-and-prosper/articleshow/80917708.cms.

Verma, T. L. (2019, April). *Policy brief: The role of micro-, small, and medium-sized enterprises (MSMEs) in achieving the Sustainable Development Goals (SDGs) | Department of Economic and Social Affairs*. United Nations. Retrieved May 6, 2023, from https://sdgs.un.org/publications/policy-brief-role-micro-small-and-medium-sized-enterprises-msmes-achieving-sustainable.

Major challenges faced by the MSME sector and their impacts. https://www.iifl.com/blogs/publisher-blogs/challenges-faced-by-MSME-sector. (9AD, November). Retrieved May 6, 2023, from https://www.indifi.com/blog/challenges-faced-by-the-msme-sector/.

Xinhua. (2021, December 15). *China to beef up financial support for MSMEs with market-based measures*. China to beef up financial support for MSMEs with market-based measures. Retrieved May 6, 2023, from https://english.www.gov.cn/premier/news/202112/15/content_WS61ba0eabc6d09c94e48a2480.html.

Khureja, K. (2022, July 26). *The need for a new foreign trade policy - explained, pointwise*. ForumIAS Blog. Retrieved May 6, 2023, from https://blog.forumias.com/the-need-for-a-new-foreign-trade-policy/

Expectations with new foreign trade policy 2021-26: IBEF. India Brand Equity Foundation. (2022, July 7). Retrieved May 6, 2023, from https://www.ibef.org/blogs/expectations-with-new-foreign-trade-policy-2021-26.

Strategic Investment Research Unit (SIRU), & (SIRU), S. I. R. U. (2023, April 6). *Revving up the competitiveness of Indian MSMEs: The MSME competition (Lean) Scheme*. Investment Promotion and Facilitation Agency. Retrieved May 6, 2023, from https://www.investindia.gov.in/team-india-blogs/revving-competitiveness-indian-msmes-msme-competitive-lean-scheme.

Media, U. (n.d.). *MSME definition*. MSME - Development Institute, Kolkata :: MSME Definition. https://sisikolkata.gov.in/msme-definition.html.