Chapter 11

Leveraging Tax as a Tool for Financial Inclusion of MSMEs: Micro, Small, and Medium Enterprises (MSMEs) and Financial Exclusion

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ABSTRACT

Studies suggest that dealing with financial exclusion requires a multi-pronged strategy. Apart from the government policies and initiatives, tax policies have also been recognized as a potent tool that furthers the cause of financial inclusion, both directly and indirectly. As in case of other policies, a one-size-fits-all approach cannot be followed in tax policy as well, so one can see a broad spectrum of initiatives trying to tackle the different root causes of this problem. By using a carrot-and-stick approach, the tax policy is maneuvering the informal sector businesses towards the formal economy, where formal sources of finance and credit become a reality.

INTRODUCTION

MSMEs are the engine of growth and development of our country. They contribute significantly to output, export and employment generation in the economy. Their role is particularly important in providing employment to semi-skilled and unskilled workers. They act as ancillary units to the large industries and compliment them in the socio-economic growth of the country. As per the Annual Report 2016-17 of the Ministry of Micro, Small and Medium Enterprises (Annual Report), there are an estimated 512.99 lakh units in the country providing employment to around

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1112.28 lakh persons. MSMEs contribute around 33% of manufacturing output and around 45% of the overall exports from India. They are hence, considered the best vehicle for inclusive growth, job creation and poverty alleviation.

The Committee on Medium-term Path on Financial Inclusion (CMPFI), which was set up by the Reserve Bank of India (RBI) to devise a measurable and monitorable action plan for financial inclusion of both households and small businesses, had set the vision of financial inclusion for MSMEs which includes increasing the access of MSMEs to formal finance with a greater reliance on technology that can cut costs and improve service delivery. In the process it had identified several challenges faced by the MSMEs. The key ones being:

1. MSMEs are often credit-starved, access to timely credit at a reasonable cost is one of the most difficult challenges being faced by this sector. Banks often do not have the requisite skills and time to assess their credit-worthiness.
2. MSMEs are often less inclined to access bank finance owing to onerous and complicated documentation procedures.
3. There is also voluntary exclusion, with some MSMEs not forthcoming with their detailed financing requirements owing to fear of tax complications and harassment by bureaucracy.
4. Technology does not appear to have been harnessed to the fullest extent in order to further the cause of financial inclusion.
5. In the absence of funding from mainstream financial institutions, most MSMEs have to rely on the informal sources and internal accruals. Though the informal sector may issue loans quickly and with little or no collateral, the issue is that such loans often carry high rates of interest. Internal accruals may often not be sufficient to cater to the fund requirements of the MSME.

The Annual Report points out that 87% of MSMEs are proprietorship concerns as against 0.91% set up as partnerships. Only 0.42% operates as private companies, 0.51% as self help groups and 0.22% as private co-operatives. Due to their inherent characteristics, ownership structures such as companies, partnerships and co-operatives provide greater access to financial resources as compared to operating as a proprietorship. Thus, operating as a proprietorship is also a reason of financial ill health.

Studies suggest that dealing with financial exclusion requires a multi pronged strategy. Apart from the other government policies and initiatives, tax policy has also been recognised as a potent tool which furthers the cause of financial inclusion; both directly and indirectly. As in case of other policies, “a one size fits all” approach cannot be followed in tax policy as well, so one can see a broad spectrum of initiatives trying to tackle the different root causes of this problem.
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