

## **EXECUTIVE SUMMARY**

This study seeks to elicit the perceptions of MSME units regarding the overall tax structure and impact of tax exemptions and concessions, VAT and property tax on the development of enterprises in this segment of the economy. The study is based on a two pronged approach - one draws on a survey of 200 enterprises across three cities and the other is based on interviews with people knowledgeable about this sector based on their association with it. The enterprises surveyed include micro, small and medium units spread across Delhi-NCR, Coimbatore and Ahmedabad. The target respondent groups are the manufacturing MSMEs (registered and non-registered both), both compliant and non-compliant with regard to VAT. Of the 200 enterprises, 100 are from Delhi NCR and 50 each from remaining two areas. This division of the sample across the cities was based on the fact that Delhi NCR has a more diverse set of industries as compared to the other two cities. Out of total 200 enterprises sampled, there are 113 micro, 70 small and 17 medium enterprises. The analysis in this report largely focuses on the differences in response between Micro, Small and Medium firms.

We also examined the registration status of these units. For the purpose of this study, registered firms are those registered with either registrar of companies or registrar of firms. Of firms which are unregistered, we found the following reasons to be important for their decision not to register: a) trouble getting information on registration process, including time required to complete the process, b) minimum capital requirements for registered enterprises in their sector is not satisfied and c) administrative burden and financial burden. Administrative and financial burden of being in the tax system is flagged by registered enterprises also as a potential reason for firms choosing not to register.

Some key observations from the survey are mentioned below:

1. There is an overwhelming perception that firms have to pay multiple taxes.
  - 1.1. They perceive that this raises the time and cost of compliance,

2. Access to credit continues to be a concern for this sector. Many firms do not want to take loans, to expand their business – 33 percent believe that they cannot get loans while the others do not want to take loans.
3. Perception on some issues like 1) whether tax staff is fair and respectful in dealing with MSMEs, 2) MSMEs are facing bias regarding tax benefits in the current tax structure, 3) difficulties faced in obtaining VAT refunds, 4) performance of VAT officials, friendliness of VAT regulations etc. varied significantly between micro to small & medium enterprises as well as between registered to unregistered firms.
4. Majority of small and medium enterprises view bribe as a problem vis-à-vis micro firms.
5. There is a consistent perception that the procedure of land acquisition is not only complex but this involves high cost and rampant corruption.
6. Among the exporters, majority of the firms want tax holiday to boost the growth of their business while majority of the non-exporters do not want tax holiday.
7. Tax exemptions are considered to be useful as a mechanism for promoting their business – this view emerges as an overwhelming response.
8. Property tax also does not emerge to be a deterrent to growth of their enterprises.
9. Majority of the respondents perceive that the overall business environment for the enterprises owned by women entrepreneurs is favorable. This is reflected even the case study reported.

Key informants have raised some crucial issues that are pointed out below:

1. For firms competing with the foreign products, their goods become less competitive because of tax structure.
2. Tax exemption is no more lucrative for MSMEs – if they avail it, then they are out of the value chain.
3. VAT refund from the central government is done timely but in some states the state VAT department does the refund after matching the

invoices of the raw material purchased and the invoices of the sellers, resulting in inordinate delay.

4. Some impressions suggest that credit to the firms is mainly done on the basis of the impression of the branch manager of the bank – makes it difficult for new firms / unit to take off with assistance from formal
5. If potential borrower does not own the land, the lack of such a collateral reduces their scope for getting credit.
6. In a number of KIIs, there was reference to the ease of obtaining working premises at reasonable costs in countries such as China – suggesting the need for reducing the cost of land and building for the entrepreneur in order to make MSMEs more viable.

The reason behind the overwhelming perception of paying multiple taxes is each of the taxes has its own compliance requirements in terms of accounting needs, returns to be filed and documentation to be maintained. This is further compounded by the fact that in sub-national taxes like State VATs, the rates of tax and the forms and procedures too can vary. These raise the cost of compliance for the firms and have an adverse impact on profit and cost of production especially for micro firms. With the introduction of GST, it is hoped that some of these taxes would be merged into one tax, thereby reducing some of the compliance costs.

While individually these responses highlight the perceived impact of taxes and exemptions on firms, since there are some differences in responses, we have attempted to cross tabulate and identify some visible patterns. Some of these are discussed below:

- A.** Firms that view bribes as a problem among small and medium enterprises are more likely to report that tax staff was not respectful when compared to those that do not view bribes as a problem, while in the case of micro firms; there is no relation between these two perceptions. One way to understand this difference could be as follows: small and medium firms are already a part of the tax system and possibly would like the system to function well. Any

demands for bribes can then be viewed as synonymous with unfair treatment by tax officials. On the other hand, micro firms are still evaluating the merits of being in the tax system or opting out. They may even be having turnovers very close to the exemption threshold and hence could be in and out of the system for some time. For these firms, bribes might be viewed as the cost of indecision on their part more than a reflection of unfair treatment by tax officials.

- B.** A substantial number of firms responded to the land acquisition related issues in a similar manner. They strongly perceive that the procedure of land acquisition is not only complex but this involves high cost and rampant corruption. The high cost of acquiring land along with limited resources available to these firms is presented as reasons for not possessing land.
- C.** Of the firms that did not take loans, 67 percent report that they did not want a loan while 33 percent reported that they could not get a loan. To understand this further, this variable is cross tabulated against the perception that “Time and Cost of compliance is high”. The result indicates that among firms that did not want a loan, a larger percentage perceives time and cost of compliance to be high, when compared to those that reported a perception that they could not get a loan. These factors suggest two important conclusions: first, for firms that perceive that they cannot get a loan, improvements in the procedures for getting loans and relaxation in the collateral requirements etc. can help them become a part of the formal economy. For the second group of firms that do not want a loan, there is a possibility that the perceived high cost of compliance is serving as a disincentive to come within the folds of taxation and hence they do not seek to take a loan and expand their business. Since access to credit continues to be dominant concern, two issues need to be addressed. First, simplifying the process and documentation for getting credit would be important to bring more SME within the fold of the formal sector. Here Aadhar based credit histories or CIBIL based credit histories can be used to expand the

access to credit. Improving the tax regime so that compliance cost is reduced too could bring in more people to the formal institutions for credit.

- D.** Statistically significant difference is observed among exporter and non-exporter firms in terms of wanting tax holiday. Among the exporters, majority of the firms want tax holiday to boost the growth of their business while majority of the non-exporters do not want. Exporters could be facing competition from other countries where tax regimes could be more supportive. Alternatively since exports are to be zero-rated in VAT and GST, while local sales are taxable, the accounting requirements to deal with these two categories requiring segregated book-keeping could be seen as a burden. The tax holidays, even if temporary could ease this burden. It is also important to recognize that historically exports have always been receiving incentives and even new firms with SEZs do have access to such privileges. This could therefore make exporters more aware of the need or the benefits from tax holidays.