

# Encouraging Small Business Procurement in Indian States



Author  
**Kriti Upadhyaya**

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By Kriti Upadhyaya

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## *Executive Summary*

Governments around the world promote small business participation in government tenders. They do so directly through procurement mandates or set-asides, indirectly via policies that encourage small business participation in the tender, or by supporting measures that level the playing field for small businesses to compete in the tender process. Greater small business participation in the government procurement process benefits not only small businesses, but the government and the economy at large. In India, policies to promote small business participation in government procurement are focused on micro and small enterprises (MSEs). At the central government level, there is an MSE procurement policy for central ministries, departments, and public sector units. At the state level, policies that increase the government's MSE supplier base vary across states. This white paper provides leading international examples in the promotion of small business involvement in government procurement, while also enumerating best practices from Indian states in growing their MSE supplier base. Finally, a list of 21 recommendations is provided for Indian states as they formulate and rework their procurement policies. This white paper is the first in a series of four white papers focused on Indian state-level business reforms.

## *Why Government-Mandated Procurement Matters*

Small businesses account for 90 percent of all firms and 50 percent of all employment [worldwide](#). In emerging markets, small businesses make up seven out of ten formal jobs. Thus, small businesses do not merely contribute to the economy; [they are the economy](#). In India, small businesses are classified into micro, small, and medium enterprises (MSMEs), which are collectively called the MSME sector. This is distinct from international small business measures which are usually (not always) focused on the small and medium-sized enterprise (SME) sector. In this paper, MSME refers to the broader classification of small businesses. The term MSE is used within the Indian context when referring to only micro and small businesses. SME is used when referring to small and medium enterprises. All three terms are distinct and refer to distinct grouping of small business classifications.

India uses turnover and investment in plant, equipment, and machinery as benchmarks for determining MSME classification.

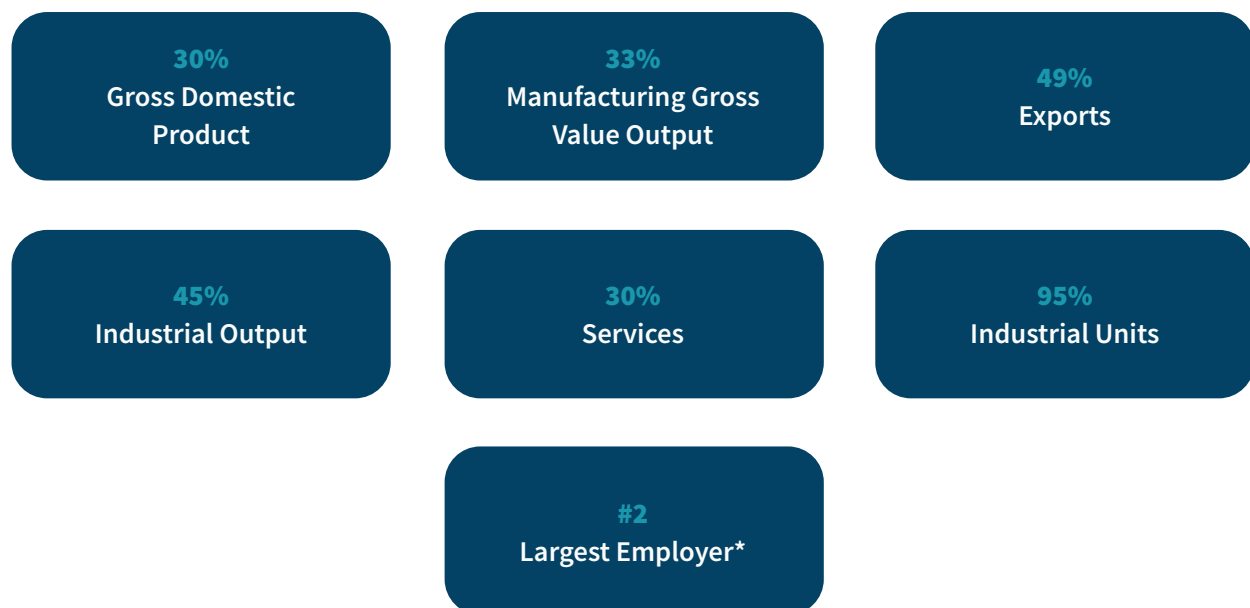
#### Classification of Manufacturing and Service Enterprises in India (USD)

Classification	Micro	Small	Medium
Manufacturing and Service Enterprises	<b>Investment</b> up to \$134K	<b>Investment</b> up to \$1.3 million	<b>Investment</b> up to \$6.7 million
	<b>Annual Turnover</b> up to \$670K	<b>Annual Turnover</b> up to \$6.7 million	<b>Annual Turnover</b> up to \$33.5 million

Source: “Gazette Notification,” Ministry of Micro, Small and Medium Enterprises, June 1, 2020, [https://msme.gov.in/sites/default/files/MSME\\_gazette\\_of\\_india.pdf](https://msme.gov.in/sites/default/files/MSME_gazette_of_india.pdf).

Much like elsewhere, MSMEs are the **growth engines** of the Indian economy. They employ the largest number of people after the agriculture sector and represent 95 percent of the industrial units and 45 percent of the industrial output of the nation. The MSME sector also generates about a third of India’s GDP, manufacturing gross value output, and services; MSMEs also account for nearly half of all exports from India.

#### MSMEs: Growth Engines of the Indian Economy



\*The MSME sector employs the largest number of people after the agriculture sector.

Source: Ministry of Micro, Small and Medium Enterprises, *Annual Report 2020–21* (New Delhi: Government of India, 2021), <https://msme.gov.in/sites/default/files/MSME-ANNUAL-REPORT-ENGLISH%202020-21.pdf>; Ministry of Micro, Small and Medium Enterprises, “Aiming to enhance MSME contribution to GDP from about 30% to 50%; and in exports from 49% to 60%: Shri Gadkari,” press release, <https://www.pib.gov.in/PressReleasePage.aspx?PRID=1652664>; “SME sector in India,” SME Chamber of India, <https://www.smechamberofindia.com/about-msme-in-india.php>; Amit Manohar, “Growth Imperative for the MSME Sector,” Invest India, <https://www.investindia.gov.in/team-india-blogs/growth-imperative-msme-sector>.

Considering the important role that MSMEs play in driving economies, governments around the world implement policies to support them in the hope that they will grow into large, successful firms. One of the ways that governments support MSMEs directly is purchase preference in procurement, creating a demand for their products and (in some cases) providing them with concessional terms for securing government orders.

## Benefits Provided to Governments through Small Business Procurement



Better value for money



Better quality of services through short management chains and approval routes



Personalized assistance



Specialized and niche product-offering capacity



Greater innovation through early adoption of technology

Source: HM Treasury, *Accelerating the SME economic engine: through transparent, simple and strategic procurement* (London: HM Treasury, November 2008), [https://webarchive.nationalarchives.gov.uk/ukgwa/+/http://www.hm-treasury.gov.uk/d/pbr08\\_economicengine\\_2390.pdf](https://webarchive.nationalarchives.gov.uk/ukgwa/+/http://www.hm-treasury.gov.uk/d/pbr08_economicengine_2390.pdf).

One major motivator for governments to undertake such policies is the benefits they accrue, not only to the small businesses, but to the wider economy. Small business procurement by the government:

- Is **employment-intensive**, as SMEs are more labor-intensive than larger firms
- **Increases competition** by including SMEs in the bidding process through targeted assistance like set-asides and bid price preferences
- **Decreases the influence** of established networks of larger firms
- **Fosters greater innovation**
- **Provides a wider choice** for government procurers
- **Helps to mainstream** and formalize large informal activities and marginalized sections of society

Moreover, MSMEs perpetuate an **economic multiplier effect**, strengthening local supply chains and the local economy. For example, a 2009 study finds that the state of California generated about \$4.2 billion and created 26,000 new jobs from 2006 to 2007 by contracting with disabled veteran-owned businesses and local small businesses instead of large companies. Studies have consistently shown wider socioeconomic benefits through greater MSME participation.

A review of literature on **recent efforts in Brazil** suggests that government procurement can provide important protections to MSMEs, and these can have effects beyond the life cycle of the government contract.

- Procurement auctions for SMEs led to growth effects that persisted for nine quarters
- Firms experienced growth for at least two years after winning a contract

- Firms that won a contract participated in 30 percent more auctions over the next three months
- Winning at least one contract in each quarter increased firm growth by 2.2 percentage points over the quarter

MSMEs also acquire soft skills and other benefits by participating in the government procurement process, such as [improved information systems](#) and greater professionalism. Winning a government contract can [increase the volume and stability](#) of demand for small businesses, providing a steady and conducive environment for them to invest and scale up.

It is, however, important to note downsides that are possible when public procurement policies are not implemented in the right way. Corruption in preferential procurement can [lead to](#) market capture, rent seeking, and other problems. Inept implementation [can create](#) long-term inefficiencies and lead to higher costs through increased SME dependency on government preferences and set-asides. The [evidence](#) on whether economic returns from MSME growth offsets any inefficiency losses from preferential procurement is also inconclusive, and although some studies indicate small business participation in government procurement fosters innovation, there are [competing studies](#) suggesting the opposite. Finally, set-asides—the most common approach for promoting MSME participation—depend on erecting barriers that can create market distortions. Hence, it is important to ensure transparency and monitoring in procurement and to have a targeted approach to ensure that the benefits provided help firms grow. One thing that governments could perhaps consider is capping MSME procurement benefits to a set number of years, so that inefficient MSMEs that fail to grow do not continue to exploit benefits and incur government costs.

### *How Governments Support Small Business Procurement*

Governments around the world promote small businesses through government procurement, both directly and indirectly, and deploy an array of supporting measures to encourage their participation in the procurement process.

- **Direct measures** include [set-asides](#) and mandates for procuring a certain percentage of total government goods and services from small businesses, reserved items for exclusive procurement by MSMEs, and the imposition of contract thresholds for tenders that will only go to MSMEs.
- **Indirect measures** include setting price preferences, encouraging joint bidding or consortia bidding, and having MSME subcontracting in tender provisions (or providing concessions for subcontracting with MSMEs).
- **Supporting measures** make the procurement process more favorable for MSMEs by leveling the playing field through preferential financial treatment, MSME support services, MSME training services, smaller tender sizes, easy-to-read tender documents, advance payment arrangements for MSMEs, e-procurement and other transparency measures, insurance for MSMEs bids, easy access to finance for delivering orders, and more.

## Popular Measures to Support MSME Procurement: India vs. OECD Countries




OECD Measure	Percent of OECD Countries Offering Incentive	Does India* Offer?
E-procurement	88%	Yes
Splitting contracts into smaller lots	83%	Provisions exist
Encouraging joint bidding and consortia	68%	Limited provisions
Simplified bidding process	57%	Attempts made
MSME subcontracting requirements	56%	No
Early payment arrangements	50%	Limited provisions
Preferential financial treatment	20%	Some preferences exist

\*Refers to central government provisions

Source: OECD, *Preventing Corruption in Public Procurement* (Paris: OECD, 2018), <https://www.oecd.org/gov/ethics/Corruption-Public-Procurement-Brochure.pdf>; and author's analysis.

Indirect measures and support are as important as set-asides; it is crucial that governments adopt an integrated approach in promoting small business procurement.

## Examples of Small Business Support Measures

 Peru	Increased transparency and SME training programs led to a 20 percent increase in total and per-worker profits for firms
 United States	Faster payment turnaround (from 30 days to 15 days) led to a 7 percent increase in annual SME payrolls after four years
 Sweden	Breaking up procurement lot sizes led to more small business participation

Source: William Nielsen, *Technical Report: Policies That Promote Participation in Public Procurement* (Donor Committee for Enterprise Development, 2017), <https://www.enterprise-development.org/wp-content/uploads/DCED-BEWG-SME-Procurement-Report.pdf>.

The text box below captures some of the practices adopted by countries for promoting the participation of MSMEs, MSEs, or SMEs in the government procurement process.

## International Examples Aimed at Promoting Small Business Participation in Government Procurement

### Italy

- **Supplier training desks** to train MSMEs on the use of electronic procurement

### United States

- **Set-asides** with a federal combined goal of 23 percent for small business, plus further set-asides for disadvantaged categories
- **Financial assistance**
- **Management and technical assistance**
- **Surety bonds**

### United Kingdom

- **Contract thresholds**

### Canada

- **Penalties for delayed payments**
- **Financial assistance**

### France

- **Access to finance** from the European Investment Bank
- **Division of contracts** into smaller lots

### Germany

- **Splitting lot sizes** both at the federal and subnational level
- Treating individual firms and consortia equally
- Prequalification schemes
- Some states have preferential treatment for SME subcontracting
- One state requires public-private partnerships to be planned in a way that SMEs can participate

### Japan

- **Yearly reserve targets** for SME procurement
- The **Small and Medium Enterprise Agency** provides **financial, management, fiscal, and commercial and regional support**

## China

- **Set-asides** of at least 30 percent of annual procurement budgets for SMEs, 60 percent of which is reserved for MSEs
- Bid-price preferences of 6–10 percent for SME applicants
- Encourage larger businesses to form consortiums with SMEs by providing bid-price preferences of 2–3 percent

## Brazil

- **Use of e-procurement**
- **All contracts up to \$15,300** reserved for SMEs
- Price preference margin of 10 percent

## Mexico

- **Use of e-procurement**
- Training for government officials and SMEs
- Financial support and advanced payments
- Public procurement fair
- Reserving 50 percent of contracts under a certain value

## South Korea

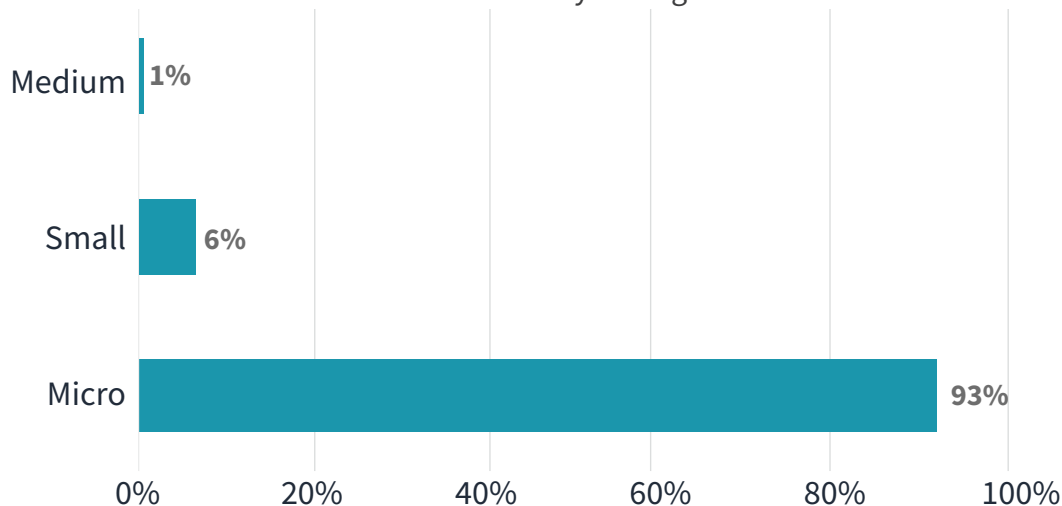
- **Use of e-procurement**
- Marketing support
- Financial assistance like fee waivers and advance payments
- Contract thresholds
- Reserved products
- Use of predetermined agreements



## India's MSME Procurement Landscape

The Indian procurement landscape is governed by policies and measures put in place by the central and state governments for promoting small business procurement. Procurement policies are focused on MSEs, which make up more than 99 percent of all MSME enterprises in India.

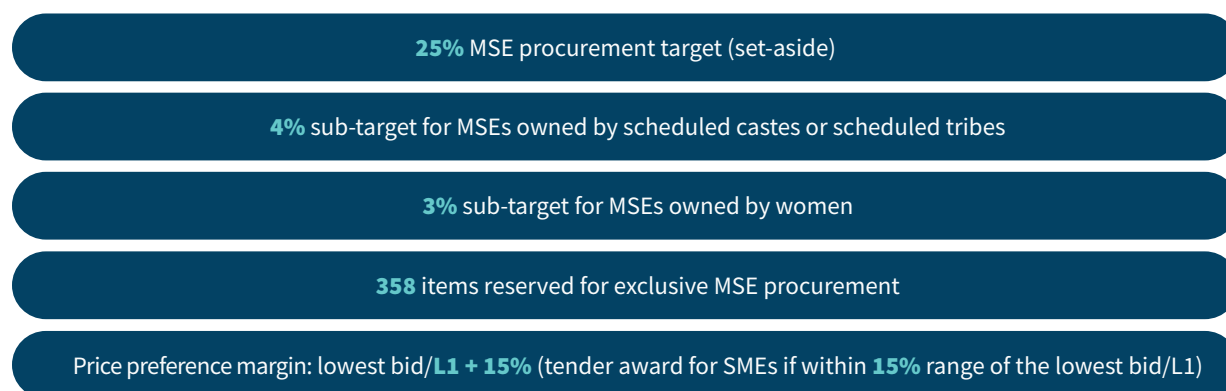
Indian MSME Sector Breakdown Based on Udayam Registrations



Source: Ministry of Micro, Small and Medium Enterprises, *Annual Report 2020–21*.

**Public Procurement Policy for Micro and Small Enterprises** promotes central government MSE procurement. Central mandates and policies are applicable to all central public sector enterprises (CPSEs), central government ministries, and departments.

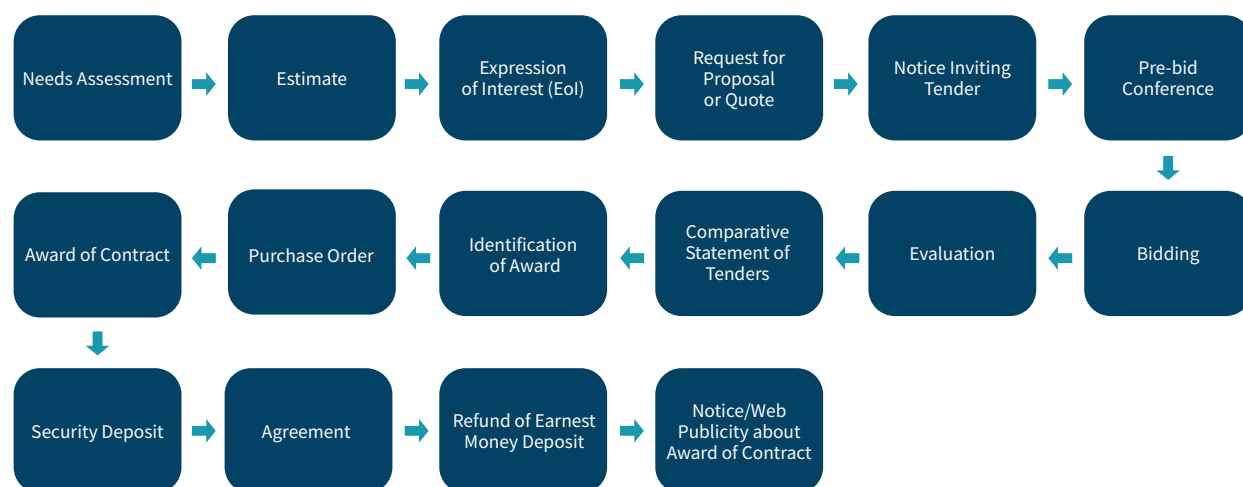
### Central Government Measures for Promoting MSE Procurement



Source: “Public Procurement Policy,” Ministry of Micro, Small and Medium Enterprises, <https://msme.gov.in/public-procurement-policy>; “List of 358 Items Reserved for Purchase from Micro and Small Enterprises,” Ministry of Micro, Small and Medium Enterprises, <http://www.dcmsme.gov.in/schemes/listof358itemsreserved.pdf>.

At both central and state levels, the procurement process is complex and multi-stage.

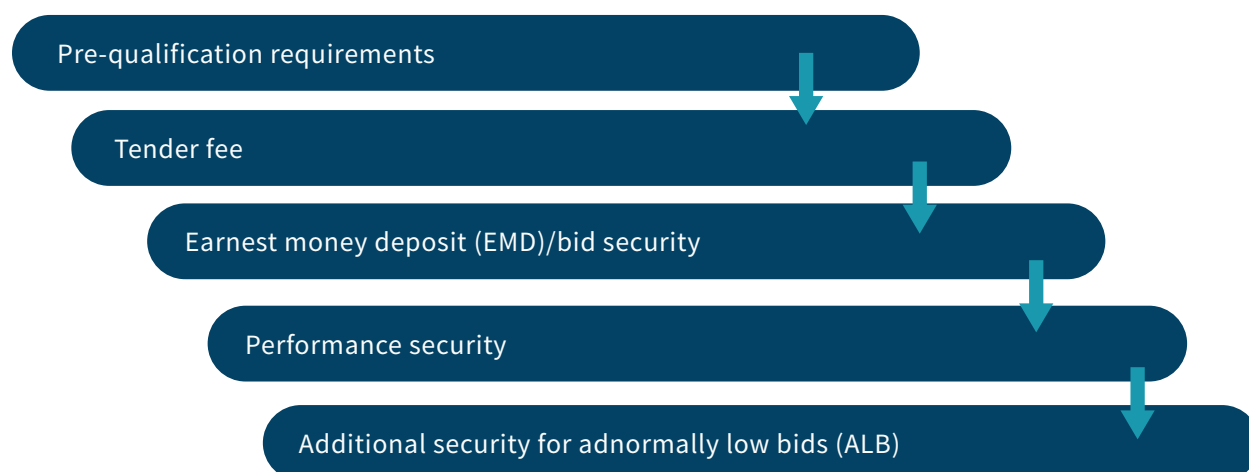
## The Procurement Process



Source: Mansoor Hasan Khan, “Public Procurement Issues with Government of India,” March 1, 2017, available at SSRN, [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2925865](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2925865).

At various stages, **financial and non-financial hurdles** thwart MSE participation in the government procurement process. Prequalification requirements—like turnover, previous government supplier experience, years in operation, and others—can limit MSE participation. Meanwhile, financial requirements—like tender fees for applying and subsequent securities—can constrain the free cash flow of MSEs, dissuading them from applying and affecting their ability to fulfill the tender.

## Prerequisites for Securing a Government Tender



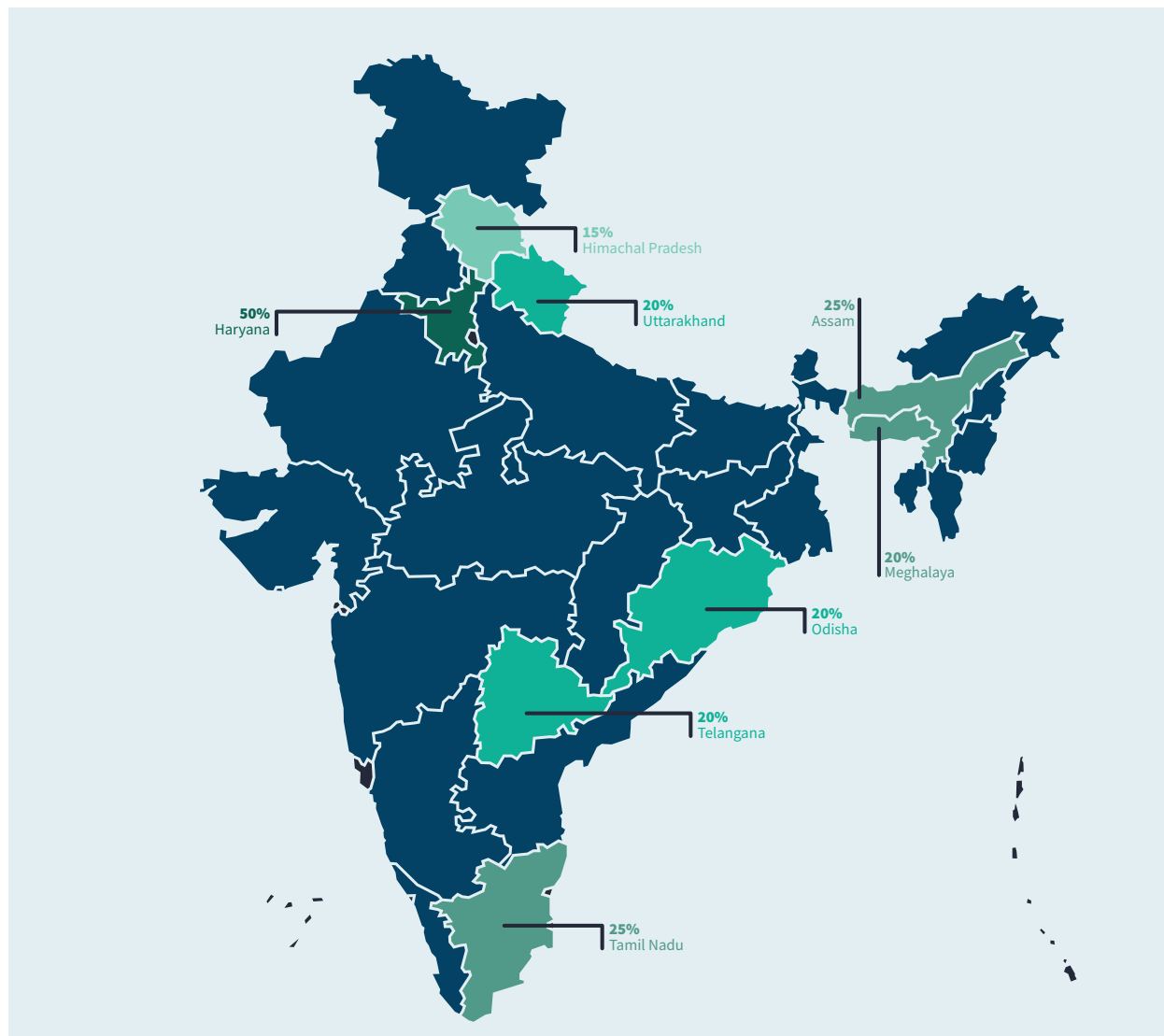
Source: Author’s analysis based on multiple sources.

For central procurement, registered MSEs are **exempt** from tender fees. Although Earnest Money Deposit (EMD), or bid security, has been **removed** for MSEs per the **General Financial Rules, 2017 amendments**, and **other orders**, EMD can still be required if deemed necessary. In many cases, EMD is being demanded from MSEs despite being removed—something that was recognized by the government when it once again **suspended EMD** and **reduced performance securities** as part of Covid-19 regulatory forbearance. Even upon completion of the order and delivery of goods, services, or works, MSEs deal with locked assets and constrained cashflows due to delayed payments. Despite a **45-day**

payment timeline, interest penalties for late payments, and other government measures, delayed payments continue to persist.

At the state level, state acts guide MSE procurement policy. States that have procurement mandates can contain them in their store purchase rules; tender rules; industrial policy; MSME policy or MSE promotion policy; procurement policy and rules; or any other state act, rule, or policy, depending on the state.

#### State MSE Procurement Mandates

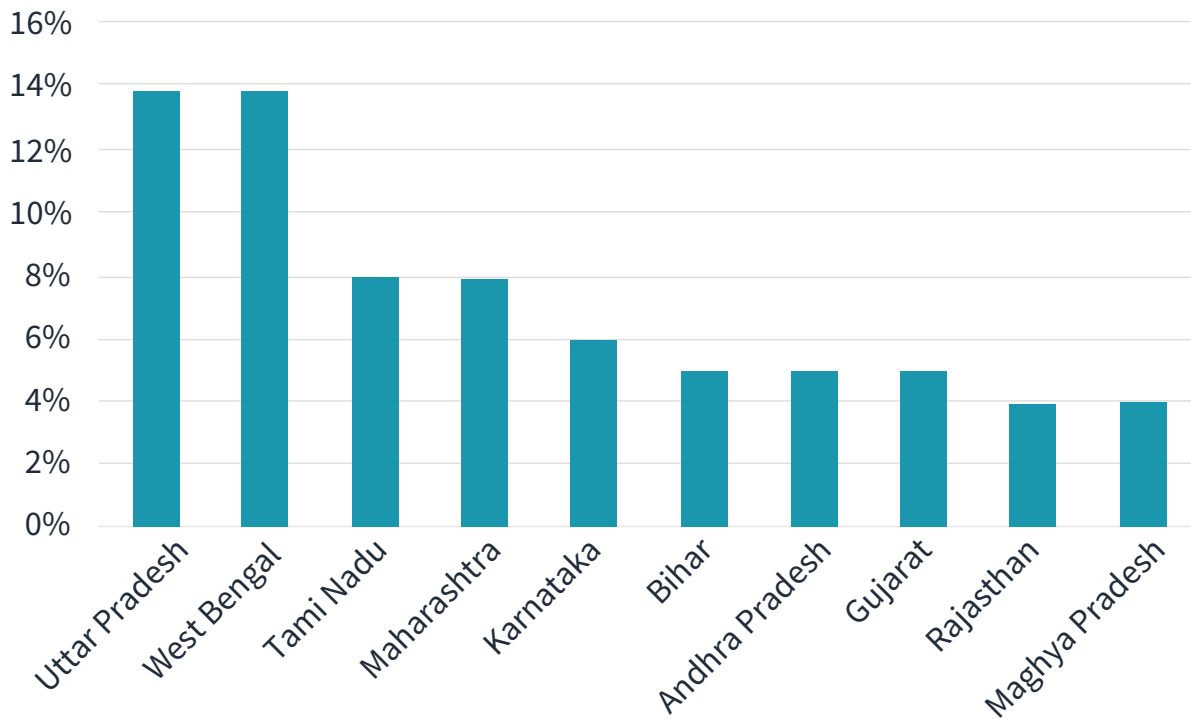


Source: Compiled from state government documents.

In addition, [Meghalaya](#) provides a 20 percent purchase preference to start-ups. [Uttar Pradesh](#) announced a 25 percent purchase preference policy for MSMEs following cabinet approval, but it has not formally notified the policy. [Maharashtra](#) advises state entities to procure 20 percent from MSMEs where possible. [Andhra Pradesh](#)'s MSME policy lapsed in 2020 but mentions leveraging the central government procurement mandate.

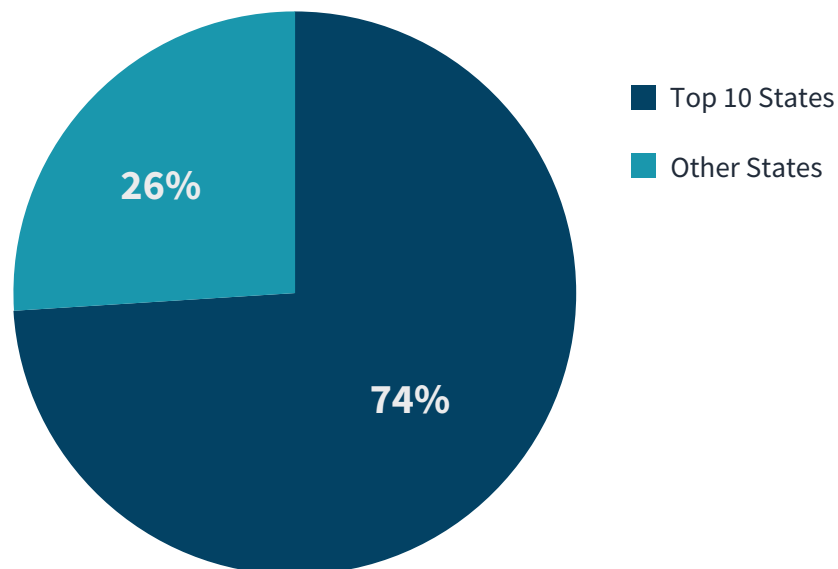
## Elements of the Perfect Procurement Policy: Best Practices from States

### Top 10 States Based on MSME Density



Source: Ministry of Micro, Small and Medium Enterprises, *Annual Report 2020–21*.

### MSME Density: Top 10 States vs Other States



Source: Ministry of Micro, Small and Medium Enterprises, *Annual Report 2020–21*.

Incentives and policies for promoting MSE participation in government tenders vary across states. Per the Ministry of Micro, Small, and Medium Enterprises, the **primary responsibility** for the development and promotion of MSMEs falls on state governments. The central government, at best, **supplements the efforts**

of the state governments through various initiatives. Hence, it is crucial that states take a leading role in framing effective procurement policies that aid in promoting MSMEs and MSEs. Many states have taken measures such as exempting or providing concessions in tender fees, EMD, and performance securities. Others have exempted or provided concessions for pre-qualification requirements like turnover, prior experience, and more. Some additional leading best practices from across Indian states are listed below.

- State procurement mandate in tune with or exceeding the central government procurement mandate—[Haryana](#) has the highest procurement mandate, at 50 percent
- Price preference for MSE procurement in tune with or above central government procurement mandate—[Himachal Pradesh](#) has a price preference margin of 20 percent
- Reserved list of items for exclusive MSE procurement—[Rajasthan](#) and [Odisha](#) have an item list, while [Karnataka](#) follows the central government's reserved list of 358 items
- Encouraging greater buyer-seller interaction—[Odisha](#) has state-led vendor development programs and buyer-seller meets
- Encouraging consortia formation—[Rajasthan's](#) MSME policy supports packaged bidding
- Supporting quality improvement—[Rajasthan](#) provides concessions for obtaining quality certificates
- Monitoring state procurement—[Andhra Pradesh](#) has a simple portal showing yearly procurement value while [Rajasthan](#) has a more visually appealing data-driven procurement monitoring portal

Based on the above, Haryana and Rajasthan lead in having policies conducive to small business procurement. While Rajasthan does not have an explicit MSE procurement mandate, Haryana offers the highest procurement purchase preference while also providing concessions on tender fees, securities, and prequalification requirements.

## *Recommendations for States*

Given the important role played by MSEs in the economy, it is important state governments come up with their own MSE promotion policy, including MSE procurement promotion policy. Some elements and reform measures that state governments can adopt as part of their MSE procurement promotion policy are enumerated below. These recommendations are based on international best practices as well as leading examples from Indian state governments.

### **DIRECT MEASURES TO PROMOTE PROCUREMENT:**

1. **Mandate MSE procurement** as a ratio of total procurement by state entities. Such a mandate should be in tune with or above the central government mandate of 25 percent.
2. **List reserved items for exclusive MSE procurement.**

### **INDIRECT MEASURES TO PROMOTE PROCUREMENT:**

3. **Encourage joint bidding and consortia bidding** through concessions and incentives.
4. **Split contracts into smaller lots when feasible** to make tenders more MSE-friendly.
5. **Encourage MSE subcontracting** through incentives and concessions in tender documents for MSE subcontracting.

#### FINANCIAL INCENTIVES:

6. **Remove EMD, tender fees, performance security, and additional performance security for ALBs** to free up MSE cash flow and encourage participation in tenders.
7. **Provide timely payments** to ensure that MSEs can deliver on contracts with ease. Timely payments will also encourage greater participation, as there is a [positive correlation](#) between time to pay suppliers and percentage of contract values going to MSEs.
8. **Implement early payment arrangements and stage-wise payments** for MSEs.

#### ACCESS TO INFORMATION:

9. **Organize digital literacy workshops**, especially in rural areas, to teach digital skills to MSE entrepreneurs who may not know about procurement portals and how to navigate the online application processes.
10. **Make pre-bid meetings mandatory**, especially for smaller tenders, so that MSEs have a chance to seek clarifications and guidance.
11. **Brief MSEs post-award** so they can learn where they fell short and how they can improve in future bids.
12. **Convene training workshops for MSEs** to prepare them for competing in government tenders.
13. **Create an online procurement hub** that shows all central and state government procurement websites and portals in one place for MSEs' ease of access.
14. **Monitor state-level MSE procurement** through a state procurement dashboard showing state procurement targets and their progress in real time.

#### REGULATORY AND LEGAL PROVISIONS:

15. **Establish a tribunal for hearing appeals of barred MSEs.**
16. **Establish revolving MSE support centers in state MSME clusters** that can provide pro bono accounting, legal, and other technical support to MSEs that are competing or trying to compete for state government tenders.
17. **Guarantee surety bonds and spur the development of a surety insurance market.** This may require the [initiative of regulators](#), but governments should push for establishing a surety insurance market and be the first movers in guaranteeing [such bonds](#).

#### PROCEDURAL REFORMS:

18. **Allow more flexibility for procurement officers** and encourage [quality-and-cost-based selection](#) over the least-cost selection method for awarding tenders where possible. This will benefit MSEs who may not provide the best price but may have innovative or higher quality products.
19. **Start soft-skill training for procurers** to supplement training manuals and help procurers in state departments absorb soft skills through workshops.
20. **Simplify tender documents**, focusing on work scope and requirements in simple language. Remove unnecessary and complicated language that makes for lengthy, tiresome documents.

- 21. Undertake onboarding drives to register MSEs** on state procurement portals, Government e-Marketplace (GeM), and other procurement portals. ■

***Kriti Upadhyaya** is a research associate with the Wadhwani Chair in U.S.-India Policy Studies at the Center for Strategic and International Studies in Washington, D.C.*

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