

PAPER I - INDIAN ECONOMY & INDIAN FINANCIAL SYSTEM

Module A: INDIAN ECONOMIC ARCHITECTURE

Chapter 4: Role of Priority Sector and MSME in the Indian Economy

Topics in this chapter

- Definition & Role of Priority Sector,
- List of Priority Sectors identified in India,
- Priority Sector Lending Norms,
- Definition of MSME,
- Role & Significance of MSME in economic development,
- Contribution of MSME in GDP,
- Recent Initiatives in MSME sector viz., Atmanirbhar Bharat package, Make in India, Start-up India, Stand-up India etc.

4.1 DEFINITION & ROLE OF PRIORITY SECTOR

In India, **Priority Sector** refers to certain areas of the economy that the Reserve Bank of India (RBI) wants banks to give special attention to when providing credit.

These sectors are considered important for overall economic development, especially for promoting inclusive growth and supporting weaker sections of society.

The concept of the Priority Sector dates back to 1967. On December 14, 1967, Morarji Desai, who was then the Deputy Prime Minister and Minister



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of Finance, stated in the Lok Sabha that there were persistent complaints that several important sectors, such as **agriculture, small-scale industries, and exports**, were not receiving their fair share of bank credit. This appears to be the first time the phrase "**priority sector**" was used.

Following this, the concept of "**social control over banks**" was introduced in 1967, directing banks to align their activities with national objectives. In July 1968, the National Credit Council emphasized that commercial banks should increase their financing to priority sectors.

Priority sector lending includes those sectors that have a significant impact on large portions of the population, especially the weaker sections, and sectors that are employment-intensive, such as agriculture and micro and small enterprises.

4.2 LIST OF PRIORITY SECTORS IDENTIFIED IN INDIA

The Reserve Bank of India (RBI) has identified the following eight categories as Priority Sectors:

The current priority sector categories are:

1. **Agriculture:** Encompasses farming, agricultural infrastructure, and ancillary activities.
2. **Micro, Small and Medium Enterprises (MSMEs):** Crucial for employment generation and economic development.
3. **Export Credit:** Loans provided to exporters to facilitate international trade.
4. **Education:** Loans for educational purposes, including vocational courses.



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5. **Housing:** Loans for affordable housing, particularly in smaller cities.
6. **Social Infrastructure:** Projects related to schools, drinking water facilities, and sanitation.
7. **Renewable Energy:** Projects like solar power, biomass, and micro-hydel plants.
8. **Others:** This category includes lending to "Weaker Sections" of society.

4.3 PRIORITY SECTOR LENDING NORMS

Banks are required to lend a certain percentage of their total credit to these priority sectors. This target is calculated based on the **Adjusted Net Bank Credit (ANBC)** or the **Credit Equivalent of Off-Balance-Sheet Exposures (CEOBE)**, whichever is higher.

The current targets are as follows:

Category of Bank	Total PSL Target	Agriculture (with SMF sub-target)	Micro Enterprises	Advances to Weaker Sections
Domestic Scheduled Commercial Banks & Foreign Banks (≥ 20 branches)	40% of ANBC or CEOBE	18%, with 10% for Small & Marginal Farmers	7.5%	12%
Foreign Banks (<20 branches)	40% of ANBC or CEOBE	<i>No specific sub-targets (agri, micro, weaker) applicable</i>	—	—



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Category of Bank	Total PSL Target	Agriculture (with SMF sub-target)	Micro Enterprises	Advances to Weaker Sections
Regional Rural Banks (RRBs)	75% of ANBC or CEOBE	18%, with 10% for Small & Marginal Farmers	7.5%	15%
Small Finance Banks (SFBs)	60% of ANBC or CEOBE (revised as of June 20, 2025)	18%, with 10% for Small & Marginal Farmers	7.5%	12%

ANBC - Adjusted Net Bank Credit

It is basically the net bank credit (loans and advances given by the bank) adjusted for certain items.

Formula:

ANBC = Net Bank Credit (NBC) + Investments in eligible PSL instruments – Deductions as per RBI

CEOBE - Credit Equivalent of Off-Balance Sheet Exposures

This is the **value of contingent liabilities and guarantees** converted into an equivalent “loan” value. It covers things not on the bank’s balance sheet but which represent potential credit risk, such as:

- Bank guarantees
- Letters of credit
- Derivative exposures
- Acceptances and endorsements

RBI uses **Credit Conversion Factors (CCF)** to turn these off-balance sheet items into an equivalent credit value.



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4.4 DEFINITION OF MSME

MSME stands for **Micro, Small, and Medium Enterprises**.

In simple terms, it's a way the government categorizes businesses based on their size. Instead of just calling a business "small" or "large," the government has specific criteria based on two main factors:

1. **Investment:** How much money the business has spent on its machinery and equipment.
2. **Turnover:** How much money the business earns in a year (its total sales).

Based on these numbers, a business is classified as Micro, Small, or Medium. Think of it like categories in sports: you have lightweight, middleweight, and heavyweight fighters. MSME is a similar classification for businesses.

- **Micro:** The smallest businesses (e.g., a local bakery, a small repair shop).
- **Small:** Businesses that are a bit larger (e.g., a small factory making components, a software firm with 50 employees).
- **Medium:** The largest of the three (e.g., a regional manufacturing plant, a mid-sized processing unit).

The government actively encourages and supports MSMEs because they are considered the **backbone of the Indian economy**. While large corporations get a lot of attention, it's the massive network of smaller businesses that drives the country forward in many crucial ways

The Government of India has revised the definition of Micro, Small, and Medium Enterprises (MSMEs), a move aimed at fostering their growth and providing them with a more conducive business environment. The latest



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definition, which came into effect on **July 1, 2020**, is based on composite criteria of investment in plant and machinery or equipment and the annual turnover of the enterprise.

The updated classification, applicable to both manufacturing and services sectors, is as follows:

Enterprise Category	Investment in Plant & Machinery or Equipment	Annual Turnover
Micro Enterprise	Not more than ₹1 crore	Not more than ₹5 crore
Small Enterprise	Not more than ₹10 crore	Not more than ₹50 crore
Medium Enterprise	Not more than ₹50 crore	Not more than ₹250 crore

The new definition of MSMEs will make it easier for small businesses to expand and grow without losing the benefits available to them from the government. The new **Udyam Registration Portal**, launched in July 2020, has made the registration process entirely online, digital, and paperless, based on self-declaration.

4.5 ROLE & SIGNIFICANCE OF MSME IN ECONOMIC DEVELOPMENT

The most important feature of the MSME sector is its **high employment potential at a low capital cost**. Globally, Small and Medium Enterprises (SMEs) account for about 90% of businesses and more than 50% of employment. In India, the MSME sector is diverse and is considered an engine of economic growth, promoting sustainable and inclusive development across all parts of the country.



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MSMEs are crucial for India's economic and social development due to several key reasons:

- **Employment Generation:** They create a vast number of jobs, especially in rural and underdeveloped areas. After agriculture, they are India's biggest employers.
- **Promotion of Entrepreneurship:** They make it easier for people to start their own businesses with low investment, encouraging new ideas.
- **Regional Development:** By setting up in remote areas, they help spread economic growth evenly across the country.
- **Export Promotion:** They make many goods and services for other countries, boosting India's exports.
- **Diversification:** They work in many different sectors, making the economy stronger and less dependent on any single industry.
- **Innovation:** They are centers for new ideas, creating new products and technologies.
- **Reduction of Income Disparities:** They help create wealth and income for a wider range of people, reducing the gap between rich and poor.
- **Support for Large Industries:** They supply essential parts and services to bigger companies, acting as their backbone.

4.6 CONTRIBUTION OF MSME IN GDP

Micro, Small, and Medium Enterprises (MSMEs) are key drivers of economic growth in India. With a robust network of over **64 million firms**, the MSME sector plays a pivotal role in industrial production, trade, employment, and regional development.



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Key Contributions of MSMEs:

- **Manufacturing Output:** MSMEs generate over **45% of India's manufactured production**, showcasing their importance in industrial activity.
- **Exports:** They account for more than **40% of total exports**, making them critical contributors to India's foreign trade.
- **GDP Contribution:** MSMEs contribute over **28% of the national GDP**, highlighting their substantial role in the economy.
- **Employment Generation:** With **approximately 111-120 million people employed**, MSMEs are the **second-largest source of employment** after agriculture, supporting livelihoods across urban and rural areas.
- **Regional Development:** MSMEs promote **balanced regional growth**, as many enterprises are located in semi-urban and rural areas, reducing migration pressures on cities.
- **Innovation and Entrepreneurship:** MSMEs encourage **innovation, entrepreneurship, and skill development**, especially among first-time business owners and youth.

Future Outlook: As India advances toward a **\$5 trillion economy**, the Ministry of MSME aims to enhance the sector's contribution to GDP to **50% by 2025**, focusing on improved access to finance, technology adoption, and market expansion.

4.7 RECENT INITIATIVES IN MSME SECTOR, VIZ., ATMANIRBHAR BHARAT PACKAGE, MAKE IN INDIA, START-UP INDIA, STAND-UP INDIA, ETC.

The government has taken several measures to support the MSME sector, especially under the **Atmanirbhar Bharat Package** launched during the COVID-19 pandemic. Some of the most important initiatives are listed below.



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- **Atmanirbhar Bharat Abhiyan (Self-Reliant India Campaign):**

- **Objective:** To help India recover from the economic impact of COVID-19 and promote self-reliance, empowering every Indian sector, especially MSMEs.
- **Five Pillars:** Economy, Infrastructure, System, Vibrant Demography, and Demand.
- **Benefits for MSMEs:**
 - **Revised MSME Classification Limits:** Increased limits to support economic growth and operations of MSMEs.
 - **Emergency Credit Line (ECLGS):** A collateral-free automatic loan of ₹3 lakh crore was made available to businesses and MSMEs affected by the pandemic. This scheme provides 100% credit guarantee to banks and NBFCs.
 - **Debt for Stressed MSMEs:** ₹20,000 crore was provided as subordinate debt to revive stressed MSMEs, with partial credit guarantee support to banks.
 - **Equity Infusion:** A Fund of Funds (FoFs) with a corpus of ₹10,000 crore was set up to provide equity funding to MSMEs with high growth potential.

Make in India:

Launched:

September 2014

Objective:

Transform India into a global manufacturing hub, raise manufacturing's share of GDP to 25% (target revised to 2025), and create 100 million jobs.

Progress (as of 2025):



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- Manufacturing share in GDP ~13-14% (declining from 16.7% in 2013-14).
- FDI in manufacturing reached ₹14.45 lakh crore (US\$165 bn) in the past decade.
- Electronics exports up 47% YoY in Q1 FY26; PMI at 59.1 in July 2025.
- PLI schemes attracted ₹1.76 lakh crore investments; ~1.2 million jobs created but many targets unmet.
- New schemes launched for drones, semiconductors, and electronics components.

Benefits for MSMEs:

- Promotes domestic manufacturing, reduces import dependence.
- Improves ease of doing business, boosts innovation and investment.
- Encourages skill development and sectoral diversification.

Challenges:

- Targets for GDP share and job creation largely unmet.
- Automation reducing labor demand.
- US tariffs (~50%) may impact exports.

Start-up India:

- **Objective:** To promote growth and help the Indian economy by providing ample benefits to entrepreneurs establishing startups.
- **Benefits for Startups (many of which are MSMEs):**
 - **Simple Process:** Easy online registration via a mobile app and website.
 - **Reduction in Cost:** 80% reduction in patent filing costs, with government bearing facilitator fees.



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- **Easy Access to Funds:** A ₹10,000 crore fund provides venture capital, and government guarantees encourage bank lending.
- **Tax Holiday:** Exemption from income tax for 3 years.
- **Apply for Tenders:** Exempted from "prior experience/turnover" criteria for government tenders.
- **R&D Facilities:** Seven new Research Parks to provide facilities.
- **Simplified Compliances:** Self-certification for 9 labor and 3 environment laws.
- **Market Credibility:** Increased market credibility and opportunities for international trade and collaboration.
- **Stand-up India:**
 - **Objective:** To promote entrepreneurship among traditionally underserved communities: Scheduled Castes (SC), Scheduled Tribes (ST), and women entrepreneurs.
 - **Loan Details:**
 - **Loan Limit:** Ranges from ₹10 lakh to ₹1 crore for greenfield projects (first-time ventures).
 - **Loan Type:** Composite loan, combining Term Loans and Working Capital.
 - **Project Coverage:** The loan can pay up to 85% of project cost (need to arrange the remaining 15%).
 - **Repayment Period:** Up to 7 years, with a maximum moratorium period of 18 months.
 - **Interest Rate:** Lowest applicable by the bank for that category, not exceeding MCLR + 3% + tenor premium.
 - **Security:** Loans can be secured by collateral or by the Credit Guarantee Fund Scheme for Stand-Up India Loans (CGFSIL).
 - **Support:** Provides hand-holding support, training, mentorship, and guidance through the Stand-Up India



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portal. Each bank branch is mandated to assist at least one SC/ST and one-woman entrepreneur.

Production Linked Incentive (PLI) Scheme

The **Production Linked Incentive (PLI) Scheme** is a government initiative designed to **boost domestic manufacturing, attract investment, and make Indian industries globally competitive.**

Key Features:

- The government has allocated **₹1.97 lakh crore** for PLI programs across **14 priority sectors**, including **textiles, steel, telecom, automobiles, electronics, and pharmaceuticals**. *(It was originally across 13 sectors in 2020-21, but Drones were added later, making it 14.)*
- The scheme provides **financial incentives ranging from 4% to 6%** on **incremental sales over a specified base year**, encouraging companies to increase production and expand operations.
- PLI aims to **reduce import dependence, enhance exports, and create employment opportunities** by supporting domestic manufacturers in scaling up their capacities.
- It also fosters **technology upgradation, innovation, and global competitiveness**, attracting both domestic and foreign investment.

Impact and Outlook: The PLI scheme is expected to **strengthen India's manufacturing ecosystem**, contribute to the **\$5 trillion economy goal**, and position India as a **global manufacturing hub** in strategic sectors.



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