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BACKGROUND PAPER - 01

Out of the frying pan and into the fire

Effects of Covid-19 crisis on micro, small and medium enterprises (MSME) in India

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CENTRE FOR SUSTAINABLE EMPLOYMENT

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Out of the frying pan and into the fire:

Effects of Covid-19 crisis on micro, small and medium enterprises (MSME) in India

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1. The Importance of the MSME Sector and the COVID-19 crisis

In an attempt to curtail the spread of COVID-19 infection, the Government of India (GoI) imposed one of the worlds' strictest lockdowns, which lasted over two months.[1] Despite these efforts, with over nine million cases and 140,000 fatalities as of December 5th, India remains one of the hardest hit countries by the pandemic. The strict lockdown also led to considerable economic distress, that disrupted both the lives and livelihoods of millions (Adhikari et al. 2020). The provisional estimates of Gross Domestic Product (GDP) for the quarter ending September 2020 confirm the severity of its economic impact.[2] In the backdrop of its performance in the previous quarter ending June 2020, where the economic output contracted by 23.9 per cent on a year-on-year basis, the Indian economy entered a technical recession with a further contraction of 7.5 per cent as against the comparable quarter of 2019.

The micro, small and medium enterprises (MSMEs) sector is a critical component of the Indian economy.[3] The sector contributes to over 110 million jobs and almost a third of India's GDP, thereby representing a large share of the overall economy as well as being a major source of employment (Government of India 2017-2018). In terms of sectoral contribution, it accounts for about half of India's manufacturing output and exports (Government of India 2017-2018). With the COVID-19 induced lockdown and the associated slowdown in economic activity, emerging evidence suggests that small businesses across the world were adversely impacted over multiple dimensions such as loss in sales, employment and survival expectations (Bartik et al. 2020; Humphries, Neilson and Ulyssea 2020; Zhang 2020). In India, the crisis had a debilitating impact on the sector. As per a survey of about 46,000 self-employed and MSME owners, about 35 per cent of the enterprises reported planning to close down as a result of the crisis and more than 70 per cent firms reported to have fired workers.[4] Smaller but more detailed surveys have attempted to quantify this distress and study heterogeneities across firm size by employment. In Rathore and Khanna (2020), we find that by end of May 2020 firms reported a sharp decline in average capacity utilisation. Production fell from about 75 per cent of capacity before the crisis to about 11 per cent

[1] "Oxford COVID-19 Government Response Tracker", Blavatnik School of Government, 2020, https://www.bsg.ox.ac.uk/research/research-projects/coronavirus-government-response-tracker
[2] "Now in recession, India is faring worse than most major economies", Quartz India, November 30, 2020, Accessed on December 1st, 2020, https://qz.com/india/1939266/now-in-recession-india-is-faring-worse-than-us-germany-france/
[3] Defined in Table 1
[4] "Nearly 35% MSMEs close to winding up: AIMO", CMIE: Economic Outlook, 2 June, 2020, https://www.cmie.com/kommon/bin/sr.php?kall=warticle&dt=2020-06-02%2015:40:07&msec=706

for these firms. Our findings also reveal a loss of sales amounting to about 17 per cent of past year's revenues and a 55 per cent decline in pre-COVID workforce. Similar to the case of United States, we find that the impact of the crisis has been significantly more severe on smaller firms by employment size (Bartik et al. 2020; Rathore and Khanna 2020)

In this paper, we first provide a background on the health of the MSME sector in the lead up to the crisis, and then examine the impact of the lockdown on the sector. For the background exercise, we attempt to document how policy manoeuvres in the past few years left the MSME sector in a vulnerable state, thereby amplifying the adverse effects of the current crisis. In the second part of the paper, we mainly rely on findings from our primary survey of nearly 400 firms conducted over May-June 2020 with units across 20 States and Union Territories (Rathore and Khanna 2020). As a part of this survey, we also conducted qualitative, semi-structured interviews with various stakeholders including entrepreneurs, representatives of business associations and administrators. Additionally, another aim of this paper is to shed light on policy measures that are most likely to serve the requirements of different sectors within the broad MSME umbrella and aid their recovery. Here, we provide additional analysis from our survey on the knowledge, perceptions, and suggestions of firm owners on policy relief measures. These offer insights into binding constraints and may provide guidance in identifying the proverbial biggest bang for the buck in terms of optimal policy response. Importantly, this evidence facilitates a nuanced view of a sector that is artificially aggregated into a common category of MSMEs, which includes vastly different businesses operating at varying scales.

2. Background on the MSME sector in the lead up to the crisis

The categorization of the MSME sector in India does not constitute a natural grouping. There exists wide variation in characteristics of micro, small and medium enterprises, with large differences in scales and technology of operation as well as the component of the supply chains they cater to, among others. However, historically, these vastly different entities have been aggregated under a common term. Until the onset of the COVID-19 pandemic, this categorization was based on thresholds of investment in plant and machinery or equipment, as specified by the Micro, Small & Medium Enterprises Development (MSMED) Act, 2006. These thresholds for micro, small and medium manufacturing (services) enterprises stood at up to Rs. 25 (1) Lakh, greater than Rs. 25 (1) Lakhs but less than Rs. 5 (2) Crore and greater than Rs. 5 (2) Crore but not exceeding Rs 10 (5) Crore, respectively. During the course of the pandemic, this classification was changed with the Government of India (GoI) notification dated 1st June 2020. As per this announcement, the upper limits of investment in plant and machinery (manufacturing) or equipment (services) for each category was expanded and linked with a turnover component, as outlined in Table 1 below.[5]

Table 1: Updated classification of Micro, small and medium enterprises as per the GoI notification in June 2020

Category	Manufacturing (Services): Investment in plant & machinery (equipment) (Rs.)	Turnover (annual) (Rs.)
Micro	Not more than 1 Crore	Not more than 5 Crore
Small	Not more than 10 Crore	Not more than 50 Crore
Medium	Not more than 50 Crore	Not more than 250 Crore

Note: Details based on official gazette published by the GoI,
https://msme.gov.in/sites/default/files/MSME_gazette_of_india.pdf

The fact that the sector was under considerable duress before the COVID-19 induced lockdown is well documented. The demonetisation of currency notes in 2016, which was followed by an abruptly implemented Goods and Services Tax (GST) regime in 2017 and a crisis in the Non-Banking Financial Companies (NBFC) in 2018, is estimated to have left the sector in a vulnerable state before the onset of the COVID-19 crisis (Dev and Sengupta 2020). The authors show that for the MSME sector, industry-wise allocation of bank credit, across major segments were low or negative on a year on year basis between 2015 and 2019. Other studies support this finding and suggest that credit growth to the MSME sector, which was already weakening, declined further in this period (Behera and Wahi 2018). Their research also suggests that transition to the Goods and Services Tax (GST) regime had an adverse effect on the exports from the sector.

[5] "What's MSME", Ministry of Medium, Small and Micro Enterprises, https://msme.gov.in/know-about-msme

Qualitative findings from our semi-structured interviews with owners of MSME units and office bearers of Industrial Associations offer further insights into the lasting effects of these two shocks in particular. Our interviews reveal that capital expansion and investment in the MSME sector declined drastically post demonetisation. Historically, a large share of transactions in the MSME sector are kept out of books from the fear of harassment and excessively high tax rates. Before demonetisation, cash could be readily brought into circulation for small ticket expenses by raising invoices or brought into books via shell companies for major purchases like capital expansion. After demonetisation, although these businessmen were able to convert old currency notes to new, GoI's action on shell companies and a change in rule that allowed borrowing only from private limited companies stalled capital expansion. Businesses were still able to cover usual running expenses by raising invoices but could not bring currency into circulation for larger expenses like capital expansion, even if they had significant cash reserves. This sentiment was well reflected in one of our qualitative interviews with an office bearer of a regional industrial association.

> *"Demonetization was good but badly implemented. Before this move, tax rate was as high as 40% if you include surcharge and this along with the fear of harassment ensured that most businessmen kept a large share of their transactions out of books. Cash could readily be brought into books via various mediums like shell companies and be used for big purchases like capital expenditure. With demonetization, although businessmen were able to convert old currency notes to new, they could not bring it in circulation anymore. Moreover, unlike previous times, now one could only borrow from a private limited company. So, while a businessman may be sitting on Rs. 1 Crore which may still be used for usual expenses by raising invoices, unless he has this money on his books (which most didn't), he would not be able to raise funds for expansion. This is the reason why capital expenditure has stalled in the MSME after demonetization."*

(an entrepreneur and a General Secretary of a regional Industrial Association, 31st May 2020)

Our qualitative interviews reveal that introduction of GST, which was envisaged to provide access to larger markets and facilitate competition also had inbuilt structures that made the MSME firms less competitive, especially in the global market. It is well established that a large section of the MSME sector is self-financed with negligible borrowings from formal institutions (Dev and

Sengupta 2020). Indeed, even in our survey, only 40 per cent of micro-enterprises relied on formal institutions as a major source of finance, which is likely to be an overestimate since our sample is somewhat skewed towards larger firms (see section 3). Thus, the liquidity of businesses in the aftermath of demonetisation was seriously curtailed. The implementation of GST largely ignored the business practices that are prevalent and unique to the MSME section. Various small businesses in our discussions reported that a majority of their sales is paid for over credit cycles lasting 45-50 days. Thus, the produce is delivered, and the payment made within the span of this credit cycle. However, the GST rules dictate filing of GST invoices by a general taxpayer has to be executed on the 20th of every month. In this way, businesses end up paying taxes without having received their due payments, which further worsens their liquidity situation and hampers their competitiveness.

In addition to these issues specific to the MSME sector, these multiple shocks also had adverse effects on the overall economy. There is largely an agreement among economists that demonetisation had adverse effects on the economy (Ramkumar 2018) and that the move led to contraction of the Indian economy (Nagaraj 2020). This had significant demand side repercussions, via loss of jobs and livelihoods. Evidence suggests that demonetisation, in its immediate aftermath, caused a decline in employment, output and credit growth to the tune of at-least 2 percentage points in the fourth quarter of 2016, with these effects sustaining over the next few months (Chodorow-Reich et al. 2020). This corroborates reports of rising unemployment in India which suggest that about 1.5 million jobs were lost in the first few months of 2017 (Vyas 2017). The effects of the move were felt profoundly in the agricultural sector, given its dependence on cash. Research shows that demonetisation had an adverse impact on arrival and prices of agricultural produce across about 3000 regulated agricultural markets (mandis) in India for 35 major agricultural commodities (Aggarwal and Narayanan 2017). Given that about half of India's population is dependent on agriculture, these findings are suggestive of the subsequent decline in demand in rural India. In fact, evidence suggests that between 2014-2015 and 2017-2018, overall consumption expenditure in India declined in absolute terms by about four per cent, with a large section of this coming from decline in rural India (Bera 2019).[6] This is likely to have initiated a vicious cycle where, as a result of decline in demand, capital expansion, which was already declining since demonetisation was curtailed further. Thus, other than the supply side effects, where capital expansion was stalled with significant capacity under-utilisation, these shocks also had spill over effects that contributed to a demand slowdown in the run up to the COVID-19 crisis.

3. The plight of micro-enterprises during the lockdown

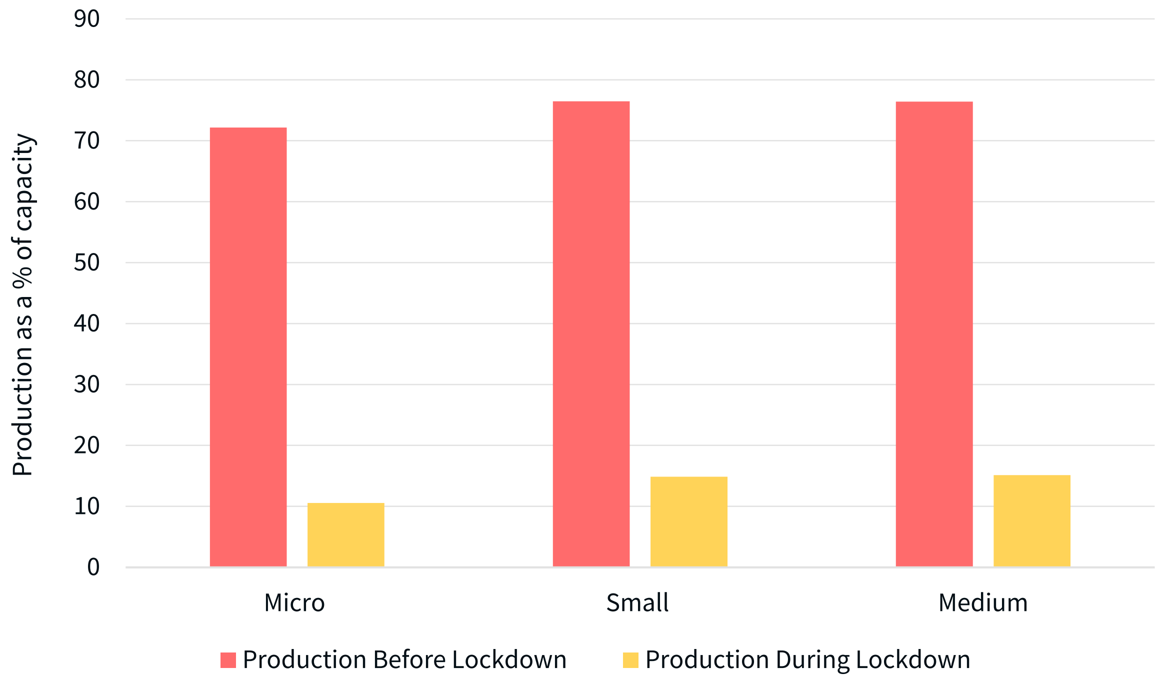
In this section, we summarize findings from our survey that are particularly relevant for policy. We launched our survey in the first week of May 2020, nearly 40 days after the nationwide lockdown began. We contacted individual firm owners primarily through reaching out to industrial associations across north India. Our survey was short but comprehensive, with questionnaires in both English and Hindi. In total, we surveyed 388 firms, with a majority from Uttar Pradesh, the state with the largest concentration of MSMEs in India. Micro, small, and medium enterprises constitute 39, 49, and 10 percent of our sample, respectively. Our sample is thus skewed towards larger firms in comparison with their distribution in the population. This is to be expected given the sampling strategy of approaching firms that were members of some industry or business associations. This is important to keep in mind as it likely means that if anything, our estimates of distress are understating the impact of the lockdown.

The first main findings to note are impacts on firms' production and employment levels, which took a serious hit in the month of May due to the strict and universal nature of the lockdown. In Figure 1, we show the production for firms before and during the lockdown. Micro-enterprises started off with the lowest production capacity before the lockdown and ended up with the lowest production numbers during the lockdown. On average, micro-enterprises were producing at 72 per cent of capacity before the lockdown, and at only 10.5 per cent of capacity after the lockdown.

[6] "India needs farm revolution to attain 9-10% GDP growth: Amitabh Kant", The Economic Times, March 19, 2019, https://economictimes.indiatimes.com/news/economy/agriculture/india-needs-farm-revolution-to-attain-9-10-gdp-growth-amitabh-kant/articleshow/68473771.cms?from=mdr#:~:text=In%20India%2050%25%20of%20our%20population%20is%20dependent%20on%20agriculture

These numbers reflect the differences in the extensive margin of production; only 37 per cent of micro-enterprises had some positive production during the lockdown, whereas over half of small and medium enterprises had positive production.

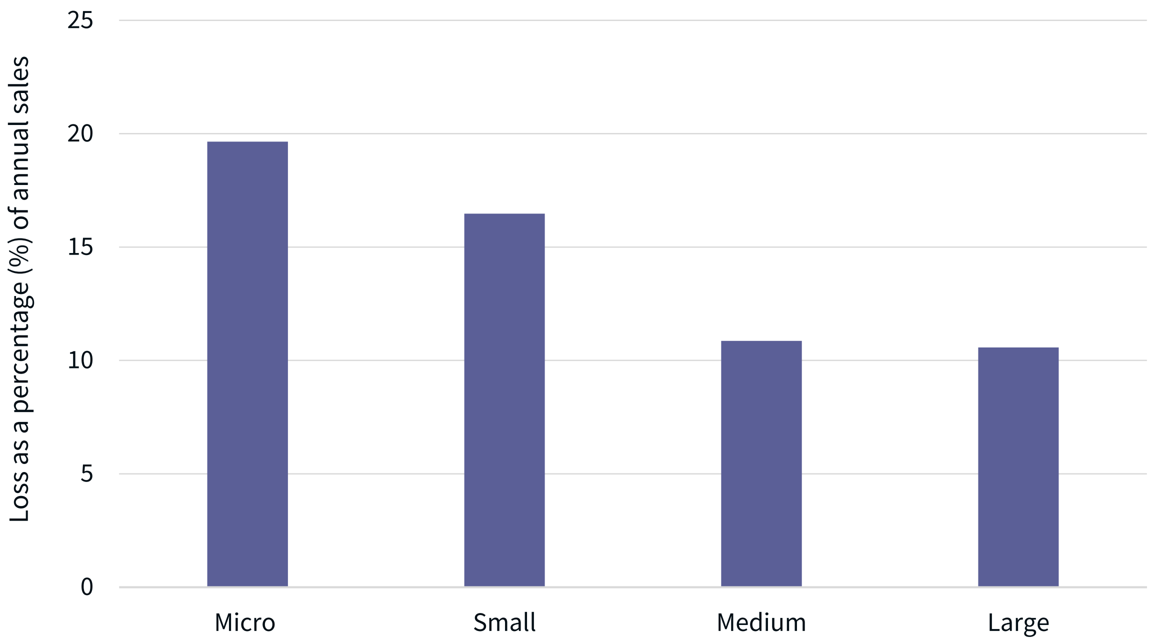
Figure 1: Production Levels as a Percentage of Capacity before and during the lockdown



Source: Authors calculations based on primary survey

This sharp decline in production was also reflected in loss in sales. The ratio of estimated losses due to the lockdown as a share of annual sales are presented in Figure 2. On average, firms lost about 17 per cent of their annual sales, which is consistent with the production numbers and the fact that firms were surveyed about six weeks into the lockdown. More importantly, the figure shows that while micro-enterprises lost nearly 20 per cent of their annual sales, medium and large enterprises lost about 11 per cent.

Figure 2: Loss as a percentage of Annual Sales

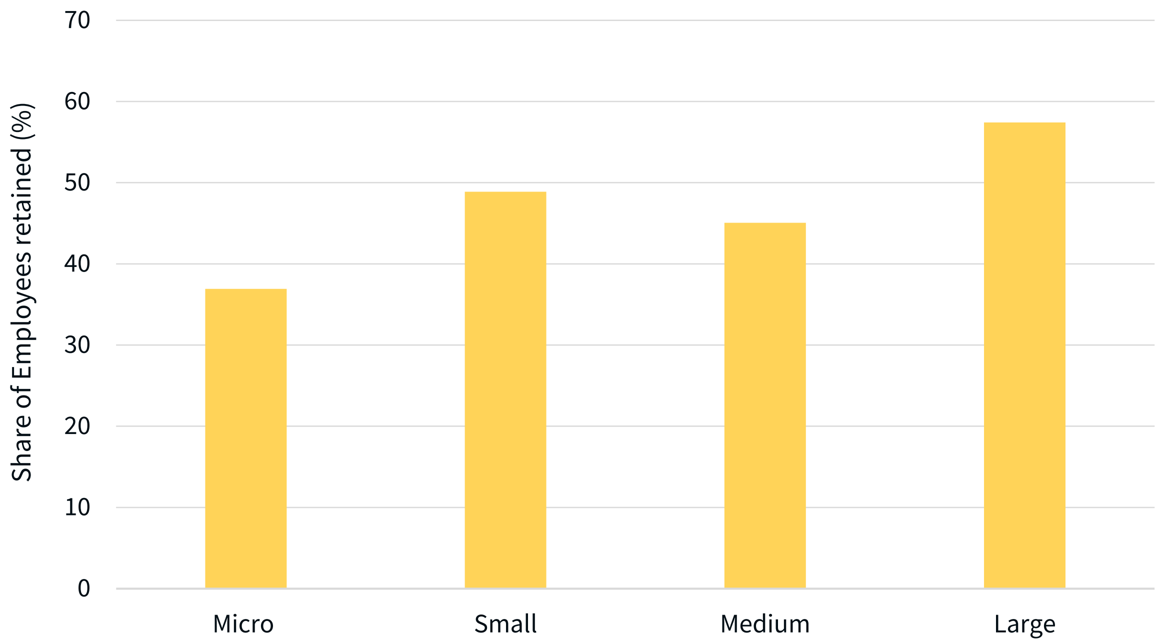


Source: Authors calculations based on primary survey

Another key finding is that micro-enterprises were able to retain a lower share of employees and suffered larger losses as a share of annual revenue, in comparison to medium and large enterprises. For instance, Figure 3 shows the stark contrast between micro enterprises and large businesses in terms of the share of employees they were able to retain during the lockdown. Micro enterprises were able to retain 37 per cent of their workforce, whereas large enterprises were able to retain 57 per cent. Thus, while employment took a big hit across the board, smaller firms were relatively worse off.

The main results for higher distress levels for micro-enterprises relative to larger firms is robust to the inclusion of other firm and owner characteristics as well as controls for broad geographic location.

Figure 3: Share of employees retained (%)



Source: Authors calculations based on primary survey

4. Firm opinions on Policy Response

In terms of policy responses to this crisis, significant relief measures were announced on the 12th of May by the Prime Minister, with details following in the subsequent days. The major component of this relief package was the ambitious Emergency Credit Line Guarantee Scheme (ECLGS) with an allocation of three lakh crores, which allowed firms to seek credit on emergency basis worth 20 per cent of their outstanding with the formal banking sector. Our survey indicated that awareness of relief measures grew over the survey period (May-June), but remained very low in absolute terms. Figure 4 shows that awareness of relief measures is the lowest for micro-enterprises and rises monotonically with firm size. Thus, the firms in the greatest need for relief also appeared to have an informational disadvantage about policy measures. While only a fourth of micro enterprises knew about any policy measures, over 40 per cent of large firms knew about them, with small and medium firms somewhere in between. Given that the qualification conditions for MSME units constituted links to formal banking sector, a large section of the smaller MSME units were left out of the ambit of the credit assistance programme. Table 2 shows the distribution across the three major sources of finance for firms in our survey, broken out by firm size. Our data also show that a far greater share of small and medium enterprises rely on banks or NBFCs as a credit source, when compared with micro-enterprises. Only about 44 per cent of micro-enterprises in our survey rely on formal sources, as they are much more likely to rely on either their own capital or informal sources, especially relative to small and medium enterprises.

Table 2: Major Source of Finance (%), for Micro, Small and Medium Enterprises

	Micro	Small	Medium
Bank or NBFC	43.79	61.38	65.79
Informal	16.34	14.29	5.26
Own Capital	39.87	24.34	28.95
Total	**100**	**100**	**100**

Source: Authors calculations based on primary survey

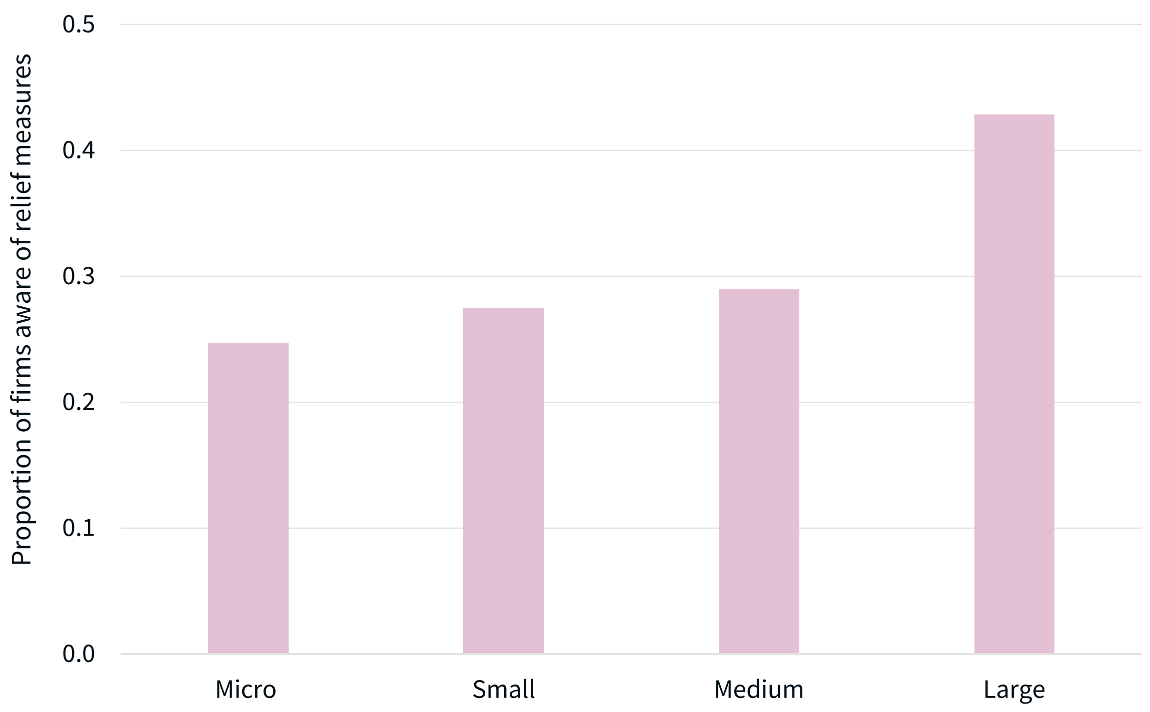
We also asked firm owners their opinion on relief measures. Specifically, we asked firm owners if they thought the relief measures would be helpful, harmful or have no impact. As Figure 5 shows, a greater proportion of smaller firms thought the relief measures would have no impact, whereas larger firms were less likely to choose this option. A reason why this could be is that during the month of May, respondents believed the ECLGS did not go far enough, and smaller firms which were less reliant on the formal credit institutions believed that they would be excluded from the benefits of this scheme. Our qualitative interviews reveal that there were increased concerns among even the eligible businesses on repayment terms of the banks after the period of moratorium expired. An electrical panels manufacturer from Uttar Pradesh who qualified under the scheme reported that though he initially felt that the scheme would help with liquidity management, the banks soon started charging all interest cost at once, which became problematic as the payment cycles remained disrupted with payments delayed.

An office bearer of an Industrial Association in Uttar Pradesh and an owner of a medium enterprise (on condition of anonymity) reported that the distance between sanctioning of a loan under the scheme and disbursement is a long one and paved with institutional bottlenecks. Despite a long and established association with his bank where there were no defaults, it took him about 3 months to have the loan disbursed.

> *"I have a 17-year association with my bank and I never defaulted on any payments in this period. Despite this, the bank took 3 months to disburse the amount for which I was eligible under the ECLGS. Once my internal sources were wiped out, I had to rely on expensive, informal sources of finance to tide over the liquidity crunch in this period."*

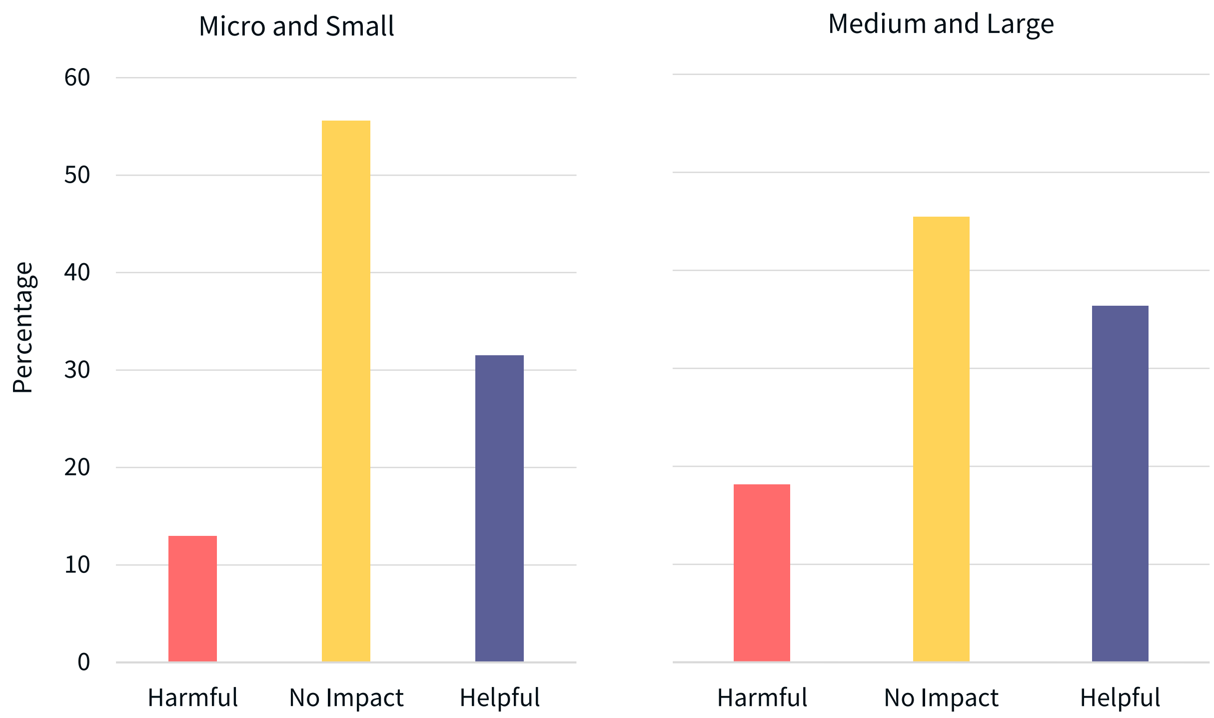
(an MSME owner from Uttar Pradesh and a customer with a govt. bank dedicated to the MSME sector, 8th August 2020)

Figure 4: Awareness of Relief measures, by Firm Type



Source: Authors calculations based on primary survey

Figure 5: Opinion on Relief Measures, for Micro-Small and Medium-Large Enterprises



Source: Authors calculations based on primary survey

In the final module of our questionnaire, we asked business owners to point out any policy measures they felt would be helpful for immediate (short-term) relief, as well as for recovery of the sector in the long run. In order to derive some broad insights into their opinions, and to avoid cherry-picking them ourselves, we conducted a text analysis of these free-form text responses. This was done through some basic natural language processing techniques that first entailed pre-processing that involved tokenization, stop words removal, stemming and lemmatization. We then examined frequency distributions of single words and of trigrams (phrases of three consecutive words), for both the short and long-term recommendations. As an example, the words 'interest' and 'loan', were the top two mentions in the text for short term recommendations, mentioned 87 and 69 times, respectively. Even more informative, however, were the top trigrams for short term recommendations, 'Fixed, Charges, Electricity' and 'Interest, Free, Loans'. Examining the responses that mentioned these indicates that several firm owners believed that fixed charges (like electricity bills) should have been waived off when all production was halted. Several others mentioned access to interest free loans as a possible solution. The next most frequent recommendation involved lowering or elimination goods and service taxes, both for relief and to stimulate demand. In general, we find that there are overlaps in the top ten most frequently mentioned phrases across short-term and long-term recommendations, but some interesting differences do emerge. For instance, long term recommendations focus more often on reforms in taxation and making labour laws more flexible for firm owners, whereas the short-term recommendations focused more on reductions to fixed costs, and on access to affordable credit.

5. Conclusion

Given its importance for the livelihoods of millions in India, the revival of the MSME sector will be critical for the recovery of the Indian economy in the coming months. In this paper, we reviewed some research that pointed to the fact that the MSME sector was already vulnerable in the lead up to the COVID-19 crisis. We then focused on some key results from our survey of nearly 400 firms conducted in the strictest phase of the lockdown. Our findings here and in our companion paper (Rathore and Khanna 2020) point to higher levels of distress for the most vulnerable firms. We also demonstrate that the smaller firms are less aware of relief measures and may be likelier to be left out of some of the relief measures proposed. A text analysis of recommendations of firm owners indicate that they believed MSMEs would have benefitted from exemptions on fixed charges like electricity bills in the short run. More generally, firm owners favoured interest free or low interest loans as tools for recovery, other than more fundamental reforms to the tax regime and labour laws.

The policy response to the COVID-19 crisis in India has largely been supply-sided, with its primary focus on availability of credit. Given the differential access to formal sources of finance, the move favours larger businesses over smaller ones. As our survey demonstrates, taking cognizance of the varying intensity of distress amongst firms of different sizes may be important. There is widespread agreement that India is currently experiencing a sharp demand slowdown, a pre-existing condition which was further exacerbated by the COVID-19 crisis.[7] At a juncture where the domestic and international consumption demand is feeble and domestic investment expenditure

[7] " 'Coronavirus was a wasted crisis for India's economy,' says Abhijit Banerjee, flags demand shock", Scroll, December 10, 2020, https://scroll.in/latest/980887/coronavirus-was-a-wasted-crisis-for-indias-economy-says-abhijit-banerjee-flags-demand-shock

is slow, a rebound of aggregate demand must necessarily lean heavily on the expansion of government expenditure. A credit-oriented policy response in this setting is likely to mitigate the immediate liquidity crunch but could eventually be constrained by anemic domestic demand. Thus, other than the policy recommendations alluded to in the previous section, we believe more traditional fiscal measures could be helpful, and would likely be more egalitarian for businesses operating at differential scales.

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