JSW SCHOOL OF PUBLIC POLICY

POLICY BRIEF

No. 2020.1

June 2020

The Case of MSMEs: Supply Side Shocks

Darpan Jain, Rajat Saha

Indian Institute of Management Ahmedabad Vastrapur, Ahmedabad,
Gujarat, India – 380 015

www.iima.ac.in/jsw-spp/

MSMEs: The Breaking Economic Backbone that Needs Immediate Healing

As a developing economy, MSMEs have been pivotal for India's economic growth. According to a study commissioned by the All-India Manufacturers Organisation (AIMO)[i], there are 65 million MSMEs in the country. Together they employ around 50% of the industrial workers and contribute more than 30% of India's GDP. However, despite being such an integral part of the Indian economy, the MSME sector has been reeling under huge distress. The government on its part has announced some appreciable schemes for the sector, but these have not had the desired impact on the ground due to the informal nature of most MSMEs. With the possibility of a whopping 43% of these firms shutting shop due to the lockdown imposed by the Indian government because of COVID-19[ii], it has become imperative to support this sector.

After a bright 2015-16 where all MSMEs witnessed growth due to high expectations from the Modi government, the sector's fortunes turned negative. The twin-pronged moves of Demonetization and introduction of GST by the Modi government in 2017 and 2018 led to a cash crunch within the sector. According to a 2018 AIMO study, Micro, Small, and Medium

Executive Summary

With[iii] a contribution of more than 30% to India's GDP, provision of employment to more than half the industrial workforce, and a contribution of more than 50% to India's exports, the 65 million firm strong MSME sector is an integral part of the Indian economy. Besides its humongous economical contribution, even more important is the social contribution made by the sector. MSMEs are equally distributed between rural and urban areas, and between manufacturing, trading, and service sectors. In fact, more than 2/3rd of the firms is operated by the most vulnerable sections of the society (SC, ST, OBC) and more than 20% are operated by women.

However, the importance of the sector doesn't make it immune to distress. Demonetization, GST, and now the COVID-19 pandemic, all have contributed to the increasing stress in the sector. It is estimated that more than 43% MSME firms have shut shops due to the losses accrued during the lockdown period. The sector is crippled and is on the verge of being brought down to its knees.

But the government has taken notice. In early May, the government announced a big Coronavirus stimulus package under the Atma Nirbhar Bharat scheme. The scheme was centred around MSME and included collateral-free loans, additional debt, and equity infusion for the sector. In addition, further steps including new definition of MSMEs, disallowing global tenders, and a better online platform to deal with MSME queries were announced.

However, the action taken by the government has largely been characterized by medium term policies. The need of the hour is immediate, short-term help. More than 70% of MSME credit needs are still met by informal sources and more than 94% firms are still informal. It is these that require immediate resuscitation. The government, in addition to their existing measures, needs to institute immediate relief policies.

Recommendations

After thorough research and analysis of the relevant data and existing literature, we recommend measures directed towards greater formalisation of the MSME sector. The highlights of our recommendations are:

1. Removal of procedural delays in payment by the public and private sector by the introduction of bank guarantees
2. Encourage SHGs to set up cottage industries by extending micro-credit
3. Complete 'One Nation, One Ration Card' and ensure registration of informal workers for targeted delivery of welfare, and greater formalisation.
4. Introduce 24/7 Helpline for MSMEs across all languages and translation services as and when required.
5. Expansion of ZED Technology Upgradation of MSMEs to make them globally competitive.

businesses suffered 43%, 35%, and 24% drop in profits, respectively.[iv] Combined with massive job losses, the sector continued to reel under pressure. Fast forward to 2020 and the situation has worsened. In January, the COVID-19 pandemic broke out in China, and by mid-March it had engulfed the entire world. The Indian government, acting quickly, announced a four-week nationwide lockdown to arrest the spread of the virus. As the lockdown extended and activities remained suspended, all sectors took a hit.

However, the blow to MSMEs has been the worst. Severe shortage of working capital, disruptions in supply chain, and shortage of labour have led to a revenue shortfall of more than 60% in the sector. On one hand, financial institutions are ever more sceptical of lending to small businesses and on other, even informal sources (which form greater than 70% of the credit supply to the sector) such as moneylenders have tightened their hands. Due to restricted activities and closed borders, supply chains have been hampered, adversely affecting the movement of raw material. Finally, due to growing economic and social insecurity because of uncertain wages, lack of food, and increased risk of catching the virus, reverse migration among workers has resulted in a labour shortage. Hence, with a shortage of capital, material, and labour due to COVID-19, MSMEs are estimated to lose up to Rs. 1.2 lakh crore in profits. With profits drying up, there is a possibility of more than 43% MSMEs shutting shop.[v]

MSMEs contribute more than 30% to India's GDP and employ 114 million people (more than 50% of India's industrial workforce). These firms are uniformly spread across rural and urban areas and are equally represented in manufacturing, trade, and services sectors. About two thirds of them are operated by socially vulnerable groups (SC/ST/OBCs) and 20% by women.[vi] A severe hit to this sector will not only have huge ramifications for the Indian economy, but also directly impact the most vulnerable sections of the society, which are already suffering both economically and socially due to the pandemic. With over 97% of these firms classified as 'micro firms' and a huge chunk of these being informal and unorganized, it might only be a matter of time before the sector is brought down, if sufficient government aid is not provided.

Analysing Supply Side Issues

The current supply side issues being faced by the MSMEs can be broken into three major heads:

Working Capital:

According to TransUnion Cibil, loans worth 2.3 lac crore are at risk of becoming non-performing. Payment cycles are also likely to get stretched. At the same time both the public and private sector combined owe the MSME sector close to Rs 5 lac crore, according to the Union Minister, Nitin Gadkari. This poses a serious problem as both receivables and new sales revenues have dried up at the same time. If MSMEs are not provided relief to get over the cash flow shock in the short term, this can pose risk to bigger businesses in the medium-term as supply of spare parts and semi-finished raw materials are reliant on MSME businesses.

Labour:

One of the major supply shocks for MSMEs has been the overnight disappearance of migrant, informal and casual labour. To prevent similar labour market shocks, there is a need for greater formalisation of labour in the MSME sector. The steps taken by the government to provide EPF contributions are welcome. However, relaxation of labour laws with regards to the MSME sector can lead to informalisation of the sector, turning the clock back and making it vulnerable to more supply-side shocks in the future.

One of the major causes of the labour market shock has been the lack of access to welfare schemes for migrant labourers working in other States. In this aspect, the One nation, One Ration Card is a step long overdue. As of now, 20 States have reportedly consented to interoperability of ration cards. Similarly, limited registration of building and construction workers with various state governments makes it difficult to provide immediate relief to such workers. Rapid registration of construction workers, migrant labour, household helps, street vendors, security guards, etc. should be undertaken to ensure robust data-backed decision-making regarding labour issues. This would also help in rapid and targeted deployment of relief measures. Similarly, ensuring JAM linkage for transfer of wages and salaries will ensure compliance with laws and hence, timely payment of wages and dues.

Raw materials:

MSMEs have a share of 50 percent of India's exports. As such, it is vital for MSMEs to continue to have supply of raw materials without disruptions.

In this context, NSIC's[vii] support to MSMEs for import of raw materials needs to be accelerated. Sourcing of raw materials through e-marketplaces should be explored for MSMEs. Nandan Nilekani-backed Power2SME[viii] is a welcome start-up in this sector.

Current Government Policies: Are They Enough?

In early May, the government took stock of the situation and announced a Coronavirus stimulus package. Various measures including collateral-free loans, additional debt, and equity infusion were rolled out. In addition, further steps including new definition of MSMEs, disallowing of global tenders, and a better online platform to deal with MSME queries were announced.

Under the Emergency Credit Line Guarantee Scheme (ECLGS), the Cabinet approved an emergency credit line of up to Rs. 3 lakh crores at a concessional rate of 9.25% for the MSME sector. The credit line is supposed to be up to 20% of all outstanding credit of eligible MSMEs.[ix] Valid till October 31, the scheme is expected to benefit more than 45 lakh units. Till late June, around Rs. 75000 crores have been sanctioned, out of which more than Rs. 32000 crores have been disbursed. Public Sector banks have been leading this initiative although Private sector banks are catching up fast. [x]The scheme is guaranteed by the government and hence, saves capital for banks. However, there are certain demerits. Firstly, it is only meant as an 'additional' facility for MSMEs that had outstanding credit of up to Rs. 25 crores with a bank. In this regard, it only covers MSMEs who have access to formal banking channels. A Bain report suggests that only 30% credit demand of MSMEs is currently met by formal channels. Secondly, within these firms, it is meant only for those who had been regularly paying their dues till before the pandemic. Therefore, the scheme, if implemented well, is aimed towards helping only a small proportion (7.5%) of MSMEs.[xi]

The second measure includes providing Rs. 20000 crore subordinated debt. Under this, promoters of stressed MSMEs will be given debt by banks, which can then be infused into the MSME as promoter equity during debt restructuring. The third measure is the creation of a fund of funds which is meant for MSMEs that are growing and hence, need equity. Both measures are well-intentioned. However, they serve as medium to long term measures. They do not provide the much-needed instant relief to this ailing sector and their effectiveness can be best judged after a couple of years.

Another long pending change that comes into effect from July 1 is the revised classification criteria for MSMEs. The new criteria have increased the maximum qualifying revenue and investment limits for each category. It has also removed the differential treatment between manufacturing and service sectors and excluded exports from accounting of turnover to be used as the qualifying limit.[xii]

Table: Revised classification criteria for MSMEs

	Micro	Small	Medium
Investment	< 1 Cr	< 10 Cr	< 50 Cr
Turnover	< 5 Cr	< 50 Cr	< 250 Cr

Source: https://timesofindia.indiatimes.com/business/india-business/msmes-to-be-classified-based-on-new-criteria-from-july/articleshow/76180931.cms

Some other announcements made include setting up an online platform for quick grievance redressal of MSME queries and protecting MSMEs from foreign competition by disallowing tenders up to Rs. 200 crores from foreign entities. Again, these are medium to long term changes, the impact of which is yet to be seen.[xiii] Further, the government, in a bid to help the corporate sector, raised the minimum threshold for initiating bankruptcy proceedings to Rs 1 crore. This is likely to hurt the MSME sector since it can be used to delay overdue payments. [xiv]

Overall, the action taken by the government has largely been characterized by medium term policies. However, the need of the hour is immediate, short-term help. More than 40% MSMEs have not opened shop even after lockdown relaxations. These need to be provided immediate liquidity to enable their functioning. Yes, the ECLGS is a good move, but it focuses on the well-off firms, those that had a good supply of credit and were able to pay their loans timely. However, more than 70% of MSME credit needs are still met by informal sources and more than 94% firms are still informal. It is these that require immediate resuscitation.

Key Policy Interventions

Based on our understanding and analysis, we believe the following recommendations can supplement government's current initiatives and provide some immediate relief to the informal sector:

Capital:

1. Mandatory Bank Guarantees for MSMEs to ensure timely payment of dues from Central and State Public Sector Units as well as the private sector, thereby removing red tape
2. Encourage MSMEs to get listed on a platform/exchange for extension of debt/equity capital by small investors[xv]
3. Extension of micro-credit to SHGs for enhancing female workforce participation and setting up cottage industries[xvi]

Labour:

1. Rolling out One Nation, One Ration Card[xvii] across the country, interoperability, accelerated registration of informal workers and JAM linkage for welfare delivery
2. Digitally Recognized Skill Certificates in Collaboration with Industry under Skill India Mission[xviii]
3. 24/7 Labour Helpline and SMS Facility for farmers. These should be made available in all vernacular languages
4. Networked Migrant Labour Help Desks at the district level to facilitate nationwide labour mobility
5. Linkage of Employment Exchanges across the country on a common platform, an expanded National Career Service portal with MSMEs, public and private sector employers on board, and nationwide roll-out in all languages[xix]
6. Digital education of the labour force in the services industry to enable them to participate in the domestic and international gig economy

Raw Material:

1. NSIC Raw Material Import and Financing Support[xx] Expansion, waiver of NSIC service charges[xxi]
2. Prioritization of MSMEs for tenders by Central, State and Public Sector Units

Technology:

1. ZED[xxii] Registration roll-out in vernacular languages, linkage with CHAMPIONS[xxiii] portal
2. Expansion of financial support under ZED for technology upgradation to match the demand from abroad for high tech products and services, as well as spares and components manufacturing
3. Translation services for MSMEs to help them access markets abroad and improved provision of inter-State trade of Goods and Services

Authors

Darpan Jain

Darpan Jain is an MBA (PGP) candidate at IIM Ahmedabad, Class of '21. He completed his Bachelors in Management Studies from Shaheed Sukhdev College of Business Studies, University of Delhi. He is a core member at the Public Policy Club of IIMA and is an incoming Junior Associate at Bain & Company. He is keenly interested in policy and has worked under IIMA and Harvard professors to publish a COVID policy brief capturing India's lessons from the COVID-19 pandemic. His paper is being used by various African governments in mitigating the spread of the pandemic.

Email ID: p19darpan@iima.ac.in
LinkedIn: Darpan Jain

Rajat Saha

Post his B. Tech in Mechanical and Electrical Engineering from IIT Guwahati, he worked in a New York-based social media analytics firm for over 2 years as a Full-Stack Developer. He has also had brief stints at Bosch and American Express. He has also briefly worked on fluid dynamics research in collaboration with researchers at National Taiwan University. He is currently pursuing his MBA from IIM Ahmedabad. As a member of the public policy society, he writes on tech, privacy and business policy issues.

Email: p19rajatks@iima.ac.in
LinkedIn:https://www.linkedin.com/in/saha-rajat/
Twitter: https://twitter.com/rajat_saha

[i]References

Saluja, N. (2020, June 2). Over one-third MSMEs start shutting shop as recovery amid Covid-19 looks unlikely: AIMO survey. *The Economic Times*. https://economictimes.indiatimes.com/small-biz/sme-sector/over-one-third-msmes-start-shutting-shop-as-recovery-amid-covid-19-looks-unlikely-aimo-survey/articleshow/76141969.cms

[ii] *The MSME sector is critical in times of Covid-19*. (2020, April 3). Hindustan Times. https://www.hindustantimes.com/analysis/msmes-is-critical-in-times-of-covid-19/story-6Juiu9zs4jKUdkHLobT6WJ.html

[iii]

[iv] asthasavyasachi. (2018, December 17). *AIMO Survey : MSMEs and Traders face job loss; Demonetization and GST to blame*. The Indian Wire. https://www.theindianwire.com/news/aimo-survey-msmes-traders-face-job-loss-demonetization-gst-blame-88199/

[v] *COVID-19 And Its Impact On MSME In India*. (n.d.). Https://Www.Outlookindia.Com/Outlookmoney/. Retrieved June 30, 2020, from https://www.outlookindia.com/outlookmoney/talking-money/covid-19-and-its-impact-on-msme-in-india-4683

[vi] *The MSME sector is critical in times of Covid-19*. (2020, April 3). Hindustan Times. https://www.hindustantimes.com/analysis/msmes-is-critical-in-times-of-covid-19/story-6Juiu9zs4jKUdkHLobT6WJ.html

[vii] https://www.nsic.co.in/

[viii] (2017, September 19). Power2SME raises $36 million in Series E funding - The .... Retrieved June 30, 2020, from https://m.economictimes.com/small-biz/money/power2sme-raises-36-million-in-series-e-funding/articleshow/60746554.cms

[ix] *Finance Minister Nirmala Sitharaman announces six measures for the MSME sector*. (n.d.). Business Insider. Retrieved June 30, 2020, from https://www.businessinsider.in/india/news/fm-nirmala-sitaraman-announces-six-steps-for-msme-sector/articleshow/75717258.cms

[x] Jun 22, P. | U., 2020, & Ist, 23:25. (n.d.). *Banks sanction over Rs 75,000 crore loans to MSMEs under credit guarantee scheme - Times of India*. The Times of India. Retrieved June 30, 2020, from https://timesofindia.indiatimes.com/business/india-business/banks-sanction-over-rs-75000-crore-loans-to-msmes-under-credit-guarantee-scheme/articleshow/76517808.cms

[xi] New measures for MSMEs should draw banks to lend to them: SBI chief. (2020, May 14). *The Economic Times*. https://economictimes.indiatimes.com/markets/expert-view/new-measures-for-msmes-should-draw-banks-to-lend-to-them-sbi-chief/articleshow/75732444.cms

[xii] Jun 3, P. |, 2020, & Ist, 20:37. (n.d.). MSMEs to be classified based on new criteria from July - Times of India. The Times of India. Retrieved June 30, 2020, from https://timesofindia.indiatimes.com/business/india-business/msmes-to-be-classified-based-on-new-criteria-from-july/articleshow/76180931.cms

[xiii] *Finance Minister Nirmala Sitharaman announces six measures for the MSME sector*. (n.d.). Business Insider. Retrieved June 30, 2020, from https://www.businessinsider.in/india/news/fm-nirmala-sitaraman-announces-six-steps-for-msme-sector/articleshow/75717258.cms

[xiv] "MSMEs crisis: New Rs 1 crore payments default threshold for ...." 23 Jun. 2020, https://www.businesstoday.in/current/economy-politics/msmes-crisis-new-rs-1-crore-payments-default-threshold-for-bankruptcy-backfires/story/407729.html. Accessed 30 Jun. 2020.

[xv] (n.d.). Small business listings: Will SME exchanges continue to .... Retrieved June 30, 2020, from https://www.financialexpress.com/industry/msme-other-small-business-listings-will-sme-exchanges-continue-to-outshine-main-board-this-diwali/1736042/

[xvi] (2020, May 17). Special financial assistance under COVID-19 scheme given to .... Retrieved June 30, 2020, from https://www.thehindu.com/news/cities/Tiruchirapalli/special-financial-assistance-under-covid-19-scheme-given-to-shg-members/article31608419.ece

[xvii] (2020, May 16). What is 'One Nation, One Ration Card'? - The Indian Express. Retrieved June 30, 2020, from https://indianexpress.com/article/explained/one-nation-one-ration-card-system-explained-6410179/

[xviii] (2019, October 1). The 3 challenges to skill development in India – and how to .... Retrieved June 30, 2020, from https://www.weforum.org/agenda/2019/10/india-skill-development-programme/

[xix] "NCS|Home: National Career Service-Home ...." https://www.ncs.gov.in/. Accessed 30 Jun. 2020.

[xx] (n.d.). Dc Msme. Retrieved June 30, 2020, from http://dcmsme.gov.in/

[xxi] (n.d.). NSIC : The National Small Industries Corporation. Retrieved June 30, 2020, from https://www.nsic.co.in/

[xxii] (n.d.). ZED | Zero Defect Zero Effect. Retrieved June 30, 2020, from http://www.zed.org.in/

[xxiii] "MSME CHAMPIONS | Our Small Hands to make you LARGE." 14 May. 2020, https://champions.gov.in/. Accessed 30 Jun. 2020.