Revitalising MSMEs

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To combat the adversities faced by MSMEs, the government has introduced vital policy measures and funding schemes for the reeling MSME sector. The lockdown has had a major impact on the economy, especially in terms of loss in output, revenue, and, most importantly, jobs. As the proverbial saying goes, "Necessity is the mother of invention," the pandemic has certainly created the need for innovative policies to rescue the ailing MSME sector.

Despite its prominent role in the economy, the micro, small, and medium enterprise (MSME) sector faces tremendous challenges to its growth. Adding to the existing set of obstacles is the onset of the Covid-19 pandemic, which has not only crippled the world economy but now poses a significant challenge to the survival of this segment of the economy. In an attempt to curb the Covid-19 outbreak, India implemented a nationwide lockdown on March 24, 2020. The lockdown has had a major impact on the economy, especially in terms of loss in output, revenue, and, most importantly, jobs. According to the recent estimates by the Centre for Monitoring Indian Economy (CMIE), the third week of April witnessed a rise in the unemployment rate to 26.2 percent, rendering around 14 crore people jobless in the lockdown period. Given the clampdown on economic activity in the past few weeks and the severe disruption the economy is likely to encounter in the future, there is an urgent need to protect the most vulnerable segment of the economy i.e., the MSME sector through appropriate policy instruments.

MSMEs are considered as the central element of the Indian economy, given the employment, output, and export potential. They contribute nearly 30 percent of India's GDP and 31 percent of GVA to the $2.7 trillion economy. The sector comprises close to 63 million enterprises, which together accounted for 48.1 percent of the total exports from India during 2018-19. According to the annual report for 2018-19 by the Ministry of MSMEs, the sector generates 21 percent of the total employment providing livelihood to approximately 111 million workers. Moreover, the MSME sector is characterised by the smaller scale of operations involving a high level of personal interaction and

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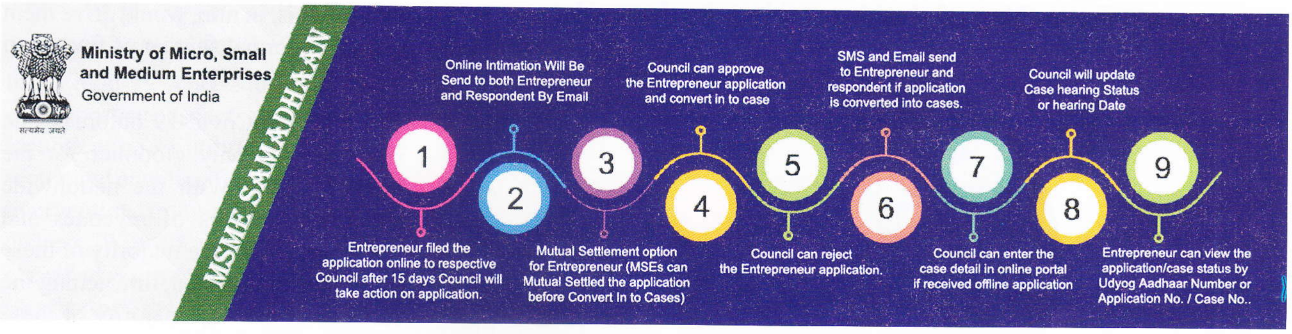

facing enormous liquidity and credit constraints. With lockdown, such interactions have come to a standstill rendering small units obsolete. Besides, a unique feature of India's MSME landscape is the widespread prevalence of the micro-enterprises (constitute 95 percent of the sector). These enterprises, mostly located in the informal economy, are likely to be the worst hit by the pandemic. Most of these units depend upon agents for collection of revenue. These firms lack access to formal finance and can fall into distress quickly when cash flow becomes irregular. They do not have the adequate information technology setup to foster the possibility of work from home, a policy taken up by many large domestic and multinational firms. Therefore, it becomes essential to develop a support system for the sustenance and revival of the MSME sector. Otherwise, the pandemic may soon turn India's demographic dividend into a demographic curse.

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Major Bottlenecks

A perpetual problem plaguing the MSME sector is access to institutional finance. Several studies have unambiguously shown access to timely and adequate finance remains a major hurdle hampering the growth of MSMEs. A high-level committee appointed by the RBI (UK Sinha Committee report[1]) highlights a multitude of obstacles faced by the MSME sector. The committee too singles out access to finance as the foremost constraint hindering the growth and development of MSMEs. To place this in context, the Economic Census, 2013 points out that the lack of institutional or non-institutional sources of finance affects 93 percent of the enterprises. The Economic Survey 2017 points out that the MSME sector received just 17 percent of the total loan outstanding. Further, estimates based on survey data from the World Bank Enterprise Survey highlights that 65 percent of MSMEs surveyed report financial constraints as one of the significant obstacles faced by them. In this context, there are two principal channels of operations that restrict the flow of formal finance to MSMEs. First, the lack of established credit history and second, sufficient collateral results in MSMEs' inability to pay, which makes lending to them risky. According to a recent study by Patnaik and Pandey (2019), micro and small enterprises receive less than 6 percent of bank credit. Further, to improve the reach of formal finance, the Prime Minister's Task Force on MSMEs recommended banks to achieve a 20 percent year-on-year growth in credit to micro and small enterprises. However, as of February 2020, the credit growth stood at 2.6 percent well below the recommended target of 20 percent. Besides, the rise in non-performing assets (NPA) is restricting banks from extending credit, especially to MSMEs, where the risk of default is much higher.[2] Consequently, banks prefer to extend credit to sectors with lower insolvency risk. Moreover, the lengthy loan process and insufficient level of credit extended (Figure 1) further restricts MSMEs from obtaining formal sources of finance. According to World Bank Enterprise Survey (WBES) data, 30 percent of the MSMEs facing financial constraints cite unfavorable interest

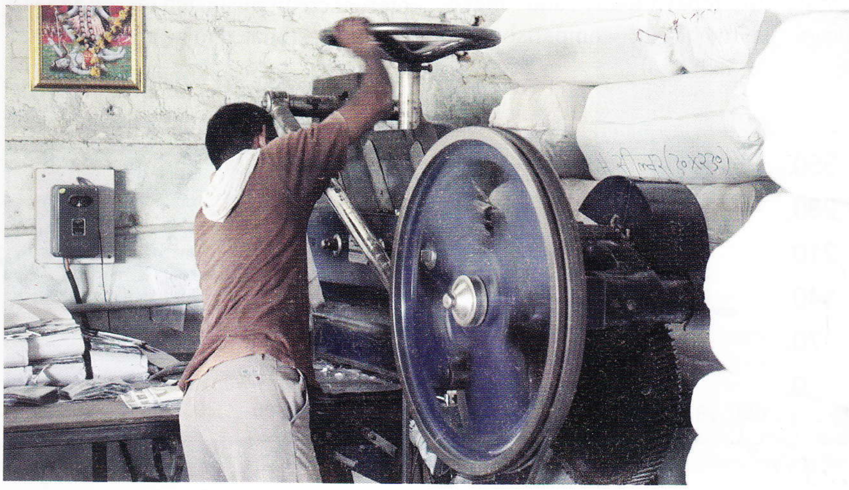
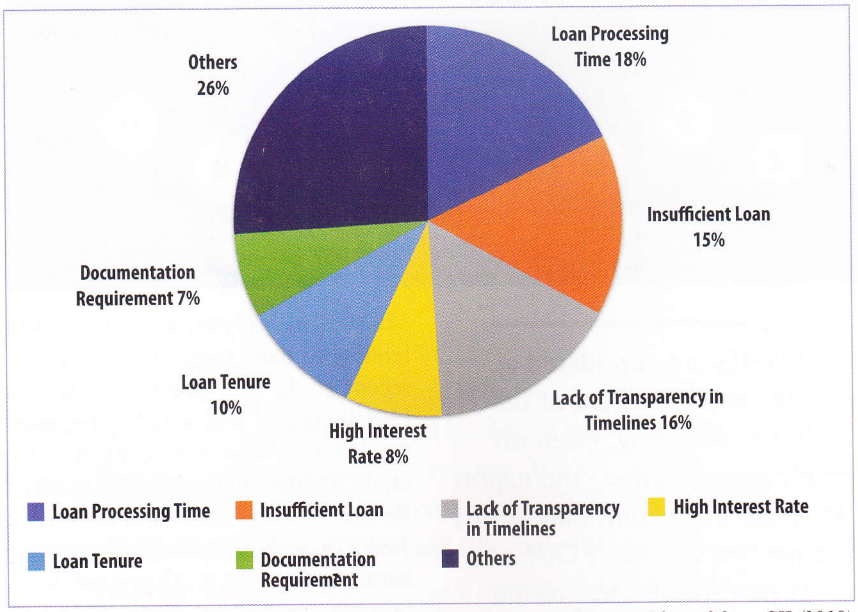


Figure 1. Factors Impeding MSMEs' Access to Formal Finance



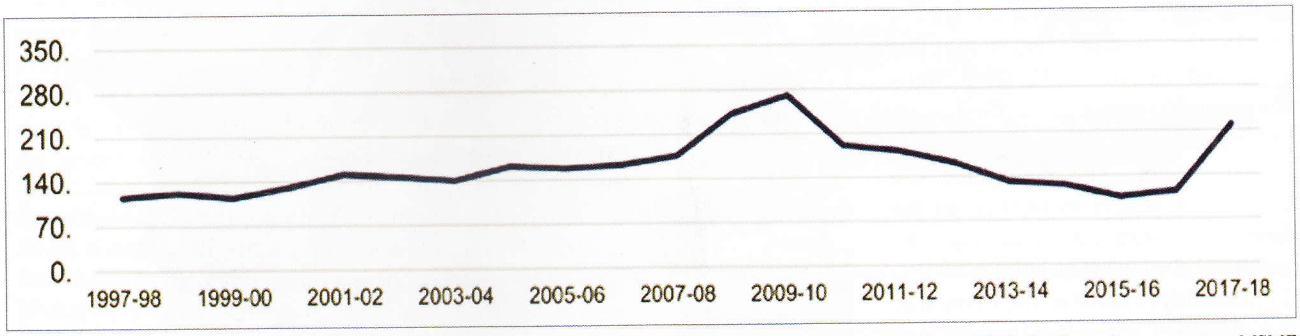
Source: Adapted from CII (2018)

rates, high collateral requirement, and insufficient size of loan and maturity period as the impeding factors.

Interestingly, factors that drive MSME borrowings into non-performing assets (NPA) and liquidity crunch are identical. One such factor is the perennial problem of delayed payments. Most MSMEs partake in the supply chain as a supplier of intermediate goods and services to large firms, including public sector units (PSUs), resulting in low bargaining power. With most large corporates operating on a credit basis with MSMEs, delayed payments significantly hamper MSMEs' ability to repay loans and make wage payments. A comparison of the 67th and 73rd rounds of the NSSO surveys on the unincorporated non-agricultural enterprises suggests that pending payments to the small firms have increased between 2010-11 and 2015-16. According to the UK Sinha Committee report, delayed payments explain 41 percent of all distressed loans in the MSME sector. Figure 2 highlights that the average number of debtor days (the time it takes to realise a payment) since 1997 has been consistently over 90 days (3 months) and reaching a mammoth 220 days by 2017. The almost doubling of debtor days is an alarming situation since such delay lengthens the working capital cycle of MSMEs. Further, the present credit mismatch for the MSME sector is estimated to be around \$20-25 trillion. This, in turn, would drive them towards informal sources of finance to bridge the cash gaps.

With the Covid-19 outbreak, the situation gets only gloomier for the MSME sector. With the nationwide lockdown, sources of revenues and cash reserves for the majority of these units have diminished, threatening the survival of the vast majority of these enterprises. The results of a survey conducted by the social media site Local Circles reveal that 47 percent of the Indian start-ups and SMEs have less than one month of cash. Probably, with the wage payments for the month of March, it is likely that most of them may have depleted their funds. The survey further highlights that only 6 percent of these firms have resources to tackle disruptions for six months, with 74 percent of these firms anticipating exit during the next six months. With the dearth of cash, MSMEs will find it strenuous to make wage payments to its employees and survive the Covid-19 pandemic. Similarly, All India Manufacturers' Organisation (AIMO) survey of 5000 MSME units report that 71 percent of them were unable to pay salaries to their workforce for the month of March. Besides, with the available resources depleting fast, resuming work with the lockdown in place would be nearly impossible for a vast majority. As a result, there has been a nationwide call from various industry organisations to the government to intervene and provide a special package to support the MSME sector.

Figure 2: Number of Debtor Days



Source: Retrieved from UK Sinha Committee report on MSME

The Informal Sector Enterprises

As the measures to combat the Covid-19 crisis are underway, an important aspect would be the identification of informal units in the sector and enabling the reach of policy intervention to mitigate the current distress. With 95 percent of MSMEs classified as micro-enterprises, it is certain that the substantial share of enterprises is in the informal sector. In the case of these informal enterprises, the disruption created by the outbreak of Covid-19 may be far more severe. Given that these enterprises lack savings and face proportionately greater financial obstacles, the onset of the pandemic is likely to significantly impact their day-to-day operations. The probable longer duration of the pandemic and the lockdown measures are most likely to make many of these units exit. The relief measures like tax reliefs may not have much influence on these enterprises since they rarely fall under the tax net. The vulnerability of these enterprises in terms of lack of financial access is evident from the previous two rounds of the informal enterprise surveys conducted by the National Sample Survey Organization (NSSO). Estimates from these surveys suggest that about one-fifth of the firms highlight access to finance as a key constraint to the growth (Figure 3). Not surprisingly, very few firms in the sector have access to institutional sources of finance.

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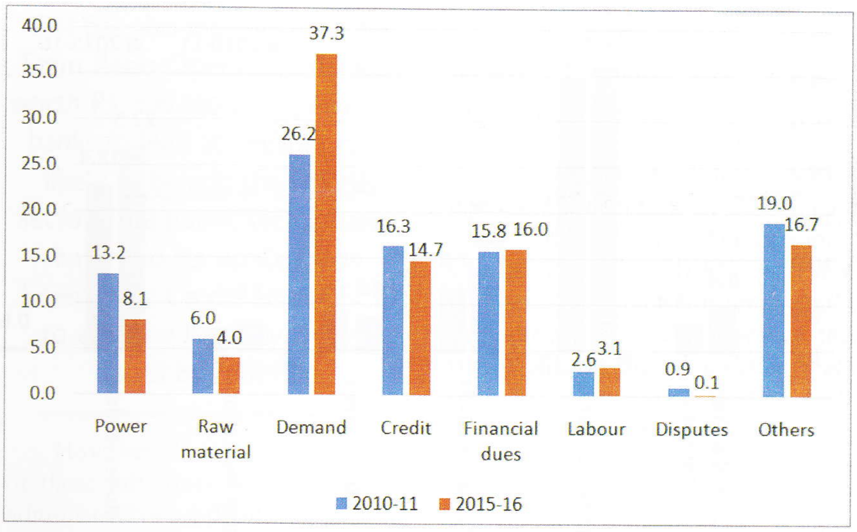
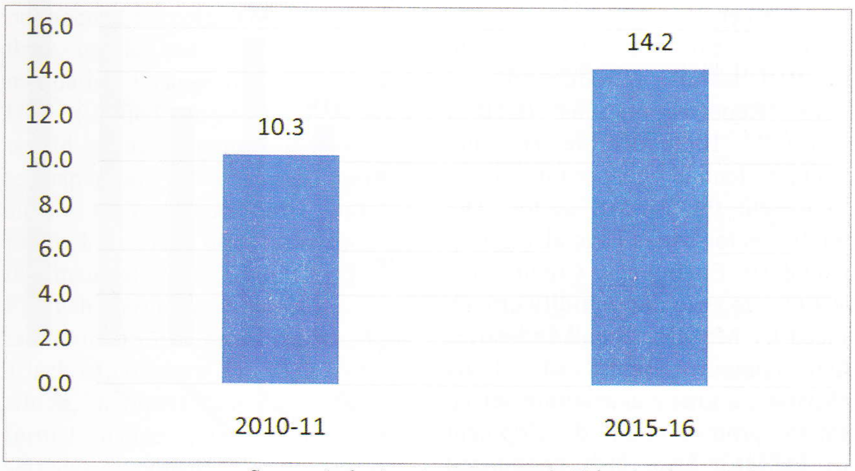
Figure 3: Obstacles Faced by Informal Sector Firms



Source: Author's estimation using the 73rd and 67th round of NSSO data on unincorporated non-agricultural enterprises

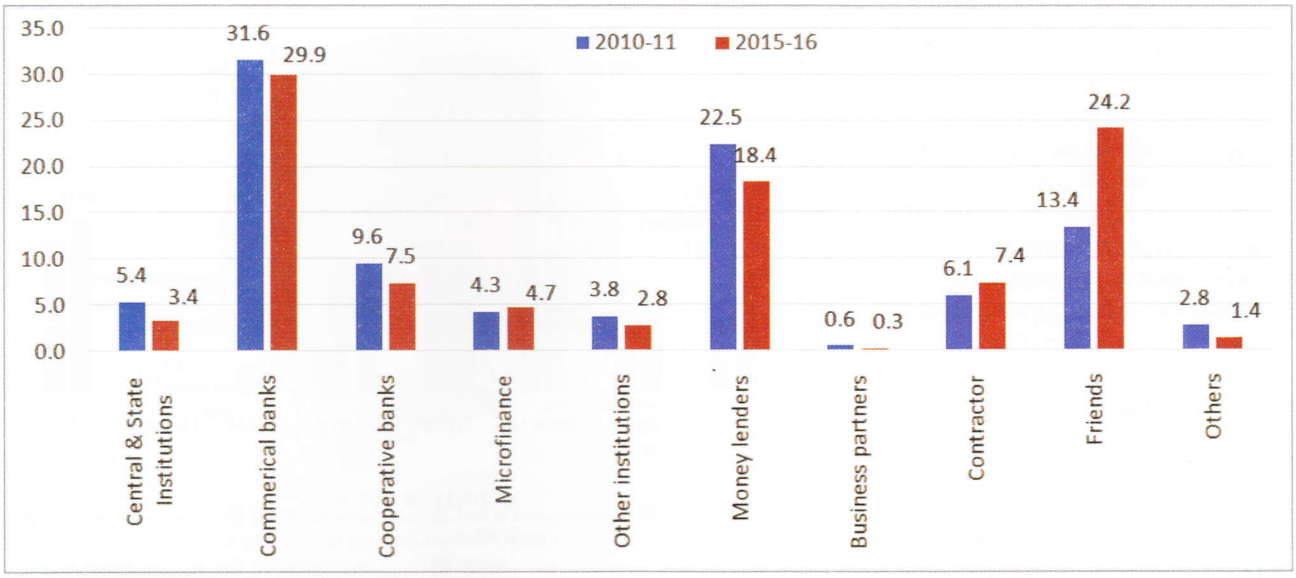
According to the recent NSSO round (2015-16), only 14.2 percent of all informal enterprises report funding from external sources (Figure 4). In fact, a major chunk of them relies on non-institutional sources for meeting financing requirements (Figure 5). Small firms in the informal sector are financially more constrained, and the presence of constraints exerts a much deeper impact on the growth of such units. We find that 65 percent of informal enterprises that reported as financially constrained in 2015-16 are owner-operated enterprises (those using only family labour). When it comes to credit access, businesses operated by hired labour seem to be the real beneficiaries, with more than 60 percent of them report to have obtained external finance (Figure 6). It could be argued that owner-operated enterprises lack credit access, possibly due to the absence of credit history along with complex application procedures, high interest rates, fear of rejection, high collateral requirements and necessity-driven may possibly be the reasons. Further, around 16 percent of the firms report recovery of past dues as another major constraint. The past dues may include payments from the delayed payments from customers. Overall our discussion

Figure 4: Share of Firms with Loan in Total Firms



Source: Author's estimation using the73rd and 67th round of NSSO data on unincorporated non-agricultural enterprises

Figure 5: Sources of Finance



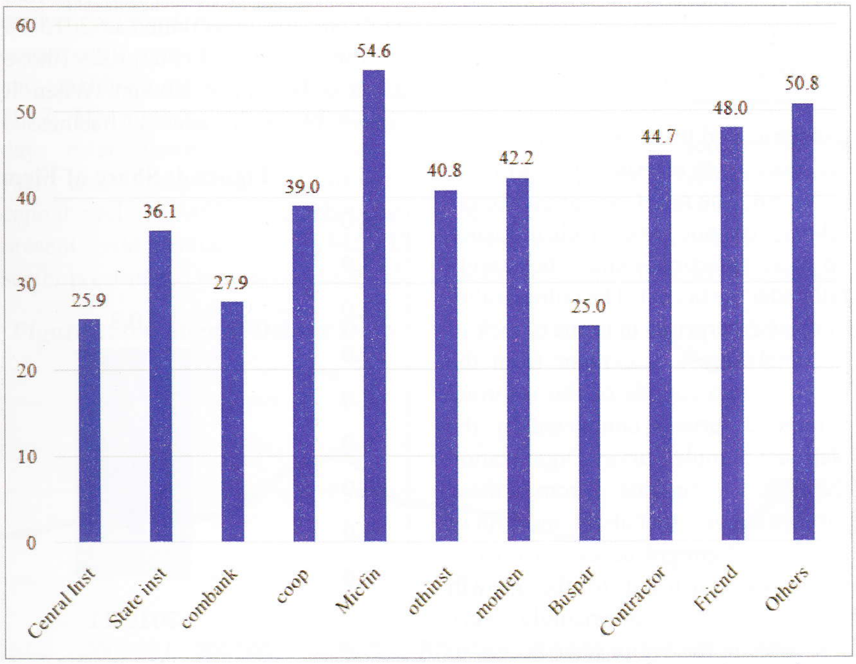
Source: Author's estimation using the73rd and 67th round of NSSO data on unincorporated non-agricultural enterprises

suggests that the policy prescriptions that are "one size fits all" and that fail to consider the heterogeneity of firms in the informal sector is of limited relevance.

The Way Forward

To combat the adversities faced by MSMEs, the government has introduced vital policy measures and funding schemes for the reeling MSME sector. The current interventions include deferring of goods and services tax (GST) payments till June 2020. RBI has allowed deferment on interest payments on working capital loans for the next three months. MSMEs are further exempted from loan payments till June. In addition, the RBI has also introduced Long-Term Repo Operations (LTRO) worth Rs. 100,000 crore, enabling banks to lend at cheaper rate, likely to benefit the MSME sector. The public sector banks have also set up Covid-19 Emergency Credit Line (CECL) to ease the liquidity crunch faced by MSMEs. Small Industries Development Bank of India (SIBDI), a financial institute set up for the promotion and development of MSMEs have also announced a concessional interest rate loan targeted for MSMEs engaged in manufacturing goods or services related to Covid-19. The MSME Minister stated that all payment dues of MSMEs with the government (estimated at Rs. 40,000-50,000 crore) would be released soon. Besides, the government is also in the process of delivering a $1 trillion MSME relief package. All these measures are steps in the right direction, especially in terms of providing temporary relief through short-term liquidity infusions. A caution needs to be exercised while releasing funds to the entities. As evident from the recent experience with the loans given to the small

Figure 6: Share of Own Account Enterprises in Total Enterprises with Loan, by Sources



Source: Author's estimation using the73rd round of NSSO data on unincorporated non-agricultural enterprises firms in the United States show that funds flowed to the areas which were least hit by the pandemic. Therefore, while designing the package for the MSME sector, policymakers will have to ensure that funds flows to the regions and industries that require it most.

However, more is needed to be done to safeguard the survival of the rickety MSME sector, especially in terms of making amends for certain long-term concerns which the pandemic has only aggravated. As mentioned earlier, MSMEs are impaired by the issue of delayed payments, which results in uncertain cash flow cycles, impeding their operational efficiency. As much as Rs. 40,000-50,000 crore worth credit is stalled to MSMEs due to the delayed payments. Therefore, it is imperative for policymakers to address the issue of delayed payments. However, some mechanisms for timely payments to MSMEs already exist. The RBI introduced the Trade Receivables Discounting System (TReDS) for MSMEs in March 2014. The platform provided a financial arrangement from a financial intermediary in which a seller obtained an amount of the sales bill before its due, after paying a discount fee. However, the lengthy process and the burden of the discounting fee and other financial charges drove MSMEs towards informal sources of finance. In a similar vein, the MSME ministry launched the Delayed Payment Monitoring Portal–MSME Samadhaan[3] in 2017, which allows MSMEs[4] to register online complaints against delayed payments. Off the 39,897 applications filed involving Rs. 10498.5 crore, Rs. 7828.95 crore[5] is still stuck with various agencies. Moreover, in many instances, despite the Micro and Small Enterprise Facilitation Council (MSEFC) issuing an order for payment of dues, buyers still delay payments.

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However, the overlapping nature of these initiatives not only creates administrative difficulties and an increase in costs of such operations but also creates confusion among the beneficiaries. In this regard, the government could introduce web and an app-based platform which highlights the procedures, eligibility criterion for application, and differences among these schemes in guiding MSMEs in the right direction. This would enable the spread of timely and vital information across with greater ease. Further, through coordination with various MSME industry associations, such an app could be mandated for all the MSMEs. Moreover, the pandemic also provides policymakers with the opportunity to promote digitisation and widen the use of FinTech services. As mentioned earlier, a chunk of micro-units depends on agents to collect payments for their goods and services. Hence, mandating the use of payments via UPI (unified payment interface) would reduce payment delays due to paperwork or other disruptions such as the one created by Covid-19. FinTech services offer a solution to the financial woes of MSMEs. These FinTech services acknowledge the fact that MSMEs are constrained by a lack of collateral or credit history, which hampers their access to formal finance. In this context, these services evaluate the repayment capacity and default risk of a unit through technology that provides a precise understanding of the time needed by MSMEs to convert investments into cash through sales of goods and services. This provides an insight into the ability of a unit to generate cash through its operation, providing an assessment of its repaying ability. For example, Capital Float, an NBFC, provides collateral-free loans for small units in India. The NBFC assesses the risk profile of the business in real-time by evaluating MSMEs cash flow and, upon meeting its criteria, provides loans to these businesses on the same day with zero paperwork. Further, the acceptance of e-KYC makes the process viable. Such initiatives help MSMEs tackle the issue of finance. As the proverbial saying goes, "Necessity is the mother of invention," the pandemic has certainly created the need for innovative policies to rescue the ailing MSME sector. ❑

References

1. CII (2018). Global Value Chains Expanding Boundaries of Indian MSMEs. *Theme Paper, Confederation of Indian Industry*.
2. GOI (2019). MSME Annual Report 2018-19, Ministry of Micro, Small and Medium Enterprise. *New Delhi: Government of India*.
3. Patnaik, I., & Pandey, R. (2019). *Savings and capital formation in India.* NIPFP Working Paper No. 19/271.

Endnotes

1. https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=924#CH7
2. The UK Sinha Committee highlights the inability and/or unwillingness of MSMEs to repay, which leads to a rise in NPA.
3. https://samadhaan.msme.gov.in/MyMsme/MSEFC/MSEFC_Welcome.aspx
4. Only those MSMEs with a valid Udyog Aadhaar (UAM) can access MSME Samadhaan portal.
5. Computed as the sum of Amount involved in Applications ready for Consideration (Rs. Crore), Actionable Application Amount (Rs. Crore), and Amount involved in Applications Converted into Case Under various stages of hearing (Rs. Crore).