Nourishing Dwarfs to become Giants: Reorienting policies for MSME Growth

The Economic Survey 2018-19 has a very simple message for MSMEs - GROW UP! This is a quick attempt to bullet-point and simplify the main contours underlying that message. For those who want it even simpler, please check out the summary at the end of this article.

But for both the convinced and the critics, please read through Chapter 3 of the Economic Survey. Behind all the “ecnomicese” (just coined a new word) there is a whole lot of sense. Now to begin……

Unshackling MSMEs for Growth

MSMEs that grow not only create:

a) Greater profits for their promoters but also;
b) Contribute to job creation and productivity in the economy.

- Our policies must, therefore, focus on enabling MSMEs to grow by unshackling them.
- Instead our policies create and maintain dwarfs. *That is, small firms that never grow, instead of infant firms that have the potential to grow and become giants rapidly*.

Large is beautiful -for jobs & productivity

Firms with less than 100 workers and more than 10-year-old are >50% of all organised manufacturing firms in numbers, but contribute only 14% to employment and 8% as the share of productivity.

In contrast, large firms (more than 100 employees) account for 75% of such employment and nearly 90% of productivity, though only 15% of the total number.

The feeling that small firms are large job creators is because jobs being lost in small firms are not taken into calculation. *Small firms may create jobs, but they also keep losing them.*

On the other hand, large firms create permanent jobs in larger numbers. Also, young firms create more jobs at an increasing rate than older firms.

Pointers for a change in policy

In the circumstances, incentives given to smaller companies, however old they may be, or labour regulations which become harsher, the larger the company; are counter-productive to increase both employment and productivity.

The remedy must be to limit size-based incentives to less than 10 years while reducing labour law restrictions. In Rajasthan, after the recent de-regulation of labour law restrictions, employment has increased significantly as compared to other states

Creating jobs for the youth -Unshackle MSMEs

A well-paying job provides the best form of financial and social inclusion to not only the individual but also his/her entire family.

Let's talk numbers. The working-age population is expected to grow by roughly 10 million per year during 2020-30 the coming decade and 4 million per year between 2030-40. Assuming that out of the above numbers, the people actually wanting jobs is about 60% of the total, then we shall need to create some 5 to 6 million jobs annually till 2030.

It is with this aim in mind, that MSMEs must be freed or unshackled to enable them to grow, become productive and create jobs.

Definition of Dwarf in the National Survey

A firm employing less than 100 workers is considered small and more than 100 workers is large.

A small firm as above, which is older than 10 years is considered a "dwarf" because it has not become large despite being 10 years old.

Analysis using firm-level data from the Annual Survey of Industries (ASI) for the year 2016-17

- Dwarfs account for more than 50% of the firms in organised manufacturing but their share of employment is only 14.1 % and only 7.6% of the Net Value Added (NVA)

  But young, large firms (>100 employees and <10 years old) accounting for only 5.5% of the firms contribute 21.2% to the employment and 37.2% of the NVA.

- Large but old firms (>100 employees and >10 years old) account for only 10.2%of the firms by number but contribute more than 50% of the employment, as well as, NVA.

Conclusion:

- Firms that are able to grow over time to become large are the biggest contributors to employment and productivity in the economy.

- In contrast, dwarfs that remain small despite becoming older remain the lowest contributors to employment and productivity in the economy.

- The study dispels the popularly held belief that small firms generate the most employment. Higher levels of job creation in small firms co-exist with job destruction, thereby leading to lower levels of net job creation (Li and Rama, 2015)

- A study of proportion of firm numbers, employment and NVA by firm age, show that as compared to the small firms, it is the young firms (<10 years old) that contribute significantly to employment /value addition and account for a disproportionate share of employment and productivity.

- A comparison with US and Mexican firms shows the average employment level for 40-year old enterprises in the U.S. was 5 times more than Indian Firms. Even Mexican firm had 40% more average employment than Indian firms after 40 years.

- There is similar tale in the case of productivity with 40-year-old American firms being 2.5 times more productive than Indian Firms and Mexican enterprises being 1.5 times more productive after 40 years compared to just 60% for a similar Indian enterprise.

What's policy go to do with it?

The National survey makes a neat distinction between *infants and dwarfs.*

*Infant firms are small and young while dwarfs are small but old. W*hile infant firms can grow to become large firms that are not only more productive and generate significant employment, dwarfs remain small and contribute neither to productivity nor to jobs.

Our policies till date create a "perverse" incentive for firms to remain small. If the firms grow beyond the thresholds that these policies employ, then they will be unable to obtain the said benefits.

Therefore, rather than grow the firm beyond the said threshold, entrepreneurs find it optimal to start a new firm to continue availing these benefits. As economies of scale stem primarily from firm size, these firms are unable to enjoy such benefits and therefore remain unproductive.

Policies which keep us small

- India has a large number of labour laws, regulations and rules, both at the centre and the state levels that govern the employer-employee relationship. Each of these legislations exempts smaller firms from complying with these legislations.

  Size-based restrictions through labour legislation creates perverse incentives for firms to remain small.

Sr. No	Labour Acts	Applicability to Establishments
1	Industrial Disputes Act,1947, Chapter V relating to strikes, lockouts, retrenchment, layoff	Employing 100 or more workers
2	Trade Union Act, 2001-Registration of trade unions	Membership of 10 per cent or 100 workmen whichever is less
3	Industrial Employment (Standing Orders) Act, 1946	100 or more workmen
4.	Factories Act,1948	10 or more workers with power and 20 or more workers without power
5.	Contract Labour (Regulation & Abolition) Act, 1970	20 or more workers engaged as contract labour
6.	The Minimum Wages Act, 1948	Employment in the schedule having more than 1000 workers in the State
7.	Employees' State Insurance Act,1948	ESI Scheme 10 or more workers and employees monthly wage does not exceed `21000
8.	Employees' Provident Fund & Miscellaneous Provisions Act, 1952	20 or more workers

Performance Indicators all up in Flexible States

- To examine the impact of labour regulations, States are classified as Flexible and Inflexible based on the restrictiveness of their labour regulations.

- This is based on the Organisation for Economic Co-operation and Development (**OECD**) state-level survey that was conducted in 2007 where 21 States were surveyed and the responses were compiled by the OECD into an index that reflects the extent to which procedural changes have reduced transaction costs by limiting the scope of regulations, providing greater clarity in the application of regulations, or simplifying compliance procedures.

- This index has been updated by covering the labour reforms initiated by the States till 2013-14. *Rajasthan introduced changes in the major Acts in 2014 after which other states followed, so 2014 has been fixed as the cut-off year for classifying States as Flexible or Inflexible.*

- Based on the scores, Assam, Jharkhand, Kerala, Bihar, Goa, Chhattisgarh and West Bengal are classified as inflexible states while the other 14 states are classified as flexible.

- The study shows that the Flexible States contribute disproportionately more, on average, to labour, capital and productivity when compared to the Inflexible States.

- Moreover, due to rigidity in the labour laws, employers in Inflexible States prefer substituting labour with capital.

- *Inflexible states are suffering in all dimensions. They are unable to create enough employment, cannot attract adequate capital into their states and their wages are lower as their productivity is lower.*

Is small really beautiful?

- Policies targeted at the small firms referred to as the MSMEs, include priority sector lending, incentives/exemptions till they reach an investment upper limit quantified in terms of investment in plant & machinery.

- Schemes such as Priority Sector Lending, Credit Guarantee Fund Scheme, Purchase Preference Policy, Price Preference Policy, Benefits in tendering, Raw Material Assistance Scheme of NSIC, Marketing Assistance Scheme, GST Composition Scheme promote small firms irrespective of their age.

- From 1997 to 2007, several product categories reserved for small-scale firms were eliminated in a phased manner. Martin, Nataraj & Harrison (2014) analysed the impact of this phased de-reservation on job creation & destruction among incumbents and entrants by their size & age.

- The study shows first, on average, after the elimination of reservations, large firms – be it new entrants or incumbents – have created more employment than small firms. Across both new entrants and incumbents, the small firms destroyed jobs while the large firms created jobs.

- Second, net job creation (negative in the case of job destruction and positive in the case of job creation) increased with firm size for both new entrants and incumbents.

- Third, large entrants created the maximum employment as seen in the effect of entrants with more than 500 employees.

- Finally, the growth in employment was both, by the entrants that started producing the de-reserved products and especially the large incumbents that were constrained by the ceilings on production owing to the SSI reservation policy.

The Way Forward

- MSMEs that grow not only create greater profits for their promoters but also contribute to job creation and productivity in the economy. Our policies must, therefore, focus on enabling MSMEs to grow by unshackling them.

- With the appropriate grandfathering of existing incentives, they need to be shifted away from dwarfs to infants. When such incentives are provided to firms irrespective of their age, the incentives create “perverse” incentives for firms to stay small.

- Under MSME’s Priority Sector Lending targets, it is necessary to prioritize ‘start ups’ and ‘infants’ in high employment elastic sectors. This would enhance direct credit flow to sectors that can create the most jobs in the economy.

- *Every incentive for fostering growth should have a ‘sunset’ clause, say, for a period of five to seven years after which the firm should be able to sustain itself. The policy focus would thereby remain on infant firms.*

- Focus on High Employment Elastic Sectors: The manufacture of rubber and plastic products, electronic and optical products, transport equipment, machinery, basic metals and fabricated metal products, chemicals and chemical products, textiles and leather & leather products*, are the subsectors with highest employment elasticities. To step up the impact of economy growth on employment, the focus has to be on such high employment elastic sectors.*

- High Spillover Effects such as Tourism: Developing key tourist centres will have ripple effects on job creation in areas such as tour and safari guides, hotels, catering and housekeeping staff, shops at tourist spots etc. It is possible to identify 10 tourism spots in each of the larger 20 states and 5 spots in the 9 smaller states and build road and air connectivity in these tourist attractions, which would boost economic activity along the entire route and would also reduce the migration of the rural labour force who form a major proportion of the total labour force.

SUMMARY

- MSMEs that grow not only create greater profits for their promoters but also contribute to job creation and productivity in the economy. Our policies must, therefore, focus on enabling MSMEs to grow by unshackling them.

- Job creation in India, however, suffers from policies that foster dwarfs, i.e., small firms that never grow, instead of infant firms that have the potential to grow and become giants rapidly.

- While dwarfs, i.e., firms with less than 100 workers despite being more than ten years old, account for more than half of all organized firms in manufacturing by number, their contribution to employment is only 14 per cent and to productivity is a mere 8 per cent. In contrast, large firms (more than 100 employees) account for three-quarters of such employment and close to 90 per cent of productivity despite accounting for about 15 per cent by number.

- The perception of small firms being significant job creators pervades because job destruction by small firms is ignored in this calculus: small firms destroy jobs as much as they create. In contrast, large firms create permanent jobs in larger numbers. Also, young firms create more jobs at an increasing rate than older firms.

- Size-based incentives that are provided irrespective of firm age and inflexible labour regulation, which contain size-based limitations, contribute to this predicament.

- To unshackle MSMEs and thereby enable them to grow, all size-based incentives must have a sunset clause of less than ten years with necessary grand-fathering.

- Deregulating labour law restrictions can create significantly more jobs, as seen by the recent changes in Rajasthan when compared to the rest of the States.

- Direct credit flow to young firms in high employment elastic sectors to accelerate employment generation by re-calibrating Priority Sector Lending (PSL) guidelines.

- Focus must be on service sectors such as tourism, which has high spill over effects on other sectors such as hotel & catering, transport, real estate, entertainment etc. Identifying and promoting tourist spots for development will help create jobs.

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