

Impact of Trade Liberalization on the Performance of Indian Manufacturing MSMEs

Abstract

The present study examines the performance of different types of Indian manufacturing MSMEs following trade liberalization by using the CMIE Prowess database for listed registered Indian manufacturing firms as well as a merged 3rd and 4th Census dataset for unlisted Indian MSME registered manufacturing firms. Existing studies, which examine the impact of trade liberalization on the performance of Indian manufacturing firms usually focus only on registered big firms or use an inappropriate measurement of firm size when differentiating between small, medium and large firms. Further, these existing firm-level studies on the impact of trade liberalization typically focus on a small set of performance measures and capture trade liberalization only through tariff liberalization. This study addresses the aforementioned gaps by: (a) classifying firms into small, medium and large firms in accordance with the definition of the Ministry of MSMEs, which is based on the level of investment in Plant & Machinery; (b) examining the differential impact of trade liberalization as captured by reduction in tariff barriers on a wide range of firm-level performance indicators; namely, productive efficiency as captured by firm-level total factor productivity, and operational efficiency as captured by growth rates of firm-level profit after tax and the gross value of output for different sized Indian firms, while taking into account firm and industry specific factors; and (c) examining the impact of liberalization in non-tariff barriers on firm performance.

The study throws up several interesting results. First, the Prowess study finds that although trade liberalization has had a positive effect on all chosen indicators of firm-level performance, it has had relatively less impact on Indian SMEs compared to large firms, suggesting that Indian manufacturing SMEs have not been able to reap the benefits of trade liberalization. Second, the study finds that these performance gains have mostly resulted from the input channel, i.e., the increased availability of lower cost and greater variety of inputs following trade liberalization. Third, both tariff and non-tariff liberalization have helped large firms to improve their performance. Fourth, the Exim Policy, 2004-09 has increased the wedge in the tariff rates between food and agro based industries on one hand and non-food and non-agro based industries on the other, which has caused the two groups of firms to diverge in their various performance indicators, post 2004. The latter policy has adversely affected the more protected food and agro based firms, while the more liberal non-food and non-agro based firms have benefited as reflected in their improved firm-level operational and productive efficiency. Further, the negative effect of the Exim Policy is seen to be more prominent in India's SME segment as a large share of SMEs are present in food and agro based industries. Overall, the findings from the Prowess study suggest that Indian SMEs are constrained by operational, financial and other structural factors, which prevent them from taking advantage of trade liberalization.

The Census data based study of Indian MSME firms, which also includes micro firms, complements the analysis based on Prowess data. It finds that the effect of trade liberalization on the MSME segment, as a whole, is minimal with regard to improvements in firm-level operational and productive efficiency. However, those MSME firms, which are able to source cheaper, better quality and increased variety of inputs following trade liberalization, have been able to benefit from the reduction in tariff and non-tariff barriers. In this regard, firm-level characteristics relating to the production and operating structure of MSMEs (e.g., power source used in the production process, maintenance of accounts, product quality standards

and technological knowledge) have played an important role in shaping the effects of trade liberalization on the performance of Indian MSMEs. In addition, certain basic firm-level features such as firm age, level of employment and access to institutional credit are also found to have influenced MSME performance. The study also finds that MSME firms in export-oriented industries have had difficulties in facing external competition following trade liberalization, due in particular to their poor quality output and lack of knowledge of modern production techniques and hence have experienced lower levels of operational and productive efficiency.

Overall, the findings suggest that firm-level characteristics are important in shaping the effects of trade liberalization in India's manufacturing sector. Indian MSMEs are constrained by operational, financial and other structural factors, which have prevented them from taking advantage of the significant trade liberalization that the Indian economy has undergone. Moreover, the results also indicate that where there is improvement in the performance of MSME firms following trade liberalization, the main source of these gains is through the input channel, i.e., the increased availability of lower cost and greater variety of inputs. From a policy perspective, this study highlights the need to focus on issues such as access to credit, technology, quality and on input markets to facilitate the growth and competitiveness of Indian MSMEs. The economy-wide benefits in terms of income and employment generation, poverty alleviation and integration into global production networks can be significant.