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Firm Transition in Indian MSMEs and Its Impact on the Productivity Differences and Productivity of the Firms

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MSMEs, in the majority of developing countries, are characterized by the persistence of skewed firm-size distribution. They have an overwhelming presence of micro enterprises and few large firms with a conspicuous ‘missing middle’ (Dhar & Lydall, 1961; Little, Mazumdar, & Page, 1987; Krueger, 2007; Mazumdar & Sarkar, 2009; Ramaswamy, 2013; Tybout, 2014). In contrast, this distribution is more in favor of small and medium enterprises in developed countries . This indicates a problem of firm transition, wherein firms incorporated as micro or small tend to remain in the same size category and does not transit to the higher size category. Transition is observed to take place when a firm crosses the threshold set by the regulator and moves to the higher size category (i.e. from micro to small and then to medium). The question of firm transition holds importance because of the following reasons: (i) medium-sized firms provide better quality jobs and are typically more productive than micro firms (Altenburg & Eckhardt, 2006), (ii) the contribution made by relatively larger enterprises to the growth indicators like GDP and employment is higher than their smaller enterprise counterparts (Ayyagari, Beck, & Demirguc-Kunt, 2007) and (iii) aggregate productivity is low in developing economies with large number of micro enterprise as compared to developed economies (Hsieh & Klenow, 2008). Therefore, it becomes essential to understand why so few micro firms which are predominant type of firms in the MSMEs, fail to make transition to the larger size firms

The objective of therefore paper is therefore three folds. First, we compare the firms that have transited from one stage to another using different definition of size categories and its determinant. Our study indicate an inverted U shaped relationship between the age of the firms and its transition which stands in contrary to the existing literature. Indian firms, in the beginning, do not have to struggle to overcome the liability of newness. Moreover, we also find that an inverted U-shaped relationship exists for all firms irrespective of their size. Additionally, it is found that transition to the medium size is evident from the data which alters the size distribution of firms. However it varies across the two definitions and for manufacturing and service firms. Manufacturing firms defined by sales criteria experience more transition to the medium-sized firms as compared to the same firms defined by the investment criteria, which sees more transition to the large size firms. On the other hand, Service firms witness more transition to the medium size as compared to the large size. This shows that transition of firms can ease the missing middle phenomenon.

Additionally our study show that access to finance is a major factor affecting transition followed by exports, imports, and innovation in formal firms. For informal firms, results suggest that usage of information and communication technology (ICT) is the key determinant in firm transition for both manufacturing and service sector. It is followed by government assistance, business network and registration status of firms. However, availability of credit does not have a significant impact on transition for informal manufacturing firms.

Next, we have examined how initial endowment and inequality of assets and credit affect the transition of the firms.

Finally, we have examined the productivity difference between the transited firms and calculated the productivity gain that can be achieved due to transition. Using National Sample Survey Organization's Survey of Unincorporated Enterprises (2010-11, 2015-16) we decompose the productivity changes over time. We establish the importance of within sector component as the driver of change in total productivity, i.e. one does not observe a shift of workers from low to high productivity sectors. We next measure the productivity differences across different regions, across enterprise categories and across ownership types and indicate unequal productivity differences can be attributed to different factors.