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Weathering the Shock: Firm Size, Formality, and the Price–output Trade-off in India's Short-run Response to Cost Increases

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Abstract: In economic theory, firms facing short-run input cost increases must choose between raising prices and reducing output, depending on demand elasticity and market power. This paper examines how this trade-off operates within India's bifurcated industrial structure, where large formal firms coexist with a vast informal micro-enterprise sector and a 'missing middle' of medium-sized firms. The paper develops six hypotheses on firm responses to cost shocks, focusing on market power, firm size, and formalisation. These are examined through Indian case studies covering energy and coal costs in Tirupur's textile cluster, FMCG and steel price responses, metal price volatility in Moradabad's brassware sector, liquidity constraints among Kanpur's informal leather tanneries, and GST-related effects on footwear producers. Across these cases, market power and formal-sector status emerge as key determinants of adjustment. Large, formal, and oligopolistic firms tend to pass higher costs through to prices while protecting output, whereas small and informal firms, constrained by weak market power, fixed-price contracts, and limited working capital, absorb shocks through output contraction. The paper concludes by highlighting the importance of improved credit access and formalisation support for strengthening the resilience of India's MSME sector.

Keywords: Short-run Cost Shocks, Firm Size, Informality, India, Market Structure, Menu Costs, MSMEs, Missing Middle.

I. INTRODUCTION

In economic theory, the distinction between the short run and the long run is defined not by a specific calendar period, but by the flexibility of inputs. The short run is characterised as a period during which at least one factor of production, typically capital, is fixed, constraining a firm's capacity to fully adapt to changing economic conditions (Mankiw, 2021). In contrast, the long run permits adjustment of all inputs, enabling firms to enter, exit, or rescale operations. Understanding how firms behave within the short-run constraint is therefore central to analysing industrial dynamics, employment stability, and the transmission of macroeconomic shocks at the firm level.

The Indian economy presents an especially rich context for this investigation. Despite its trajectory as one of the world's fastest-growing major economies, India's industrial structure is characterised by a pronounced duality: a concentration of large conglomerates on one end and a vast sea of micro-enterprises on the other, with relatively few medium-sized firms occupying the intermediate space. This structural anomaly, sometimes termed the 'missing middle', has been extensively documented in the development economics literature (Hsieh & Klenow, 2014). Importantly, the simultaneously large informal economy, which accounts for about 94% of total employment but is characterized by low and often unstable incomes (ILO, 2018) in India, and a much smaller, more embedded formal sector complicates how firms in varying sectors respond to cost pressures.

Whenever input costs spike as a result of an international commodity price shock, currency depreciation, supply chain disruption, or policy adjustment, firms have to quickly decide how they will regain their balance. The MC curve and the MR are responsible for this decision, where in perfectly competitive markets they intersect to create a profit-maximising output. But in practice, real markets, particularly within developing nations like India, are rarely fully competitive. Firms have very different levels of price-setting power depending on the industry, with consumer goods being modeled as monopolistically competitive and heavy industries like steel and cement having oligopolistic structures (Varian 2019; Tirole 1988).

The purpose of this paper is to analyze theoretically informed hypotheses on how Indian firms across different firm sizes and levels of informality deal with short-run cost shocks, using detailed data. The research is centred on six hypotheses, each corresponding to a behaviour at the firm-level under stress: contraction in output alongside price preference; large-firm pricing power and small-firm vulnerability of output in excess of debilitation of informal-sector fragility or resilience vis-à-vis formal-sector leverage by way of policy adjustments. Through systematically addressing each hypothesis in an empirical context, this paper aims to inform the theory of short-run microeconomic behaviour as well as provide insights into the policy debates on industrial resilience facing many developing economies.



A) Theoretical Background: Key Concepts

The profit-maximisation condition in microeconomic theory holds that a firm should produce at the level of output where $MC = MR$. When input costs rise, triggering an upward shift in the MC curve, the profit-maximising output level falls, provided that MR remains unchanged. This basic principle underpins the first hypothesis examined in this paper. The extent to which firms will respond by increasing prices vs cutting back output is crucially dependent on the elasticity of demand in part, the market power they face and level. (Varian 2019)

In a perfectly competitive market, firms are price takers; they cannot change the market-clearing equilibrium price and can keep prices in response to cost increases only by adjusting output. Firms with market power, either in oligopolistic or monopolistically competitive markets, can transfer at least some cost increases to consumers by raising prices, thus shielding production volumes. This divergence in adjustment mechanisms is the theoretical cornerstone of the hypotheses related to firm size (H3 and H4) and formality (H5 and H6) examined in this paper.

The concept of price rigidity is also relevant here. The fear that menu costs, the direct and indirect costs of price adjustment (Mankiw, 1985; Ball & Mankiw, 1994), will lead to a reluctance among firms to change prices regularly. The strategic rationale to maintain output at the expense of margin while protecting market share (Tirole, 1988) would also hold for firms with entrenched brand relationships and long-term contracts. The case studies presented in the chapters that follow echo those theoretical tensions.

The theory of the firm under credit market constraints is also relevant for informal-sector behaviour. Formal firms encounter a fundamentally different liquidity constraint because they can access credit from formal markets, whilst informal enterprises do not (Banerjee & Duflo 2007) due to the lack of collateral or documented revenue streams. This embedded structural weakness makes informal firms very sensitive to working-capital shocks and binds their response to cost pressures largely, if not entirely, into output contraction.

B) India's Industrial Landscape: Structural Context

The manufacturing sector of India is sorely bifurcated. Estimates based on National Sample Survey data conducted by the Ministry of MSME (2021) reveal that as many as 26 million micro, small and medium enterprises or MSMEs exist in the country, contributing a significant share to GDP, along with employment figures exceeding well above a hundred million. These enterprises are closely located across various sectors like textiles, food processing, handicrafts, leather goods and engineering components.

In contrast, the formal industrial sector is increasingly concentrated in a number of large conglomerates such as Tata Group, Reliance Industries, JSW Group (fifth-largest steel manufacturer worldwide), Adani Enterprises and Mahindra & Mahindra, which control significant market shares of capital-intensive sectors. These firms typically boast sophisticated risk management systems, access to both domestic and global capital markets, as well as the institutional capacity to navigate extensive regulatory landscapes. Their short-run responses to cost shocks are therefore qualitatively different from those of MSMEs (Kotwal, Ramaswami & Wadhwa, 2011).

The coexistence of these two industrial poles separated by a stark gap in size, formality, and institutional access creates what development economists have called the 'missing middle' (Hsieh & Klenow, 2014). The absence of medium-sized firms that could serve as buffers and intermediaries in supply chains amplifies the vulnerability of the small-firm sector to macroeconomic shocks. Understanding the short-run behaviour of firms across this spectrum is therefore not merely an academic exercise but a matter of significant policy consequence.

II. HYPOTHESIS TESTING THROUGH CASE STUDIES AND EVIDENCE

A) H1: Firms Reduce Output When Costs Increase in the Short Run

a. Conceptual Overview

This hypothesis follows from the classical law of supply and the microeconomics profit-maximisation condition. If production costs go up, this is like an upward shift of the marginal cost curve. To illustrate: if the size of a firm were viewed as constant, it would be where it was within its marginal revenue curve, reflecting competitive behavior with the seller acting like an influencer, that is, a price taker, and only adjusting at new MC-MR intersections. Thus, the firm outsources production in order to refrain from producing units with a marginal cost that exceeds their average revenue (Mankiw 2021; Malkiel & Ellis, Pindyck and Rubinfeld 2019).

Such a mechanism is particularly pronounced in thin-margin, input-intensive industries. In such situations, even small increases in cost can raise variable costs above the market price and operating at full capacity becomes economically unviable. Short-run output reductions could also be conditional on inventories, contracts and working capital constraints that vary depending upon the type of firm.

b. Case Study: The 2021–2022 Energy Cost Shock in Indian Textile Manufacturing

International coal and energy prices surged, as supply disruptions combined with a speedy recovery in energy demand to stimulate global post-pandemic economic revival; meanwhile, India suffered severe domestic coal shortages and rising costs of electricity through 2021–22 (S&P Global Commodity Insights, 2022). Among the industrial clusters best exposed to this shock were small-scale textile units in Tirupur, Tamil Nadu, one of India's greatest knitwear export hubs, which rely on captive power and process heat. According to output-based industry associations, sharply rising energy and raw-material prices increased production costs, causing a reduction in operating shifts in many units and, in several cases, shuttering the activity altogether (Fibre2Fashion, 2022; Deccan Herald, 2022).

Unable to quickly switch to alternative energy sources or fully absorb the higher costs within existing price structures, many units reduced production volumes rather than raising prices, since their buyer-driven, largely export-oriented contracts left little room for unilateral price increases. This response is consistent with the theoretical prediction: when cost-push shocks are both sudden and substantial, and pricing power is limited, output contraction becomes the dominant equilibrating mechanism. The case supports H1, illustrating how cost-push pressures translate into supply contraction, especially in the short run when capital restructuring is infeasible.

A broadly similar pattern has been reported in other energy-intensive SME clusters facing input cost volatility during the same period. Across these sectors, the dominant response has tended to be output reduction rather than price escalation, primarily because prevailing buyer-driven market conditions limit the ability of small producers to unilaterally raise prices.

B) H2: Firms Prefer Increasing Prices Over Reducing Output in the Short Run

a. Conceptual Overview

While H1 describes the general tendency toward output contraction, H2 addresses the strategic preference of firms with market power. The theory of the firm under monopolistic competition and oligopoly suggests that firms with brand identity, product differentiation, or consumer loyalty can use pricing power as a first-line response to cost increases, thereby protecting market share and production volumes (Tirole, 1988; Krugman & Wells, 2018).

Price increases in branded consumer markets may be executed directly by raising the listed MRP or indirectly through 'shrinkflation' reducing the product quantity while maintaining the nominal price, which raises the effective price per unit. Both strategies increase the effective price per unit of output while maintaining production volumes and supply chain relationships. The preference for this mechanism is theoretically grounded in the concept of menu costs and the strategic value of sustained market presence (Ball & Mankiw, 1994).

b. Case Study: FMCG Sector Response — Hindustan Unilever Limited

One sector which provides a pragmatic example of H2 is virtually the Indian Fast-Moving Consumer Goods (FMCG) space. The sector was under margin pressure from late 2021 through 2022 due to increasing input costs, in particular palm oil, crude derivatives and packaging materials. As a result, India's largest FMCG player, Hindustan Unilever Limited (HUL) had to take multiple rounds of price hikes, including 3–20% increases on soaps and detergents in January 2022 (Business Standard, 2022a), followed by another round in February 2022 of 3–13% (Business Standard, 2022b), and again in April covering brands like Lux, Lifebuoy for soaps Surf Excel, Wheel Rin for home care portfolio Dove Prioritizing incremental price hikes Business Standard reports HUL's response.

Apart from direct price increases, HUL and its FMCG peers also adjusted effective prices through pack size or grammage changes, the mechanism that lies at the foundation of shrinkflation (Business Standard, 2022d), showing how firms can push realised revenue per unit up without having to change listed prices for every SKU. When raw material prices started to cool in late-2022, HUL unwound some of these hikes by reducing prices on select soap and detergent brands by 2–19% in October (Business Standard, 2022d), a pattern consistent with the theoretical notion that for firms with strong brand equity operating in relatively inelastic consumer markets, price is the principal adjustment margin, rather than output.

Demonstrating these price adjustments rather than production cuts over the sequence of H2 provides support for their theory, showing that firms with enough market power and brand equity in consumer markets prefer price adjustment to output reduction as a first-order response to cost shocks.

C) H3: Large Firms Adjust Prices More Than Output

a. Conceptual Overview

Many large firms in capital-intensive sectors steel, cement, automobiles, petrochemicals and telecommunications operate in oligopolistic market structures. The Herfindahl-Hirschman Index (HHI) is a measure of market power that is usually high in markets where market power rests with three or fewer players. Such concentration allows firms to act less as

price takers and more as price setters, passing on cost increases to buyers with inelastic demand, with the degree of inelasticity of the relevant set of products increasing by more than 5% year-on-year (Varian, (2019); Pindyck & Rubinfeld (2018)).

Possible explanations are based on oligopoly pricing models: firms could raise prices synchronously with each other if all competitors face the same public cost shock. This scale allows them to arrange long-term purchase contracts, hedge their commodity exposures and tap into low-cost capital lending, which also keeps production volumes safe during a period of high cost inflation (Tirole, 1988).

b. Case Study: The Indian Steel Industry — Tata Steel and JSW Steel

After the Russia-Ukraine war started in February 2022, global coking coal prices, an essential input into blast furnace steelmaking, soared within weeks, with reported prices increasing from USD 300 per tonne to USD 650–700 per tonne (Business Standard, 2022e). The response: Prices of hot-rolled coil (HRC), rebar, and other products followed sequential rounds of price increases by major steel producers, such as Tata Steel, JSW Steel, ArcelorMittal Nippon Steel India (AM/NS), Jindal Steel & Power and SAIL in India, with reported hikes of about ₹1,500–₹5,000 per tonne across multiple rounds during March and April 2022 (Business Standard Article| The Tribune Article).

The fact that infrastructure contractors, automobile manufacturers and construction firms, the main consumers of steel in India, face short-run demand that is relatively elastic since there are no credible substitutes to steel and projects cannot be postponed if deadlines are, for example, fixed has permitted large primary steel producers to pass on a large share of cost increases to consumers with limited volume impacts. Production volumes reported by the leading producers remained relatively unchanged during this period (Business Standard, 2022e).

This case supports H3. The comparative ability of large, oligopolistic firms to maintain volumes while adjusting prices sharply contrasts with the output-contraction behavior of smaller producers, and underscores what we know about market structure's role in determining short-run adjustment strategies.

D) H4: Small Firms Reduce Output More Than Prices

a. Conceptual Overview

Small firms typically operate in highly competitive market segments where price elasticity of demand is high. As price takers, they lack the market power to unilaterally raise prices without losing customers to competitors, often dozens of other small producers in the same cluster or locality. Faced with a cost shock, these firms must therefore choose between producing at a loss or contracting output (Kotwal, Ramaswami & Wadhwa, 2011).

The output-contraction response is further reinforced by the contractual structure of small-firm supply chains. Many small producers operate under fixed-price agreements with buyers, exporters, large retailers, or intermediaries that explicitly or implicitly limit unilateral price revision within the contract period. In such conditions, maintaining prices while absorbing rising costs leads to margin erosion, and the only financially rational response is to reduce production or temporarily shut down.

b. Case Study: The Brassware Industry in Moradabad, Uttar Pradesh

The Moradabad brassware cluster is one of India's most prominent artisanal industrial clusters, responsible for a significant share of India's metal handicraft exports. The cluster comprises thousands of small workshops, most employing fewer than ten workers, engaged in the casting, fabrication, and finishing of brass and copper goods. Global base-metal prices, including copper and zinc, rose sharply through 2021–2022 amid post-pandemic demand recovery and supply constraints, raising input costs for metal-working clusters such as Moradabad.

Because the primary customers of Moradabad brassware are export intermediaries and large retail chains typically operating under fixed-price contracts, artisanal units have limited scope to revise their prices upward within a contract cycle. Industry reporting on the cluster has documented furnace shutdowns, temporary layoffs, and production stoppages during periods of sharp input cost inflation. The reduction in output in such episodes reflects not a strategic choice but a structural imperative, the main available mechanism for managing costs when prices are externally constrained. This is consistent with H4, indicating that small firms tend to bear the brunt of cost shocks through output volatility rather than price flexibility.

E) H5: Informal Firms Reduce Output More Sharply Than Formal Firms

a. Conceptual Overview

The distinction between formal and informal firms is not merely administrative but reflects big differences in institutional access, financial resilience, and operational flexibility. These informal firms, by their nature, those which operate outside of official registers, tax systems and formal financial markets, run on cash-based, hand-to-mouth financial cycles. As

a broad statement, they are not typically offered any kind of working capital credit, trade credit or bank overdraft facilities, which make adverse cost or liquidity shocks immediate crises (Banerjee & Duflo, 2007; ILO, 2018).

In contrast, formal firms are able to borrow in the short run until prices or productivity adjust to higher input costs. They also tend to have less concentrated sources of suppliers, inventory buffers and risk management protocols that lessen the initial impact of cost-type shocks. The theoretical prediction, therefore, is that informal firms will exhibit sharper and faster output contractions in response to cost increases than their formal counterparts.

b. Case Study: Leather Tanneries in Kanpur — Impact of Liquidity and Regulatory Shocks

Kanpur, Uttar Pradesh, is home to India's largest concentration of leather tanneries. The sector is bifurcated between a small number of large, registered tanneries that export finished leather and leather goods, and a far larger number of small, informal units that supply semi-processed hides to the formal sector. This structure was severely tested by the 2016 demonetisation and, subsequently, by the introduction of the Goods and Services Tax (GST) in 2017 alongside tighter pollution-control enforcement.

Demonetisation disrupted Kanpur's predominantly cash-based tanning economy, halting payments and raw-material purchases and sharply reducing production, while a 2017 Uttar Pradesh Pollution Control Board directive requiring a substantial reduction in effluent-treatment infrastructure forced many units to operate at reduced capacity or shut down intermittently. As per reports and industry data, the Kanpur region saw a fall in the number of operational tanneries from 600 to just over 200 across said period (Drishti IAS, 2023). Larger, registered tanneries found themselves in a comparatively better position to access institutional credit and GST input tax credits to manage the transition, while smaller informal units, more reliant on cash liquidity and less able to absorb compliance costs, suffered a disproportionate share of the output losses as a result. This evidence is, in general, in accordance with H5, which highlights the structural precariousness of informal enterprises and their uneven burden in absorbing macroeconomic and regulatory shocks.

They are part and parcel of more general evidence on informality and economic resilience from low- and middle-income countries. Using data from the World Bank Enterprise Surveys, Aterido, Hallward-Driemeier and Pagés (2011) found that firms with limited access to formal finance experienced substantially larger output contractions during periods of economic stress than comparable firms with banking access, a finding that is particularly relevant for India's predominantly informal MSME sector.

F) H6: Formal Firms Pass Cost Increases to Prices More Effectively

a. Conceptual Overview

The sixth hypothesis addresses the differential in pricing power between formal and informal firms. Formalisation confers several competitive advantages relevant to price-setting: brand recognition and product differentiation, which reduce demand elasticity; GST compliance, which enables recovery of input tax credits and thus reduces the effective cost burden; integration into structured supply chains with transparent pricing mechanisms; and access to institutional finance, which allows firms to sustain operations while adjusting prices gradually (Kotwal, Ramaswami & Wadhwa, 2011).

These institutions and market advantages combined result in higher pricing power, meaning formal firms can more fully and quickly pass increases in costs through to consumers than informal competitors. Due to the nature of informal firms selling mainly in price-sensitive markets without any brand premium leverage, they are unable to sustain higher prices without losing clients, which renders the ability to use such a tool as a cost management technique practically unusable.

b. Case Study: Organised versus Unorganised Footwear Sector

H6 is the theory of targeting footwear, and H7 is covered in this. In late 2021, the GST Council announced a rise in the uniform GST rate on footwear from 5% to 12%, coming into effect on 1st January 2022 (Business Standard, 2021; TaxO, 2022). Formal footwear players such as Bata India and Metro Brands were able to change the MRP of products to reflect the new rate, communicate through packaging and retail systems and enjoy wide acceptance among consumers given their brand loyalty and product differentiation.

Informal street-side manufacturers and unregistered footwear sellers, whose consumer base is largely low-income urban and rural households, are acutely price sensitive, faced a starkly different situation: even a modest price increase risked a loss of customers. Unable to recover input costs through GST input tax credits, which are available only to GST-registered firms, and unwilling to risk losing price-sensitive customers, many informal units instead absorbed the higher effective tax burden through squeezed margins or scaled back to their most profitable product lines. Industry commentary from the period noted particular concern among smaller, unorganised producers that the flat 12% rate replacing a previous rate structure with a lower band for cheaper footwear would disproportionately affect low-priced, mass-market products (Business Standard, 2021).

This case is consistent with H6, demonstrating that formalisation functions as a structural facilitator of effective cost pass-through. The policy implication is significant: supporting the formalisation of small enterprises not only improves tax compliance and data quality, but may also materially enhance their economic resilience to future cost and policy shocks.

III. DISCUSSION

A) *Synthesis across Hypotheses*

Taken together, the six case studies point to a consistent underlying pattern: the way an Indian firm responds to a short-run cost shock is shaped less by the nature of the shock itself than by two structural characteristics: the degree of market power it holds and its position within the formal or informal economy. The Tirupur textile and Moradabad brassware cases (H1 and H4) show that firms without pricing power, whether due to competitive market structure or fixed-price export contracts, default to output contraction almost mechanically when costs rise, since price adjustment is simply not available to them as an adjustment margin.

By contrast, the HUL and Indian steel cases (H2 and H3) show that firms with brand equity or oligopolistic market position treat price as the primary adjustment lever, protecting production volumes even through substantial cost shocks. The Kanpur leather and footwear cases (H5 and H6) suggest that formality operates as an additional, partly independent axis of resilience: formal status confers access to credit, input tax credits, and institutional buffers that allow firms to smooth the impact of a shock over time, in a way that informal firms, regardless of size, generally cannot.

These two axes, market power and formality, are correlated in the Indian context but not identical: large formal firms sit at one extreme, combining both advantages, while small informal firms sit at the other, lacking both. The evidence assembled here suggests that firms falling toward the latter end of this spectrum exactly the segment of the economy that the 'missing middle' literature identifies as under-represented in India are systematically the most exposed to short-run cost volatility.

B) *Policy Implications*

This asymmetry carries direct implications for industrial policy. First, expanding access to formal working-capital credit for MSMEs, whether through targeted lending schemes, credit guarantees, or fintech-enabled lending against digital transaction records, would directly address the liquidity constraint identified as the central driver of informal-firm fragility in the Kanpur case. Second, continued support for formalisation, including simplified GST compliance for very small enterprises, could allow more firms to access input tax credits and thereby narrow the cost pass-through gap identified in the footwear case. Third, policies that encourage the growth of medium-sized firms addressing the 'missing middle' directly could create a buffer segment of the economy less exposed to the extreme output volatility observed among the smallest, most informal producers.

More broadly, the findings suggest that macroeconomic and trade policy decisions with cost implications for industry energy pricing, import tariffs, exchange rate movements are unlikely to affect Indian firms uniformly. The same shock that is absorbed by a large, formal steel producer through a modest price increase may translate into shift reductions or shutdowns for a small, informal supplier several tiers down the same supply chain. Policy responses to cost shocks, including compensatory measures or transition support, may therefore need to be targeted toward firm size and formality status rather than applied uniformly across a sector.

C) *Limitations and Directions for Future Research*

This paper's methodology, six hypotheses tested against a single illustrative case study each, offers depth and real-world grounding but not statistical generalisability. The cases were selected because they are well documented and clearly illustrate the mechanism under examination, but they cannot establish the prevalence of each response pattern across the wider population of Indian firms. Future research could usefully test these hypotheses using firm-level panel data, for example, from the Annual Survey of Industries or enterprise surveys covering both formal and informal firms, to estimate the relative magnitude of price versus output adjustment across firm-size and formality categories more systematically. Comparative work examining whether these patterns hold in other large emerging economies with similarly dual industrial structures, such as Indonesia or Nigeria, would also help establish whether the dynamics documented here are specific to India's institutional context or reflect a more general feature of firm behaviour in developing economies.

IV. CONCLUSION

This paper set out to examine how Indian firms, differentiated by size and formality, adjust to short-run cost shocks through the competing margins of price and output. The evidence across six case studies spanning textiles, FMCG, steel, brassware, leather, and footwear supports a clear and consistent conclusion: market power and formal status jointly determine a firm's capacity to protect production volumes by passing costs through to price, while firms lacking both attributes are left with output contraction as their primary, and often only, response. Given that India's industrial structure is disproportionately weighted toward small and informal enterprises, this asymmetry has significant implications for aggregate industrial resilience, employment stability, and the transmission of cost shocks through the wider economy. Addressing the structural gap identified

in the 'missing middle' literature, and extending formal financial and institutional access to smaller enterprises, therefore emerges not only as a matter of equity but as a matter of macroeconomic stability.

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