

The Impact of the Endowment Effect and Loss Aversion on Business Recovery: SMEs in Indonesia Examined During the COVID-19 Epidemic

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Abstract: This study looks at how the endowment effect and loss aversion affected how small and medium-sized businesses (SMEs) recovered in Indonesia following the COVID-19 epidemic. Using a qualitative analysis approach, the study investigates how SMEs have responded to the pandemic and how their responses have been affected by the endowment effect and loss aversion. The endowment effect and loss aversion have had a negative effect on SMEs' business recovery, according to the study's findings. It also provides insights into the strategies and practices that SMEs can adopt, such as forming price agreements among businesses, investing in insurance products with a guaranteed return, and expanding online, to ensure their long-term survival and recovery. As well as to inform government intervention such as the monetary policy to help foster the recovery of SMEs during the pandemic. The results of the paper can also be used to inform other countries in their responses to similar pandemics, including the allocation of resources and support for SMEs, in terms of both SMEs' approaches and government policies.

Keywords: endowment effect, loss aversion, business recovery, small and medium enterprises

1. Introduction

The COVID-19 pandemic has had a significant influence on the world economy, and the methods attempted to manage it have had negative effects that are far-reaching [1]. Small and medium-sized businesses (SMEs) in less economically developed nations (LEDs), like Indonesia, are more negatively impacted by the influence. Since March 2020, the government of Indonesia has implemented large-scale social distancing measures to de-risk the transmission of COVID-19. This has harmed social movements and economic productivity. This rule has had a negative impact on many SMEs, which account for 90% of all business organizations in the nation. These vital companies play a vital role in local economic development [2], creating jobs, boosting the tax base, getting people involved, and offering diverse, locally sourced/made products and services [3]. 60% of poll participants said that at least half of their staff members are unable to resume their jobs. Many of those affected by layoffs started their own business to bring a source of income, which has boosted business competitiveness and significantly competition [4,5]. Facing new lifestyles and increased competition, MSMEs must be able to rise to global challenges, such as developing human resources and technology, innovating products and services, and expanding marketing reach [6].

During COVID-19, research on SMEs in Indonesia has concentrated on how the pandemic has affected business operations, economic expansion, and profit maintenance. Despite the pandemic's impact on certain industries, many SMEs have been able to carry on with business thanks to government assistance programs and technological advancements. SMEs that are already connected to the digital ecosystem and are taking advantage of the existing market in Indonesia are among those that can thrive throughout the COVID-19 era [7]. Yet, the pandemic has generally had a detrimental effect on the economic performance of SMEs, leading to reduced profits and lower revenues. Profitability has been impacted by heightened competition, decreased demand, and rising costs. Despite the difficulties, some SMEs have managed to innovate and adapt to stay competitive. The possibility of the endowment effect and loss aversion has not, however, been examined in the above studies. Understanding these concepts could help inform strategies for SMEs to better survive and prosper in their economic environment. Moreover, long-term and medium-term planning are required to guarantee a sufficient supply of energy for the economy following the crisis. [8].

The endowment effect is a phenomenon in which people overestimate the value of goods they have acquired or had, valuing them higher than either their market price or their objective value [9]. This concept has been widely studied in economics, psychology, and other disciplines. In particular, researchers have focused on how the endowment effect influences decision-making and risk-taking in the business context. It is established that this endowment effect frequently causes SMEs to overestimate the worth of their products in comparison to those of similar but lower quality. As a result, customers are likely to be charged a higher price than what they would pay when buying from other SMEs [10]. This can lead to an uneven recovery of business under the COVID-19 pandemic for SMEs, as some might be able to offer better prices than others at times of constricting demand and rising costs, due to their ability to more accurately assess the worth of their products.

Past findings also suggest that the endowment effect is linked to loss aversion, which is when people fear possible losses more than they value the gains they have already received, they often act irrationally [4]. This implies that when faced with potential losses, businesses are likely to be more resistant to change, as they value the status quo more than a potential gain. Consequently, businesses that face potential losses may be less likely to adopt new strategies or technologies.

This essay focuses on the effects of loss aversion and the endowment effect on the pandemic-related recovery of SMEs in Indonesia. It will start by going through the idea of the endowment effect, why it is important in the present, and how it has been used in the Indonesian context. This will be followed by a discussion of the concept of loss aversion and its relevance to the current situation. Finally, the paper will analyze the impact of the endowment effect and loss aversion on the recovery of SMEs in Indonesia during the pandemic. The paper will conclude by offering insights into the implications of the endowment effect and loss aversion on SME recovery in Indonesia, as well as potential strategies for SME recovery during and after the pandemic.

2. Analysis of Indonesia SMEs

2.1. Background Information

Globally speaking, businesses have been devastated by the COVID-19 epidemic in 2020, especially Indonesian small and medium-sized firms (SMEs). The SME sector comprises almost all business units in Indonesia (99%), and absorbs 97% of the labor force in the economy, with the large industrial sector making up the remaining 3%. The first and second quarter economic growth rates of 2.97% and -5.32%, respectively, show how seriously the pandemic has affected these firms [11]. According to a poll by the Indonesian UNIDO, 81% of respondents anticipated a severe decline in revenue, with a decline of more than 50% in 2020 compared to 2019.

Given the huge proportion of SMEs in the Indonesian economy, their recovery is essential for the country's economic recovery. Therefore, there is an increased focus on solutions to the decrease in SME profitability, to ensure sustainability. Previous research has discussed the influence of the endowment effect and loss aversion on business performance, yet solutions were not discussed in the research. The endowment effect and loss aversion, as an economic irrationality, can be extremely difficult to overcome. It can lead to SMEs finding it difficult to recover in the face of financial losses associated with the pandemic. Therefore, it is important to consider appropriate interventions that can help SMEs to overcome these effects to ensure their recovery.

This case study aims to look into how the COVID-19 pandemic affected SMEs in Indonesia and the endowment effect and loss aversion's effects on company recovery. To provide context for the issue and illustrate how COVID-19 has affected the business performance and profitability of SMEs, secondary data will be used. Statistical data of irrational business behaviors, arising from endowment effect and loss aversion, will also be used to demonstrate the relationship between these behavioral economic irrationalities with business profitability, to explore how these two cognitive biases can impact SMEs' recovery from COVID-19.

Endowment effect and loss aversion cognitive biases have been found to significantly influence how people make decisions, but their effects on business recovery for SMEs in Indonesia during the COVID-19 pandemic have not yet been investigated.

During the COVID-19 epidemic, the endowment effect and loss aversion have adverse consequences on SMEs in Indonesia. The endowment effect causes SMEs to give wrong interpretations of the value of their product, leading to overpricing and decreased competitiveness against rival businesses. Loss aversion causes SMEs to be reluctant to expand their business, leading to missed opportunities for potential profit and business stagnation in the recovery process. To make matters worse, the endowment effect and loss aversion have been made worse by the economic crisis brought on by the pandemic. As a result, SMEs in Indonesia are in a much more challenging position than they were previously, and more work is required to assist them in overcoming the challenges presented by these psychological repercussions.

The data in Figure 1 shows that 56% of SMEs in Indonesia experienced a decline in sales turnover. Furthermore, 4% of SMEs had difficulty obtaining raw materials due to the disruption of supply chains caused by Covid-19. This could be due to restrictions on the import and export of goods, leading to shortages of materials in the market, or because of the disruption of production processes. Similarly, 22% of SMEs had difficulty obtaining necessary financial or credit due to the tightening of credit policies as a result of the pandemic. Furthermore, 15% of SMEs had difficulty in distributing goods due to the closure of physical stores and the shift to online channels.

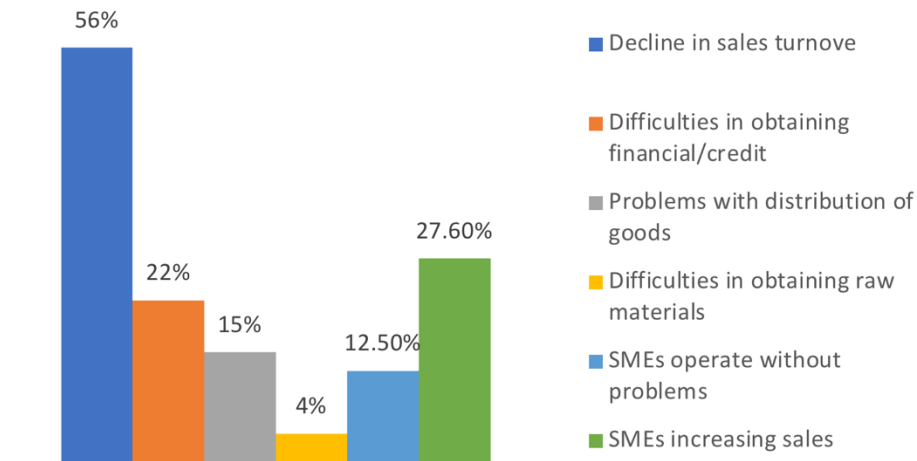


Figure 1: SME's business performance influenced by COVID-19.

(Source: The Ministry of Cooperative SMEs and Bank Indonesia).

Yet, 12.5% of SMEs claimed to be operating without any issues, while 27% said their sales were rising. Observing the statistics, one can see that the vast majority of SMEs with increasing sales turnover have either decreased their prices despite an increase in the cost of their raw materials or invested in technology to ease the transition to digital platforms, like e-commerce and digital payment systems. This is mainly because they have eliminated the endowment effect by accurately valuing their product and changing prices in response to market demand, or because they've overcome their loss aversion and are now willing to take risks and expand their business to new platforms to meet shifting customer needs and preferences. This helped them maintain their competitiveness and draw in more clients.

Based on the data, it is evident that under COVID-19, Small and Medium Businesses (SMEs) that were impacted by the endowment effect and loss aversion saw a reduction in sales and a standstill in business recovery, which in turn caused Indonesia's overall economic growth rate to slow. This data can help inform policymakers and business owners on how to better prepare for potential losses in the future and how to best manage their businesses during uncertain and volatile times.

2.2. Analysis

The COVID-19 pandemic has posed a hitherto unheard-of problem to small and medium-sized businesses (SMEs) around the world, particularly in Indonesia. Many SMEs have faced severe financial difficulties due to the sudden disruptions in cash flow, and are finding it hard to operate and recover from the pandemic. This is mainly due to financial concerns such as payment of wages, loans, and fixed costs, so many SMEs are in debt during the pandemic, making it harder to operate with the rising demand in cash outflows. Furthermore, the "social distancing" restriction has made it even harder for SMEs, since their marketing strategies are mostly based offline. Due to this budget cut, many SMEs has to close down, leading to increasing unemployment, and forcing unemployed workers to start their own business.

An essential issue to take into account is how the endowment effect and loss aversion affected the recovery of SMEs in Indonesia during the COVID-19 pandemic. Loss aversion can cause SMEs to be reluctant to make investment decisions, or to expand their business, for the fear of loss. This reduces the potential income to sustain their business. Meanwhile, the endowment effect leads SMEs to overestimate the value of their product and sell at a higher price than their rival firms, resulting in a potential loss of sales when customers compare the prices of identical products between SMEs.

To address these problems, SMEs in Indonesia should consider looking into digital marketing strategies as a way of expanding their customer base, while still adhering to social distancing regulations. They should also focus on creating a cost-effective marketing plan that is tailored to the budget they have. In addition, the government could introduce a monetary policy of reducing the interest rate. The low-interest rate will encourage SMEs to make investment decisions, which allows them to expand their business and increase their potential income. The low-interest rate will also reduce their cost of borrowing, further allowing them to increase their capital to invest in their business. Furthermore, the reduced interest rates will also encourage customers to purchase goods from SMEs, as they will be cheaper than those from rival firms. This will increase the sales of SMEs and help them to recover during the pandemic. At the same time, SMEs should consider developing pricing strategies that are competitive in the market, and think of more efficient ways to reduce their cost of production. This can help to attract more customers while ensuring that they are still able to make a profit.

3. Suggestions

The Indonesian government has taken various initiatives to provide subsidies and support to SMEs during the pandemic and has also exempted their income tax to help them cope with the shortage in cash flow and to kickstart business recovery. However, the lack of liquidity is only one of the problems that SMEs are facing. Another major issue is the “endowment effect” and “loss aversion”, which have a significant impact on business recovery.

The endowment effect is a propensity for people to overvalue things they already own, which causes goods and services to be overpriced. To address this issue, businesses can come together and form price agreements to reduce competition and set fair prices for their offerings. This way, the endowment effect is minimized while ensuring that all parties involved benefit from the agreement. By doing so, it allows them to gain profit even during times of difficulty.

Loss aversion is another issue that needs to be tackled. People tend to be more afraid of losses than gains, leading to risk-averse behavior. To minimize risk exposure and potential losses, SMEs should invest in insurance products that have a guaranteed rate of return. This will ensure that they can make more profit with less fear of losses. Additionally, SMEs should expand their business online following the “social distancing” restriction. This will enable them to tap into a wider customer base and increase their revenues.

As a result, to help businesses recover in the post-COVID-19 period, two significant issues—the endowment effect and loss aversion—need to be addressed. The Indonesian government has taken steps to assist and subsidize SMEs, but it's crucial to make sure that these companies can set fair prices for their goods and limit their exposure to risk. By forming price agreements among businesses, investing in insurance products with a guaranteed return, and expanding online, as well as informing government intervention such as the monetary policy to help foster the recovery of SMEs during the pandemics, SMEs can ensure that they can make more profit and remain competitive in the market.

4. Conclusion

Small and medium-sized businesses (SMEs) in Indonesia have found the COVID-19 epidemic to be a formidable obstacle, with many of them finding it difficult to adjust their business practices to the limitations imposed by the pandemic. This study has shown that the endowment effect and loss aversion impede SMEs' business recovery during this time. To combat this problem, it is essential to develop policies and solutions that will aid SME development in the face of the pandemic. Potential measures could include providing financial support, as well as advice on how to adjust and manage operations. It should also be noted that this research was limited in its scope and did not provide first-

hand data for analysis. Nevertheless, these findings can serve as a basis for further studies on the topic, and offer valuable insight into the current state of SMEs in Indonesia amid the pandemic. By employing these results, policymakers and organizations can create more effective strategies for SMEs to promote their recovery from the crisis. Ultimately, this could help SMEs to cope with the difficult economic climate caused by the pandemic, and contribute to the overall economic recovery of Indonesia.

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