

# What hinders and what enhances small enterprises' access to formal credit in India?

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## Abstract

We investigate enterprise level factors affecting access to formal credit for small enterprises in India by employing a probit sample selection model. Our results indicate that enterprise size, owners' education level, being registered under an agency and being involved in diversified activities are positively associated with access to formal credit. However, the ownership of land that can be used as collateral is negatively associated with the likelihood of receiving formal credit. This may be due to an obsolete land administration system resulting in high transaction costs of land as collateral. These results provide some insights into the factors to improve credit constraints for small enterprises in India.

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## 1. Introduction

Small enterprises contribute enormously to the socio-economic development of India. The sector accounts for more than 95% of the industrial units and contributes 45% of the manufacturing output and 40% of the export (Ministry of MSME, 2014). Therefore, small enterprises play a crucial role in creating employment and helping in the industrialisation of rural and backward areas.

The promotion of small enterprises in India dates back to the late 1950s. Since then, various preferential schemes have been conducted to improve credit supply, marketing, and skill and technology for this sector. As many studies, such as those of Beck and Demirgüç-Kunt (2006) and IFC (2012), demonstrate, of the many challenges impeding the growth of small enterprises, inadequate access to formal credit is one of the key bottlenecks

for small enterprises. India is no exception. In spite of favourable credit policies, many small enterprises in India remain credit constrained.

In this paper, we examine the enterprise level factors affecting access to formal credit for small enterprises in India, using large-scale unit level data. We employ a probit sample selection model to examine the factors associated with small enterprises' probability of access to formal credit.

There are many studies on access to formal credit for agriculture and rural households in India.<sup>1</sup> In spite of being an important sector in the Indian economy, however, credit availability for small enterprises has not been studied adequately. This study is an attempt to fill the gap. Our empirical study also presents some nuances of the Indian context compared to the earlier studies on credit constraints for small enterprises.

Kohli (1997) and Eastwood and Kohli (1999) are the only existing studies examining the determinants of bank loans for small enterprises in India employing panel data over the period

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<sup>1</sup> As several examples among many, Binswanger et al. (1993), Burgess and Pande (2005), Burgess et al. (2005), Basu (2005), Basu and Srivastava (2005), Kamath et al. (2010), Shah et al. (2007) and Cole (2009).

1965–78. They found that the firm size, age, and collateral of enterprises have a positive and significant impact on the probability of receiving bank loans. Using the natural experiments (difference-in-difference) approach, [Banerjee and Duflo \(2014\)](#) examine the impact of policy change in priority sector lending on productivity of small enterprises in India for the period 1996–2002.<sup>2</sup> These studies are, however, restricted to a limited sample of small enterprises that had received priority sector advances from commercial banks.

The data we employ in this paper are from a national level sample survey of more than 80,000 manufacturing enterprises conducted over the period 2005–06. In line with the existing literature on credit constraints for small enterprises, we find that more organised enterprises have a higher likelihood of access to formal credit. Enterprises with female owners and enterprises engaged in capital intensive industries are more likely to face credit constraints. However, the ownership of land that can be used as collateral is negatively associated with the likelihood of receiving formal credit. Production under subcontracting relations with other enterprises is not significantly associated with receiving formal credit.

This paper is organised as follows. Section 2 provides an overview of small enterprises in India and presents a brief description of credit policies for this sector. In Section 3, we present the literature on credit constraints for small enterprises, followed by Section 4 where we present our data, model specification and empirical results. Section 5 concludes.

## 2. Small enterprises in India

### 2.1. The rationale for promotion of small enterprises

Support schemes for small enterprises form an important development strategy in many economies. Since the late 1950s, the Indian government has supported small enterprises to generate employment and to promote balanced regional development. Various preferential schemes such as credit assistance, tax exemption, purchase preference by the government agencies and preferential access to raw materials have been provided for small enterprises. The most important scheme, however, was the reservation policy.<sup>3</sup> The schemes of protection and promotion of small enterprises were designed on the presupposition that small enterprises cannot obtain adequate credit due to asymmetric

information and that they cannot enjoy scale economies in material purchases and marketing. Since the economic liberalisation began in 1991, the environment surrounding small enterprises has changed. On the one hand, small enterprises have faced severe competition from imported products. On the other hand, small enterprises have been increasingly expected to act as a growth engine due to their flexible and innovative nature.

The definition of small enterprises varies across countries and sectors. In India, micro and small manufacturing enterprises have been defined in terms of the value of investment in plants and machinery since 1966, and the investment ceiling in plants and machinery has been revised from time to time. As per the Micro, Small and Medium Enterprises Development (MSMED) Act 2006, micro and small manufacturing enterprises are defined in terms of enterprises whose investment in plants and machinery does not exceed Rs. 50 million.<sup>4</sup> These enterprises produce over 6000 products and account for approximately 45% of India's total manufacturing output ([Ministry of MSME, 2014](#)). In this paper, we confine our analysis to micro and small manufacturing enterprises ("small enterprises" hereafter). This is partly because lending to medium enterprises is not included for priority sector lending described below and partly because manufacturing enterprises have more nature and potential for creating jobs.

### 2.2. Credit policies for small enterprises in India

The Government of India and Reserve Bank of India (RBI) have been instrumental in devising a multi-agency approach to extend financial services to small enterprises. These include commercial banks, co-operative banks and development financial institutions. Commercial banks with their extensive networks of branches accounted for 91.2% and co-operative banks accounted for 6.5% of the total formal credit for small enterprises, and development financial institutions such as the Small Industries Development Bank of India (SIDBI) and State Financial Corporation (SFC) accounted for 2.3% of the total formal credit as of March 2008 ([SIDBI, 2010](#)).

Commercial banks have been the most important source of formal credit to small enterprises. In particular, public sector banks have been playing a dominant role in disbursing credit to small enterprises since the nationalisation of major commercial banks in 1969 and 1980. In 1972, small enterprises and agriculture were identified as a priority sector, which might not receive timely and adequate credit in the absence of this special dispensation. Although there was initially no specific target fixed

<sup>2</sup> They found that bank lending to small enterprises and their revenues increased for enterprises that became eligible for the priority sector because of upward revision of definition for small enterprises in 1998, and then those decreased for enterprises that lost eligibility as a result of reversal of the definition in 2000, compared to small enterprises that were already getting bank credit before 1998.

<sup>3</sup> The reservation policy was introduced in 1967 when a list of items that would be reserved for production exclusively for small enterprises was created. With the introduction of the policy, the production capacity of large enterprises that were producing the 'reserved items' was frozen. In addition, no new large enterprise was allowed to produce them. At its height, there were 872 items in the reserved list ([Ministry of Industry, 1997](#)). With the introduction of policies of trade liberalisation, the reserved list was gradually reduced. Eventually the list was completely removed in April 2015.

<sup>4</sup> What had been known as Small Scale Industries (SSI) prior to 2006 has been renamed 'Micro, Small and Medium Enterprises (MSME)' with the enactment of MSMED Act in 2006. Under the Act, there was a three-fold paradigm shift: first, the globally well-known concept of 'enterprises' has replaced the term 'industries'; second, the definitional scope has been expanded to medium enterprises; and third, rapidly growing service enterprises such as retail trade, hotels and restaurants have been added to the ambit. Thus, the entire non-agricultural sector of the economy has been brought under the concept of the MSME sector subject to the revised criteria prescribed for defining micro, small and medium enterprises separately for manufacturing and services sectors. For more details, see [Nikaido et al. \(2012\)](#) regarding the SSI sector and the MSMED Act 2006.

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