Determinants of Access to Institutional Credit for Small Enterprises in India

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Abstract

Support schemes for small and medium enterprises form an important development strategy in many countries including India. In the 1950s, India’s industrial policy attempted towards heavy industrialisation through import substitution for economic development as well as promotion of small scale industries (SSIs) for employment generation and equitable income distribution. For the SSI sector (or the MSME sector, as they are referred to after 2006), various preferential schemes such as financial assistance from commercial banks, tax exemption, reservation of products, purchase preference by the government and preferential access to materials have been carried out, presupposing that SSIs cannot get adequate credit due to asymmetric information and that SSIs cannot enjoy scale economies in material purchases and marketing.

Credit policy directing commercial banks to set up branches in underbanked areas and specialized branches for SSIs and to allocate credit to SSIs as part of the vulnerable is one of the most important schemes. It was believed that such a policy would increase the availability of credit to SSIs that are so severely credit-constrained. However, in spite of such a long-standing credit policy, SSIs continue to remain credit-constrained. Given the changing environment in India’s banking sector since the 1990s as a consequence of financial sector reform where greater operational flexibility and autonomy have been provided to commercial banks, the problem of credit constraints may no longer be solved by supply-driven policy alone. It becomes pertinent to re-look at the issue of credit availability for small enterprises from the demand side as well as the supply side.

In this paper, we first provide a descriptive evaluation of the supply side credit policy for small enterprises in India. Then we present an econometric analysis of a large scale data on small manufacturing enterprises in an attempt to examine the demand side factors associated with credit availability. The major contributions of this paper are as follows.

First, this is the only study that analyses credit availability for India’s small enterprises in the post-liberalization era. So far many studies discuss access to institutional credit for agriculture and rural households in India that also enjoy similar credit policy, while no study discusses access to institutional credit for SSIs that could be a key sector for extracting India from a ‘jobless growth’ situation. Considering India’s demographic transition over the next decades, India can sustain economic growth using ample working-age population. However, this can be possible only if the economy provides its labour forces with productive jobs in the manufacturing. Thus, stimulating growth in small

manufacturing enterprises by removing their credit constraints can be one of the most important aspects to absorb unskilled labour that shifts away from agriculture.

Second, our empirical analysis presents some nuances of the Indian context, while it also strengthens the existing literature on credit constraints. In line with the existing literature, we find that more transparent and more organised enterprises have higher likelihood of access to institutional credit. However, contrary to the existing literature, firm size and owned land and buildings as a proxy for collateral do not seem to affect availability of institutional credit for India’s small enterprises. In addition, small enterprises having diversified activities seem to be less likely to receive institutional credit. Also, small enterprises having contractual relationship with large enterprises are not associated with the likelihood of receiving institutional credit. While the literature identifies diversification of business activities and relationship with large enterprises are associated with less volatile production schedule and more creditworthiness respectively, these factors seem not to indicate less volatility and creditworthiness and to be rather driven by distress in case of India’s small enterprises. Our results not only present differences of the India’s context but also highlight demand side issues that should be paid attention to.