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Problems Related to the Financing of Small Firms in India

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Abstract:
Micro-Small and Medium Enterprises (MSMEs) contribution is highly remarkable in the overall industrial economy of the country. In recent years, the MSME sector has consistently registered higher growth rate compared to the overall industrial sector. In the Indian market, MSME's rapid growth could be seen as Indian entrepreneurs are making remarkable progress in various Industries like Manufacturing, Precision Engineering Design, Food Processing, Pharmaceutical, Textile & Garments, Retail, Agro and Service sector. MSMEs complement large industries as ancillary units and contribute enormously to the socioeconomic development of the country. However, MSME's contribution is phenomenal in the growth of Indian economy, simultaneously; they are facing intense pressure and constraints to sustain their competitiveness in a globalized world. Some other issues such as the recession, low demand, finance, heavy competition from MNCs etc. are becoming exposed problem to MSMEs in India. The availability of external finance for them is a topic of significant research interest to academics and an important issue to policy makers around the globe. Therefore, in present work an attempt has been made to identify the problems related finance of MSMEs.

Key words: *Finance, MSMEs, problems*

1. Introduction

Today, small and medium industry occupies a position of strategic importance in the Indian economic structure due to its significant contribution in terms of output, exports and employment. The small-scale industry accounts for 40% of gross industrial value addition and 50% of total manufacturing exports. More than 3.2 million units spread all over the country producing about 8000 items, from very basic to highly sophisticated products. The SMEs are the biggest employment-providing sectors after agriculture; providing employment to 29.4 million people. However, MSMEs, which constitute more than 90% of the total number of industrial enterprises, are now facing a tough competition from their global counterparts due to liberalization, change in manufacturing strategies, technological changes, and turbulent and uncertain market scenario. The sector is exposed to intensified competition since liberalization of Indian economy in 1991. Small industry in India has been confronted with an increasingly competitive environment due to:

- Liberalization of the investment regime in the 1990s, favoring foreign direct investment (FDI);
- The formation of the World Trade Organisation (WTO) in 1995, forcing its member countries (including India) to drastically scale down quantitative and non-quantitative restrictions on imports, and
- Domestic economic reforms: The cumulative impact of all these developments is a remarkable transformation of the economic environment in which small industry operates, implying that the sector has no option but to 'compete or perish' [1].

In particular, they have to undergo some change when they compete with global companies and other large buyers, as they are dependent on supply contracts from the same. This puts considerable pressure on MSMEs to control both their costs and quality and meet the different legal requirements. This is a serious challenge for them, especially for those operating in developing countries with labor-intensive technologies, where labor cost is a major concern [2].

2. Financial Management in MSMEs

Finance is the key input of production, distribution & development. The financial investment of these small units comes mainly from within; most of them invest their own funds or borrowed funds. Much less comes from banks & government channels. Small-scale entrepreneurs face a lot of problems, while availing loan facility from commercial banks and Government agencies. Financial institutions ask for a lot of information & data, state financial corporation takes several months to take decision on extending term

loans small-scale sector are not in a position to offer guarantee required by the banking sector. Even when small loans are raised from Government agencies, the procedure is so cumbersome that most of the entrepreneurs who either illiterate or semiliterate, hesitate to make use of these facilities. This makes matters very difficult for the small industrialist, particularly when he is new to this way of life and he has to deal with both state financial corporation as well as banks [3].
The conceptual framework to which most of the current research literature adheres has been quite helpful in understanding the institutions and markets that provide funds to MSMEs in developed and developing nations. This framework has also provided insights into the effects of policies that affect access to funding by creditworthy MSMEs in these nations. However, the current framework is oversimplified, and neglects key elements of the financial system that affect MSME credit availability [4].
Information is a key input that goes into the credit decision of banks and one of the challenges for banks is to acquire information about the credit risk of the borrower, as borrowers have more information than the lender about the projects [5]. This fundamental information problem is a key concern that needs to be addressed in the allocation of loans; the absence of a mechanism to bridge the information asymmetry between the borrower and the lender would lead to a failure to allocate loans efficiently.
According to Chen et al. [6], the corporate tax system encourages debt financing and discriminates against MSMEs in most countries, since corporate interest payments are tax deductible. Such a type of tax non-neutrality between the financing methods favors large firms, which have easier access to bank loans.

2.1. Type of Industrial Finance

Depending upon the type of activity, entrepreneur requires three types of Finance

- Short-term finance: For the period of less than one year, it is usually required to meet variable, seasonal or temporary working capital needs.
- Medium-Term finance: For the period of 1-5 years, it is usually required for permanent working capital, small expansions, replacements, modifications etc.
- Long-Term Finance: For the period exceeding 5 years, Long-term finance is usually required for procuring fixed assets, for the establishment of a new business, for substantial expansion of existing business, modernization.

2.2. Financial Sources of MSMEs

Usually the commercial banks provide short-term credit to MSMEs. The institutions like State Financial Corporations (SFCs), Small Industries Development Corporations (SIDCs), National Small Industries Corporation (NSIC) and National Bank for Agriculture and Rural Development (NABARD) provide short-term loans. The financial assistance in the form of supply of machinery on hire purchase basis, from NSIC and to some extent from SIDCs is available. The Small sized units and tiny units also get some short-term loans from commercial banks along with working capital in the form of composite loans [7].
The Small Industries Development Bank of India (SIDBI) provides refinance to these institutions. This kind of refinance includes, assistance provided to State Financial Corporation Bills, Finance Scheme, Special Capital/Seed Capital Scheme, new debt instruments and to the National Small Industries Corporation. In the small scale industrial units, long-term loans are provided by SFCs mainly through Single Window Scheme and National Equity Fund and direct assistance provided to State Financial Corporations in the form of refinance. State Financial Corporations provide some part of working capital for pre-operative expenses of Small Scale Industrial Units under the Single Window Scheme.

2.3. Own Financial Resources for Innovation

The financing experiences of MSMEs around the world suggest that smaller firms typically depend on internal finance for initial capital and external finance for liquidity, and studies have noted that banks are the major source of external finance. Berger and Udell [4], in their study on small business finance in the US, concluded that smaller and younger SMEs relied on internal source of financing (personal or family savings), trade credit and angel finance for the initial capital. This is due to their limited accessibility to small business financing in the market.
While the bulk of research had been predominantly undertaken in developed countries, particularly the UK and US, research on MSMEs finance in developing countries is still insufficient and incomprehensible [8]. Nevertheless, existing literatures suggest that MSMEs in developing countries behave rather similarly to those MSMEs in developed countries. A specific study by James [9] on fiscal and financial factors that affect SMEs in ASEAN (Malaysia, Indonesia, Philippine, Thailand and Singapore) exposed that most small and medium entrepreneurs in the region use personal savings for initial funding.

2.4. Difficulty in Access to Finance

MSMEs face a lot of problems while availing loan facility from commercial banks as well as Government agencies. Financial institutions ask for a lot of information & data, state financial corporation takes several months to take decision on extending term loans small scale sector are not in a position to offer guarantee required by the banking sector. Even when small loans can be raised from Government agencies the procedure is so cumbersome that most of the entrepreneurs, who either are illiterate or semiliterate, hesitate to make use of these facilities [3].
When MSMEs have been offered to external finance, they will be charged with high rates of interest as smaller enterprises provided to be more risky & more likely to fail than larger firms. The lack of financial resources hinders many MSMEs from initiating or - even worse - completing their innovative ideas. MSMEs had abounded innovation activities. They have problems to acquire loans because

financial institutions are often reluctant to (co-)finance risky innovation projects. Another financial constraint refers to the problem of getting access to public funding for innovative ideas and bureaucratic application procedures associated with them. Further, it was pointed out that innovation projects must be delayed owing to regulatory reasons until the application has been approved [10].

2.5. Government Policies

Government aid is paramount in the case of small scale manufacturing organizations. Government can assist organizations in several ways, such as through collaborative training programs, R&D programs among government-funded research centers, universities for specific sectors of the manufacturing industry. Government can encourage networking, promote growth ambitions and encourage new product development by making them aware that it is a risky option to continue with their existing products/customers regardless of market changes. Government can provide sector specific specialist advice within the manufacturing industry and provide more financial and tax incentives [11].

It can support programs to build infrastructure as well as the incentives (such as tax incentives) and special start up programs to develop private sector [12-14]. Increase in technological innovation demands that government should enhance spending on R&D [15].

3. Literature Review

- **Tagoe et al. (2005)** examines the impact of financial sector liberalization (FSL) policies on the financial management of micro, small and medium-sized enterprises (MSMEs) in Ghana, using six case studies. Their findings, which confirm and extend the conclusions of previous studies; are integrated into a framework that explains the impact of FSL and the factors at work. The main financial challenge faced by MSMEs is access to affordable credit over a reasonable period. This is determined by the financial needs of MSMEs and the action of investors. MSME financing needs reflect their operational requirements, while the action of investors depends on their risk perception and the attractiveness of alternative investment (which affects their willingness to invest). Government borrowing, the general economic climate, availability of collateral, quality of MSME record keeping, and MSME investor relations skills affect the way in which this challenge is managed. The impact of the activities and potential of enterprise development agencies is also discussed [16].
- **Berger and Udell (2006)** suggested a more complete conceptual framework for analysis of MSME credit availability issues. This framework shows that the key conduit through which government policies and national financial structures affect credit availability is leading technologies. The feasibility and profitability of different lending technologies are affected by the casual chain from policy to financial structures. These technologies, in turn, have important effects on MSME credit availability. Financial structures include the presence of different financial institution types and the conditions under which they operate. Lending technologies include several transactions technologies plus relationship lending. The frequent misleading conclusion is that large institutions are disadvantaged in lending to opaque MSMEs [4].
- **Subrahmanya et al. (2010)** have discussed the probes of the drivers, dimensions, achievements, and outcomes of technological innovations carried out by SMEs in the auto components, electronics, and machine tool sectors of Bangalore in India. Further, it has certain the growth rates of innovative SMEs in relation to non-innovative SMEs in terms of sales turnover, employment, and investment. Thereafter, it probes the relationship between innovation and growth of SMEs by (i) estimating a correlation between innovation sales and sales growth, (ii) calculating innovation sales for high, medium, and low growth innovative SMEs [17].
- **Thampy (2010)** give a brief description about the major bottleneck to the growth of the vital Indian small and medium enterprises (MSME) sector is its lack of adequate access to finance. The major issues in the financing of MSMEs in the Indian context are examined under this paper. These include the information asymmetry facing banks and the efficacy of measures such as credit scoring for SMEs, whether transaction lending would be adequate to address the information issues or would lending have to be based on a relationship with the SME. Whether the size and origin of the bank affect the availability of credit to SMEs. The author also gives an importance of the credit appraisal and risk assessment processes in today's banking landscape and the role that banks can play in developing the MSME sector in India [18].
- **Manan et al. (2011)** have discussed that similarity between the stylized patterns of MSMEs financing in other parts of the world with that of Malaysian MSMEs is something that the study would attempt to investigate. Using descriptive analysis, findings of the study showed that the MSMEs in Malaysia are no less different from the rest of their counter parts. One interesting highlight of the study is the fact that a significant number of SMEs sought Islamic financing modes such as Murabahah, Bai bithaman, Ajiland Ijarahas sources of external capital. This could give a positive signal for the Islamic financial institutions to offer more of such facilities to the MSMEs [19].
- **Jeswal (2012)** has discussed that the role of MSMEs in Indian economy. The role of small and medium enterprises in the economic and social development of the country is well established. MSME s emerges leaders during the period of recession, restoring jobs and business activity lost during the time despite a slow and fragile economy. The small-scale industry sectors play a vital role in the growth of the country. It contributes almost 40% of the gross industrial value added in the Indian economy.
- The growth rates during the various plan periods have been very impressive. The number of small-scale units has increased from an estimated 0.87 million units in the year 1980-81 to over 3 million in the year. When the performance of this sector is viewed against the growth in the manufacturing and the industry sector as a whole, it instills confidence in the resilience of the small-scale sector [1].

- **Liu et al**. **(2012)** have discussed the economic effect and management effect in small and medium enterprises (MSMEs), the theoretic model of technological innovation engineering is given in the paper. By model design, pre-test and pilot test, reliability test and validity test, factor analysis can effectively reveal the correlation among innovation planning, innovation implementation, and innovation platform and innovation performance. For illustration, 245 questionnaires return from 11 provinces and autonomous regions, and the return ratio is 70%, which satisfy the requirement that the questionnaire returns-ratio is not lower than 20% in the data investigation. The empirical results show that model fitting work well, and have a high convergence validity [20].
- **Meuleman and Maeseneire (2012)** studied that for alleviate debt and equity gaps for small firms' innovation projects some countries spend public money on R&D grants, for this these firms may be certify as private financiers by experienced government officials. They used a unique Belgian dataset of approved request and denied request for a different type of R&D grants for examining the impact of subsidies on small firms' access to external equity, short and long-term debt financing. They also find that R&D subsidy gives a positive signal related to MSME results and quality in a better access to long-term debt [21].
- **Mungaya et al. (2012)** conducted a survey about the fact that the tax plays an important role in the growth of MSMEs. The role of MSMEs is critical in pushing the socio-economic development agenda in the low-income country like Tanzania. For this reason, alignment of the tax system to the environment specific MSME growth needs can be considered an important agenda for the policy makers. Keeping this issue as an important issue, the study aimed to explore the managers/executive officers' perception of tax-system effectiveness in promoting MSMEs growth in the Country. Some selected respondent uses a questionnaire and interview to administer the survey. The descriptive analysis method is used to analyze the data and findings were presented in terms of frequencies and percentage analysis. Findings indicate that the majority of the respondents perceives the adverse impact of existing tax policies on the growth of MSMEs and suggest for reforming the tax policies in the Country. The findings would help the stakeholders in designing measures to align the tax-system to MSMEs in a more effective manner [22].
- **Shanker (2012)** has examined the problems of MSMEs of Pathankot area. They examined the scope of further financing of MSMEs by Banks in Pathankot area and devise requisite strategies for financing, thereby increasing the MSMEs loan portfolio which would help the banks and ultimately the country. On the analysis of the secondary data, which was obtained from Banks Performa Reports, Annual Returns and Annual Credit Plans, it was observed that the huge scope exists for the banks in Pathankot centre for intensive financing of MSMEs. This is observed from the data that at present CD Ratio at the centre is 58.71% (below the prescribed national average of minimum 60%) and the share of SMEs to total advances being 31.58%, which need to be increased to at least 50%. The primary study was conducted based on random samples of five hundred micro, small and medium enterprises from manufacturing and service sectors in Pathankot. The tabulated data were analysed by applying requisite statistical tools and inferences drawn. Based on the percentage wise responses the innovative and dynamic strategies have been suggested [23].
- **Xiao and Zhao (2012)** provides the information after examining the newly-available World Bank survey of over 28,000 firms from 46 countries that how financial development affects firm innovation around the world. They find that while stock market development significantly enhances firm innovation, banking sector development has mixed effects. They show that the latter result can be explained by different levels of government ownership of banks. Specifically, in countries with lower government ownership of banks, banking sector development significantly enhances firm innovation; while in countries with higher government ownership of banks, banking sector development has no significant, or sometimes even significantly negative effects on firm innovation. Such negative effects are significantly stronger for smaller firms. The results are robust to various controls such as firm's human capital and ownership structure, to estimations using instrumental variable techniques and alternative measures of firm innovation [24].

The following factors are identified from an extensive literature review, which affects financial management of MSMEs:

3.1. Factors Affecting Financial Management

- Shortage of own financial resources for innovation
- Difficulty in access to finance via bank loans, Government subsidies etc.
- Slow process for loan applications
- Lack of Government policies like subsidies, relief in taxes etc.

4. Conclusion

Industries from the backbone for national development and are one of the important components for the growth of national economy and the growth of the MSMEs sector at a healthy rate is crucial for overall growth of the industry. However, lack of proper financial facilities is the barrier of better performance. There are not many financial resources available for innovation activities within the MSMEs.

It is found that the MSMEs depended much of their initial capital on internal sources as they have accessibility problems in getting external debt or equity financing. Even if they are offered with debts, they will be charged with high rates of interest as smaller enterprises are perceived to be more risky and more likely to fail than larger firms are. This problem is shared by the MSMEs around the world, irrespective of the differences in the countries' financial infrastructure.

In this study, an attempt has been made to identify the factor affecting financial management of MSMEs. The present work presents four key issues under financial management. These include Shortage of own financial resources for innovation, Difficulty in access to finance via bank loans, Government subsidies etc., Slow process for loan applications, Lack of Government policies like subsidies, relief in taxes etc. Effective management of these issues can lead to the better performance of MSMEs in the competitive environment faced by them.

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