

Impact of Credit on Development of MSMEs in Uttar Pradesh

ABSTRACT

SUBMITTED TO
BABASAHEB BHIMRAO AMBEDKAR UNIVERSITY
(A CENTRAL UNIVERSITY)

LUCKNOW

**BABASAHEB
BHIMRAO
AMBEDKAR
UNIVERSITY**



• LUCKNOW •
प्रज्ञा शील करुणा
ESTABLISHED 1996

FOR THE AWARD OF DEGREE OF

Doctor of Philosophy

IN

ECONOMICS

Under the Supervision of

Prof. L. C. Mallaiah

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Enrollment No. 1238/19

Year: 2023

ABSTRACT

India has realized the need for industrialization soon after the independence. The Second five-year plan strongly emphasized the importance of industrialization as a tool for sustainable growth and development of the country. For that heavy investment was done in building capacity over a wide range of industries. The emphasis was given to the development of the basic and heavy industries. Basic and heavy industries like mining, chemical, petrochemical, fertilizers, steel, capital goods, and engineering goods industries were set up during the period. Later on, the importance of small-scale industries (or Micro, Small and Medium scale enterprises) was felt for employment generation and sustainable development of the economy in India. Due attention was given for the development of this sector.

A noticeable feature of the Indian economy is the robust growth of small-scale industries. They use local materials, technology and less capital, but provide employment to a large number of unskilled and semiskilled labour i.e., they have a low capital-labour ratio. So, the MSME sector becomes very crucial for developing countries like India. This sector is very important in terms of income generation and contributes significantly in nurturing entrepreneurship and innovation. It produces a wide range of products and services to meet the needs of the local market as well as the global market. The MSME sector in India has been playing a crucial role in employment generation. Its expansion in rural and urban areas has created many employment opportunities and helped in reducing regional disparity. The sector has been receiving the attention of policymakers for growth and development since independence.

The Micro, Small and Medium Enterprise Development (MSMED) Act came into existence in 2006 to address the policy issues of small-scale industries and cover the investment ceiling of the sector. After the introduction of this act, small-scale industries were renamed as Micro, Small and Medium Enterprises (MSME). For the first time, the service sector enterprises working at small scale were also included in the purview of MSMEs. The classification of enterprises under Marginal, Small and Medium Enterprises was done according to the investment used by them in plants and

machinery. For the manufacturing sector, micro enterprises are those whose investments are up to twenty-five lakh rupees, small enterprises are those whose investments range from twenty-five lakhs to five crore rupees and medium enterprises are those whose investments range from five crores to ten crore rupees. Similarly, for the service sector, investment limit for micro-enterprises is less than ten lakh rupees, small enterprises have investments ranging from ten lakhs to two crore rupees and medium enterprises have investments ranging from two crores to five crore rupees.

The MSME sector is very important in terms of income generation. They contribute significantly in nurturing entrepreneurship and innovation. It contributes around 30% to the GDP of India in terms of value addition (GOI 2018). The MSME sector supports innovation, which is the reason behind expanding number of MSMEs countrywide. It produces a wide range of products and services to meet the need of the local market as well as the global market.

The sector contributes around 31 percent of the value addition in India. This means that MSMEs make a substantial contribution to the country's overall economic output. Additionally, the sector is stated to be responsible for around 30 percent contribution to the GDP of the country. This suggests that the MSME sector's activity and output significantly contribute in the growth and performance of India.

The MSME growth majorly depends on the availability of sufficient and timely credit support. Industries generally require two types of capital, long-term capital and short-term capital. Long-term capital is required for the acquisition of fixed capital like the installation of buildings, plants and machines. On the other hand, short-term capital is required to meet the day-to-day requirements of industries like paying wages to employees and paying rent. So, it could be concluded that adequate capital is always required for industries to function properly. Industries can raise their capital through (a) internal sources or (b) external sources. Capital raised through internal sources is a part of the profit that is further invested for growth. The External credit can be raised either through share capital, debentures, loans and advances from commercial banks. They are usually unable to assess the capital market because of their relatively small size and high transaction cost. Commercial Banks are the main source of external finance for the MSMEs across countries.

After Independence, a large chunk of investment came from public investments. The private sector could not foster in the initial years after independence as banks were reluctant to provide long-term loans to the industrial sector. To overcome the lack of finance for launching the long-gestating industrial project in the private sector, the government promoted the development of financial institutions (DFI). At present, a few institutions providing credit to industries are the Industrial financial corporation of India (IFCI), Industrial Development Bank of India (IDBI), Industrial Reconstruction Corporation of India (IRCI) and Small Industrial Development Bank of India (SIDBI). There are 18 State Financial Corporations (SFCs) and 22 State Industrial Development Corporations (SIDCs) and State Industrial Investment Corporations working at the regional level to fulfil the need of local industries. Apart from these institutions, commercial banks, Industrial cooperatives, Unit Trust of India (UTI), Life Insurance Corporation (LIC), investment companies and foreign investments also provide financial support to industries.

The new economic reforms were initiated in 1991 to overcome the macroeconomic crisis. The deregulation of the industrial and financial sectors was the major step that was taken. The major objective of Industrial Policy 1991 was “dismantling of the regulatory system and increasing competitiveness for the benefit of the common man” [GoI 1991]. This came into effect through the wholesale abolition of industrial licensing and a major amendment to the Monopolies and Restrictive Trade Practices Act (MRTP). Moreover, the list of industries for the public sector was reduced from seventeen to six and private sector participation was allowed in many industries reserved for small firms and the public sector. India’s financial sector experienced rapid growth after the new economic reform. Liberalization of the financial sector enables the system to perform efficiently.

The banking sector has been the leading source of credit to the industrial sector. Hence, in this study, we are focusing only on scheduled commercial bank credit as a source for industrial development. Moreover, the Reserve Bank of India has made it mandatory for commercial banks to lend to MSMEs under priority sector lending in order to ensure sufficient credit availability to the sector. Scheduled commercial banks (SCBs) are those banks that are listed in the second schedule of the Reserve Bank of India (RBI). The banking system in India went through a lot of changes since independence. The nationalization of fourteen major banks in 1969 is

one of the major milestones in the history of the banking system. The step to the nationalization of the banking system was taken by the Government of India (GoI) to channel much-needed funds to the weaker sectors of the economy like agriculture and small-scale industries. In year 1980, GoI again took over another six commercial banks. In year 1980, certain directives for priority sector lending were issued by RBI. Under these directives, banks are required to provide advances to the priority sector as 40% of their aggregate credit.

Uttar Pradesh is the most populous and fifth largest state of India. U.P. is basically an agriculture-based economy. Agriculture employs approximately 70% of the workforce. The industrial sector has emerged as the second largest sector of the economy of Uttar Pradesh with a 20% contribution to GSDP. The state owns robust infrastructure including 15 industrial areas, 12 specialized parks and 20 operational Special Economic Zones (SEZs). The state is amongst the top manufacturing destinations of India as it contributes more than 8 percent of national manufacturing output. It is a leading manufacturer and exporter of textile, leather, Agro and food processing and electronic manufacturing. The industrial sector in U.P. employs 5.7% of the workforce. The state ranked 2nd in ease of doing business ranking in year 2021. Given the workforce coupled with the natural asset, U.P. holds great industrial potential which is yet to be fully utilized. The MSME sector in the state has played an even more important role in generating employment opportunities. It has helped in the industrialization of rural and backward areas thereby reducing regional imbalances. The central government and State government have taken various steps to accelerate the pace of industrialization through MSME in the state. Today, U.P. has the third highest number of MSMEs in India followed by Tamil Nadu and Gujrat. According to the data provided by the Directorate of Industries, U.P., the number of MSMEs established in 2014 was 52231 employing 417967 people.

Research Gap

Studies mentioned above have explored many aspects of industrial credit, problems faced by the sector to avail credit and the development of the MSME sector. Fewer studies have taken time series analysis to estimate the impact of credit on the development of the MSME sector especially in the context of Uttar Pradesh. This study contributes in this direction and tries to analyze the impact of credit on the

development MSME sector in terms of the number of MSME unit, employment, fixed capital and production with special reference to Uttar Pradesh.

Objectives

The specific objectives of this study are listed below-

1. To analyze the performance of MSMEs in UP.
2. To analyze the pattern of credit for MSMEs in UP.
3. To analyze the impact of credit on the growth of MSMEs in U.P.

Hypotheses

1. The performance of the MSME sector in U.P. is satisfactory.
2. The credit to MSMEs is progressive.
3. Credit has positive impact on the development of MSMEs in U.P.

Research Methodology

The study attempts to analyze the relationship between credit and the growth of the MSME sector in India with special reference to Uttar Pradesh. It is quantitative in nature. The period of study is from 1991 to 2020. The study is based on secondary data taken from various sources like the Handbook of Statistics on Indian Economy, RBI (Various Editions), Census 2011, Statistical Diary of Uttar Pradesh, Udyog Aadhar Memorandum (UAM), Uttar Pradesh Audyogic Vikas Pragati Samiksha 2011-12, Annual Report of MSMEs (Various Reports), State Level Banker's Committee (SLBC), and Banking Statistical Returns (BSR). The industrial performance is estimated by selecting some major macroeconomic variables like units, investment/capital, employment, and value addition. The industrial performance or efficiency is estimated. For analyzing the employment generation capacity of the sector, employment elasticity with respect to output and fixed capital is estimated. The growth of credit is evaluated using the Average Annual Growth Rate (AAGR) and Compounded Annual Growth Rate (CAGR). Structural change in the flow of credit is estimated by the Bai-Parron test. Gini Coefficient and Lorenz curve are used to understand the inequality in the distribution of credit in the districts of Uttar Pradesh. The causality relation between the variables is checked using the Granger

Causality test. The Vector Autoregression (VAR) model is used for factors affecting credit to the MSME sector. To study the relationship between credit and MSME development in time series, Auto-Regressive Distributive Lag (ARDL) model is used and for cross-sectional data multiple linear regression model is used. R, Microsoft Excel and STATA software are exercised for analysis and interpretation in the study.

The study is catalogued under six chapters keeping in mind the objectives of this study. A brief description of these chapters is given below:

Chapter 1: Introduction - This chapter primarily deals with a brief introduction to the importance of MSMEs in the context of India, different sources that provide credit to the sector and an overview of MSMEs in Uttar Pradesh. It also gives a brief review of the available literature on MSMEs to understand the literature gap. Apart from this objective, the hypothesis and methodology of the study are also taken into account.

Chapter 2: Theoretical and Conceptual Framework - The second chapter provides a conceptual framework for the study. It discusses the main theories that support the provision of credit for the development of industries. It also provides a review of committee reports supporting the financing of MSMEs.

Chapter-3: Status of MSMEs in Uttar Pradesh - The Third chapter discusses the industrial development in U.P. It includes an overview of the development of micro small and medium-scale industries in the U.P., policies for the promotion of the sector and the chapter assess the development of the sector on the parameters like the number of units of MSMEs, employment, investment and value-added.

Chapter-4: An Overview of Credit to MSMEs in Uttar Pradesh - The fourth chapter provides an overview of the major credit providers to the MSMEs in India and in U.P. and assess their performance.

Chapter-5 Impact of Credit on the Development of the MSME Sector in Uttar Pradesh - The fifth chapter assess the impact of industrial credit on industrial development in U.P. through the regression analysis and scrutinize whether the credit is playing any significant role in the development of MSMEs in U.P.

Chapter-6 Summary and Conclusions - This chapter provides sum up of all the above chapters. Conclusion and inference have been derived on the basis of analysis of above chapters. The chapter provides some recommendations to improve the credit

flow to the MSME sector based on the analysis and this chapter sees how the objectives of the study met.

Major Findings

The MSME sector plays a crucial role in the growth and development of Uttar Pradesh. Uttar Pradesh has the third-highest number of registered and highest number of unregistered enterprises in India. The state has the highest number of micro units (91%) followed by small enterprises (9%). The share of medium enterprises is just 0.36% in Uttar Pradesh. Analyzing the MSME units according to the activity shows that service sector enterprises dominate in U.P. Around 56% of MSMEs are engaged in the service sector whereas 44% are in the manufacturing sector. The scenario is quite similar to that of India where 60 % of MSMEs are in the service sector and 40% belong to the manufacturing sector. Looking at the ownership of MSMEs, it is found that 83% of MSME units are owned by male entrepreneurs whereas only 17% are owned by female entrepreneurs in Uttar Pradesh. Socio-economic distribution of ownership shows that the majority of MSME units are owned by the backward entrepreneurs (61%) of which 45% are owned by OBC entrepreneurs, 14% are owned by SC and 2% are owned by ST entrepreneurs. Regional distribution of MSMEs shows that the western region is the most industrially developed with 50% of MSME units of U.P. providing 55.6% employment in the sector followed by the eastern region and central region with 27% and 16 % of MSME units respectively. Bundelkhand has the least number of MSME units. It has only 6% of MSME units that gives employment to 4.5% of total employment in the MSME sector in U.P. Observing the key industries in U.P., it is found that the highest number of MSME units are engaged in the repair & service industry followed by food processing and Garment industries. In similar fashion employment is also distributed i.e., the repair & service industry, food processing and garments have the maximum share of employment in U.P. However, it is found that investment per employment is minimum in Hemp and Mesta textiles whereas it is maximum for the tobacco industry in U.P.

The analysis of technical efficiency of MSMEs is shows that Uttar Pradesh is among the worst-performing states. It is only better than West Bengal in terms of input-oriented technical efficiency. The state has a high value of unutilized capital.

The time series analysis of growth of MSMEs in India shows a consistent growth of the sector in terms of the number of MSME units, employment, fixed capital and production at constant price during the post-reform period except the year 2008 which is due to the introduction of the MSME Act 2006 and the year 2018 which indicates the adverse effect of demonetization and GST implementation. A jump in fixed capital can be noticed during the period 2008-2020 that indicates towards capitalization of MSMEs in India. Employment elasticity with respect to output and fixed capital is studied using a log-linear regression model. In the case of India, employment elasticity with respect to output is found to be 0.54 and with respect to fixed capital it is 0.65. For Uttar Pradesh, employment elasticity with respect to output is estimated to be 1.98 and with respect to fixed capital, it is estimated as 0.35. These findings indicate that employment in India, is less responsive to changes in output and fixed capital compared to Uttar Pradesh. Uttar Pradesh exhibits higher employment elasticity with respect to output, indicating a greater impact of output changes on employment in the state. However, employment in Uttar Pradesh is less responsive to changes in fixed capital compared to the national average. The growth of MSMEs in U.P. shows that the growth of MSMEs is not increasing constantly as in India. The marginal productivity of labour shows variation but the marginal productivity of capital remained constant after 2010 in case of Uttar Pradesh. Hence, we reject the null the performance of MSMEs in Uttar Pradesh is satisfactory.

The analysis of the growth of credit to the MSME sector in India shows that after financial liberalization growth of credit to the MSME sector could not turn to fulfill the expectation. For the purpose of analysis, overall credit i.e., Non-food credit, industrial credit and credit to the MSME sector has been taken. The structural changes in the data are investigated by using the Bai Perron test has been used. For Non-food credit, we got three structural breaks i.e., in the years 2002, 2008 and 2013. The average annual growth rate in the period 1980-2002 is found to be 16 percent. The growth of credit picks up from 2003 to 2008. The AAGR was 27% during this period. But due to the global slowdown in 2008, we could observe a declining credit growth in the period 2009-2014. The AAGR remained at 17 percent in this period. The credit growth further converged during 2015-2020. The AAGR was just 9 percent during this period. For industrial credit, only two structural breaks are found, one in 2005 and the other in 2011. The AAGR during the period 1980-2005 was 16 percent. It

increased to 25 percent during the period 2006-2011. Then it declined and remained at 7 percent during the period 2012-2020. For SSI/MSME sector we got three structural breakpoints, 1997, 2007, and 2013. The AAGR during the period 1980-1997 was 17 percent. It declined to 13 percent in the period 1998-2007. We could observe a boost in the credit in the period 2008-2013 when AAGR reached 25 percent. That is due to the inclusion of medium enterprises in the sector defined in the MSME Act 2006. But this growth could not continue further. The sector faced the sharpest decline in the period 2014-2020. The AAGR for this period was just 5 percent which is the smallest of all three sectors. The VAR model analysis of factors influencing credit to the MSME sector reveals that monetary policy easing does not have a significant impact on credit availability. Conversely, the presence of Non-Performing Assets (NPAs) in commercial banks negatively affects credit accessibility. This pattern holds true for both India as a whole and the state of Uttar Pradesh (U.P.). The growth of GDP has helped the sector to avail more credit in India. However, in U.P., a higher Gross State Domestic Product (GSDP) does not influence the MSME sector's ability to obtain more credit. An overview of credit to the MSME sector in Uttar Pradesh shows that the spread of public sector banks in U.P. is highest followed by Regional Rural Bank (RRB) and Private sector Banks Distribution of bank branches in rural, semi-urban, urban and metro areas shows that penetration of public sector banks is highest in all four areas of U.P. The RRBs have significant reach in rural area and considerable in semi-urban areas. Taking bank branches per lakh of population, commercial bank branches in urban areas of U.P. is 0.14 per lakh whereas for rural areas it is just 0.020 per lakh i.e., the number of branches in rural areas is far less than the branches in urban areas. Comparing the credit to the MSME sector in U.P. with that of India, we get that the proportion of credit disbursed to the MSME sector in U.P. is low. Although it has shown an increasing trend in the studied period. In 2020 U.P. gets 23% of the total credit disbursed to the MSME sector in India. Analyzing the growth of credit in U.P., the trend of the growth rate of the overall credit scenario i.e., total credit, credit to the industrial sector and credit to the MSME sector) has a positive slope. The analysis of the percent share of credit to the MSME sector in total lending and priority sector lending shows the AAGR of total credit is 14.53 percent, for priority sector lending it is 12.71 percent and for the MSME sector, it is 17.62 percent. Comparing it with all India level, it is found that the growth rate of credit in U.P. is higher than the national level. The district-wise analysis of credit was done for

the Year 2020 to find out inequality in the distribution of credit in the state of Uttar Pradesh. For this purpose, the Gini coefficient is calculated. The value of the Gini coefficient is found to be 0.4702 which is quite high. There is inequality in the distribution of credit in Uttar Pradesh but this inequality may not be a matter of concern. Our null hypothesis that the credit to the MSME sector in U.P. is in a positive trend is accepted

The impact of credit on the development of the MSME sector in Uttar Pradesh is investigated taking commercial banks as the major source of credit for MSMEs. The growth of MSME is estimated in terms of an increase in the number of MSME units, employment, fixed capital and production. Theories like Schumpeter's Theory and Goldman Smith's theory indicate a positive impact of credit on the growth of the MSME sector. For the analysis, a time series regression model is used. The stationarity of the time series data is checked by the PP test and KPSS test. The data for credit, fixed capital and production is converted into logarithmic form. The stationarity test shows that all the series are stationary at the first level. The direction of causality is checked by using the Granger causality test. There is bidirectional causality between the number of MSME units and fixed capital with credit whereas there is unidirectional causality between employment and credit. An Increase in employment is causing credit to increase. However, no causal relation is found between production and credit. Bound-F statistics is used to conclude if the series are cointegrated. The test result shows cointegration among the variables (credit, number of units and employment) Optimum lag in the model is estimated by using AIC and BIC criteria. Auto-Regressive Distributive Lag (ARDL) model is used to analyze the relationship between credit and other growth variables. Analyzing the impact of credit on the number of MSME units shows that one percent increase in credit increase 0.21 lakhs of MSME units in India. Taking credit as the dependent variable for the credit unit model shows that credit majorly depends upon credit disbursed in the previous year. ARDL model for employment and credit suggests that one lakh increase in employment opportunities increases credit by 40 opportunities only. The relation of credit with fixed capital using the VAR model shows with one percent increase in credit in the previous year increase 0.43 percent in fixed capital in the MSME sector at the India level. A restricted error correction model is used to check for the convergence of the series toward the predicted value. For Autocorrelation Durbin-

Watson test is used and for heteroscedasticity, the Breusch-Pagan test is used. The test shows no autocorrelation and no heteroskedasticity in the models. The Cumulative Sum of Recursive Residual (CUSUM) test is used to check the long-run stability of the model and found that all the models are stable in both the long run and short run. The same procedure is employed to analyze the impact of credit on the development of the MSME sector in Uttar Pradesh. The stationarity test of the time series data for credit, number of MSME units, and fixed capital show all the series are stationary at first difference. The Granger causality test suggests that there is no causal relation between the number of MSME units and employment with credit. Only fixed capital and output show unidirectional causality with credit i.e., fixed capital causes credit to grow whereas credit causes output to grow in U.P. ARDL model suggests with one percent increase in fixed capital in MSME units increases 0.43 percent credit. One percent increase in credit helps to increase 0.18 percent of output in U.P. A district-wise analysis is done to understand the impact of credit in establishing new MSME units across the districts of U.P. The growth indicator is taken as the number of new MSMEs registered in the districts of U.P. in the year 2020. Including credit, the other variables that are taken into consideration are geographical area, educational institutes in terms of the number of ITI and polytechnics per lakh of population, road length (per square Km) electricity (KWH per capita consumption) and number of industrial areas per lakh of population. A multiple linear regression model is used for the analysis. The model reveals a direct relationship between the number of new MSME units registered and credit, road length and electricity consumption. The economic region is also one of the important factors to establish a new MSME unit. Hence, our null hypothesis that credit has a positive impact on the growth of the MSME sector in Uttar Pradesh is accepted. The time series data shows credit positively impacts the output from the MSME sector. The cross-sectional data show that the credit helps in establishing new MSME units in Uttar Pradesh.

This study concludes that the credit is playing a significant role for the development of MSME sector in Uttar Pradesh in terms of increasing fixed capital and production. It also plays an important role in setting up new MSME units across the districts of the state.

Recommendations

1. The performance of the MSME sector in Uttar Pradesh is found not satisfactory. The sector is not using its inputs efficiently. The sector could improve by providing management skills, training and marketing facilities.
2. The MSME sector is getting more capital-intensive. To encourage more employment in the sector credit could be extended on the basis of number of employments generated through the enterprise.
3. There is a high regional disparity in the distribution of MSME units in Uttar Pradesh, which must be reduced so that all the state's regions could be developed.
4. Although the credit scenario has improved in the state, still it is not getting the proportion of credit by the number of MSME units. So, more credit needs to be disbursed in Uttar Pradesh for the development of this sector.
5. The MSME sector becomes a victim of high NPA of the commercial banks although they may not contribute significantly to increasing NPAs. Banks should have a flexible definition for NPA for MSMEs as they usually face the issue of delayed payment.
6. Banks usually treat the sector as a risky sector. The government could help in this direction to make the sector lucrative for creditors by providing them with proper training and market assistance.
7. The government should focus on the financial education of entrepreneurs/ MSME owners to avail them of more credit from financial institutions.
8. In Uttar Pradesh, credit impacts the growth of production. The availability of more credit could help the sector to enhance its efficiency.
9. The credit is demand driven in India as well as in U.P. To fulfil the dream to become a manufacturing hub it is required for growth to be credit-supply driven.

Limitations-

1. The data of the MSME sector after 2012 is cumulative data taken from UYAM and UDYAM reports. We could not reach to the exact number of working MSMEs in India and in U.P.
2. Data for production from MSMEs is not available for U.P. Hence, overall industrial output in U.P. is taken as proxy data for production.

3. Only Scheduled Commercial Banks are taken as the credit source for this study.

Further Study-

1. The study could be further extended for the overall credit source available for MSMEs in U.P.
2. Credit impact on the growth of the MSME cluster could be a determining factor for MSME growth in U.P.