

**INFORMATION ASYMMETRY AND HIGH TRANSACTION COSTS: CHALLENGES FOR MSMEs
IN SECURING FINANCIAL SUPPORT**

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<https://doi.org/10.69893/gjle.2024.000065>

ABSTRACT

MSMEs are an untapped sector of the Indian economy with the potential to foster growth by benefiting the affluent industry and the country's middle class. There are multiple schemes run by Indian governments to cater to this agenda, but they are still unable to actualize the true potential of the MSME sector. This research paper explores the historical context and contemporary challenges faced by Micro, Small, and Medium Enterprises in India, which struggle to keep pace with other sectors of the economy. Despite their potential to drive economic growth and enhance middle-class livelihoods through increased productivity and employment generation, MSMEs' potential remained underutilized and constrained by various obstacles. This study uses secondary data from credible sources to investigate key factors contributing to the persistent credit gap between credit demand and supply to MSMEs. The findings reveal that information asymmetry poses a significant barrier to accessing financing, as lenders often lack reliable data on the creditworthiness of potential borrowers. This uncertainty drives financial institutions to favor existing borrowers, leading to a skewed loan disbursement process that favors existing borrowers to reduce the enforcement cost of loan disbursement and collection. It also increases the difficulties for new entrants in getting easy loans from lenders. The paper highlights the urgent need for strong institutions to address these imbalances and capture gains from trade by expanding the credit market to small and new borrowers without any hassle.

Keywords: *MSMEs, Asymmetric Information, Transaction Costs, Credit demand and supply Gap.*

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1. INTRODUCTION

The fundamental principle of economics is exchange. 'Exchange creates surplus,' making it a key factor in economic growth. In the context of law and economics, the market is not limited to the buying and selling of goods and services; it also means the lending and borrowing of money. To an extent, the market for law and economics also represents the interaction between two individuals, active or passive.

If the market works entirely on the assumptions of classical economists, the market is self-sufficient in efficiently producing and allocating resources (Myint, 1977). Unfortunately, the beliefs of perfect rationality, perfect information, and zero transaction costs are unrealistic in the real world. Bounded rationality, high transaction costs, and information asymmetry are the sources that can hinder such exchanges in the market (Hodgson, 1998).

Transaction costs are the cost of the transaction; they can be monetary, such as brokerage fees, legal fees, and transportation costs, or/and non-monetary, such as time, effort, and resources required to gather information, negotiate, and complete a transaction (North, 1986). It has three elements: the search and information costs, the bargaining and negotiation costs, and the enforcement costs. The market fails to perform if transaction costs are high due to any or all of these elements. These costs persist in the financial market, too, and if high, can create market failure (Hau, 2006).

In the following few pages, we have analyzed the MSMEs in India and their performance in production, employment generation, and number of units registered under the Udyam scheme. We are also exploring the factors that can improve the performance of MSMEs with the main focus on Credit Demand, Supply, and Credit Growth.

2. LITERATURE REVIEW

The review of literature has been done under two categories: historical context and new policies of the government.

i. The Historical Context

A strong industrial base is essential for any economy's growth and development. Industries serve as the backbone of a nation. During India's Second Five-Year Plan (1956-1961), the Mahalanobis model, developed by Prasanta Chandra Mahalanobis, provided a crucial framework for India's industrialization and economic growth goals. This model emphasized the importance of heavy industries, such as steel and coal, over consumer goods. The key aspect of the model is the strategic investment in heavy industries to maximize India's manufacturing

potential. Later, this model was criticized for underestimating the power of agriculture and small and medium enterprises (Komiya, 1959).

Since independence, India had policies to support small-scale industries. To identify and promote small and medium enterprises (SMEs), in the 1950s, India adopted a formal definition of small-scale industries (SSI), which was based on investment and employment, particularly to identify and promote this segment accordingly. The government has also established organizations to develop a network for institutional support, such as Small Industries Development Organization (SIDO). It has also introduced measures to protect this segment, like price preferences, product reservations for SSI, and fiscal incentives, which were lately criticized in the study done by Ramaswamy as he observes that the output share of reserved items has not increased as per the estimate (Ramaswamy. 1994).

The work towards boosting small-scale industries post 1991 among competition has taken flight by establishing Small Industries Development Bank of India (SIDBI) and, more importantly, in 2006, establishing the Micro, Small and Medium Enterprises Development (MSMED) Act 2006. MSMED Act of 2006 is considered to be a milestone in the evolution of MSMEs in India (Subrahmanya, 2021)

Naya, S., in his writing, mentions the attention this segment requires from the government and policymakers for overall growth and development. He has demonstrated that small and medium enterprises are crucial in India and Asia. He notes that production in developing countries largely focuses on agriculture. As this sector experiences growth in output and income, new markets emerge for consumer and intermediate goods essential to agriculture. This contributes to GDP and helps small farm households and landless labourers get employment (Naya, S. 1985). Subrahmanya, in his article, mentions how The Small Scale Industries (SSI) and Small and Medium Enterprises (SME) segment in India has evolved significantly, especially following the MSMED Act of 2006. This growth reflects their increasing contribution to the economy since the pre-liberalization era. We can gauge the strength of the SME sector with 63 million enterprises employing 120 million people before COVID-19, which made the SME sector the second largest sector, giving employment after the agriculture sector in India. Small and medium-sized enterprises (SMEs) play a crucial role in manufacturing production, national revenue, and exports, yet their innovative potential is often overlooked nationally. (Subrahmanya, 2021).

ii. New Policies of The Government

According to the newest booklet, Schemes for MSMEs, published by the Government of India, India has implemented many policy measures to promote small-scale industries, including micro, small, and medium enterprises (MoMSMEs, GoI, 2024). These policies aim to reduce the challenges small and medium-sector enterprises face in getting financial support and becoming productive and competitive in the era of globalization. After the Industrial Policy Resolution 1956, which reserved certain products for small-scale industries, initiatives like the MSME Development Act of 2006 established a legal framework for enterprise classification. To provide financial support to the small sector, the GoI introduced a Priority Sector Lending Policy, ensuring that banks disburse a significant amount of their credit to MSMEs. Schemes such as the Credit Guarantee Fund Scheme have been introduced to simplify access to finance for these units. The National Manufacturing Competitiveness Programme was initiated to improve manufacturing processes. Atma Nirbhar Bharat Abhiyan introduced significant revisions in defining MSMEs and added emergency support measures in the face of economic challenges.

Similarly, according to the MSME Scheme Booklet 2024 of the Government of India, 17 schemes have been introduced to promote Micro, Small, and Medium Enterprises (MSMEs), including five new initiatives. These schemes aim to boost entrepreneurship and employment, guarantee credit for MSMEs, and promote skill development and innovation. Moreover, programs like the MSME Champions Scheme and the Entrepreneurship Skill Development Programme (ESDP) aim to enhance sustainability and competitiveness among enterprises. Under new initiatives like PM Vishwakarma support artisans, the Self Reliant India (SRI) Fund and RAMP Work to help small and medium-sized businesses (MSMEs) do better and create a friendly environment for their growth.

The objective of these schemes, as per the booklet, is “The scheme aims to provide financial assistance to set up self-employment ventures and generate sustainable employment opportunities in rural and urban areas. To generate sustainable and continuous employment opportunities for rural and unemployed youth and prospective traditional artisans and thereby halt occupational migration.” (MoMSMEs, GoI, 2024)

3. RESEARCH METHODS

This study's research methodology involves secondary data sources. The secondary data includes reports from reliable institutions and the Government of India. The data comes from

interviews with CEOs of MSMEs featured in newspapers. The objective is to analyze credit-related aspects within the MSME sector, including credit demand, supply, gap, and growth dynamics. The data collected from interviews with MSME CEOs featured in newspapers provides valuable first-hand insights. This approach ensures a comprehensive exploration of credit dynamics while acknowledging and mitigating the limitations of relying on pre-existing data and news sources. The process involves gathering data from various reports to gain insights into borrowing trends, lending activities, and potential credit gaps. The study examines any imbalances that could lead to potential credit gaps by comparing demand and supply. The findings are then analyzed in the context of these potential pitfalls, considering their implications on research outcomes. Recommendations for overcoming these pitfalls are provided to enhance the research's robustness.

4. ANALYZING THE ECONOMIC PERFORMANCE OF MSMEs

As per the MSME website, MSMEs are Manufacturing Enterprises and Enterprises rendering Services. Micro stands for enterprises with Investment in Plant and Machinery or Equipment of not more than Rs.1 crore and an Annual Turnover of not more than Rs. 5 crores. Small enterprises have investments in Plant and Machinery or Equipment that are not more than Rs.10 crore, and Annual Turnover is not more than Rs. 50 crores. Medium enterprises have investments in plants, machinery, or equipment of more than Rs.50 crore and Annual Turnover of not more than Rs. 250 crore (Ministry of MSMEs, 2020).

MSMEs in India are the key players in generating employment and contributing to economic growth (IFC, 2018). As per the latest press release by the press information bureau of the government of India, MSME contributes nearly 29% of India's gross domestic product, with a total share of 36 percent in all of India's manufacturing output. MSMEs employed almost eleven crore workers last year (Press Information Bureau, GoI, 2023).

The Micro, Small, and Medium Enterprises (MSME) sector plays a pivotal role in the Indian economy even after the hit of the pandemic. It is often called its backbone (Behera, Mishra, Mohapatra, & Behera, 2020). This sector, known for its labor-intensive nature, contributes significantly by offering employment opportunities with relatively lower turnover requirements. Given India's substantial population, the demand for employment avenues is significant, and the MSME sector effectively addresses this demand. Characterized by a reasonably short gestation period, MSMEs foster a growth cycle by promoting entrepreneurship and concentrating on niche markets. In a broader context, this sector has made

substantial contributions to rural development through industrialization, employment generation, and related initiatives.

What sets MSMEs apart is their ability to achieve substantial growth even with modest capital investment, indicated by their lower capital-output ratio. The MSME Act of 2006 outlines enterprise definitions based on capital expenditure ceilings for plant and machinery or investment in equipment for service-oriented activities. As of 2018, their classification is determined by annual turnover levels (Reserve Bank of India, 2019). Given India's status as a burgeoning economy, this sector holds untapped potential that, once harnessed, promises substantial growth. This is underscored by the notable rise in the number of MSMEs in India, which surged 18.5 percent between 2019 and 2020 (SIRU, 2022).

The MSME sector is crucial in driving overall economic growth, narrowing the gap between rural and urban development, and addressing gender inequality. This is particularly evident in rural India, where the increasing presence of women-owned MSMEs signifies progress in grassroots-level socio-economic development. According to the MSME Annual Report of 2020-21, out of the 32.48 million enterprises in rural India, an impressive 51 percent are owned by women. These enterprises also make a substantial contribution to India's export trade. The expansion of export activities is demonstrated by the fact that MSME products accounted for 49.5 percent of total exports in the fiscal year 2020-21, 45.0% in 2021-22, and 43.6% in 2022-23 (Press Information Bureau, 2023).

i. Exploring MSMEs Post-Pandemic Performance

In the following pages, we will explore the post-performance of MSMEs based on authentic reports from the Government of India and other sources.

Economic Survey 2022-23: The performance of MSMEs has been documented in the economic survey of 2022-23. The MSME sector experienced impressive growth in credit, averaging over 30.6% between January and November 2022, thanks to the government's extended ECLGS. This shift from unstable bond markets and higher-cost external borrowing to banks also contributed to an overall increase in credit (Economic Survey 2022-23).

The recovery of MSMEs is evident in the increased GST payments and eased debt concerns due to the ECGLS. The credit growth surpassed 30.5% on average between January and November 2022, supported by the government's extended ECLGS. Banks aggressively provided credit, prompted by better financial health, similar to corporates.

The introduction of ECLGS in FY21 protected micro, small, and medium-sized enterprises from financial distress. An August 2022 CIBIL report on ECLGS Insights revealed that 83% of borrowers were micro-enterprises, with many having exposure under ₹10 lakh. ECLGS users had lower non-performing assets than eligible non-users. GST payments by MSMEs rebounded and crossed pre-pandemic levels, demonstrating resilience and effective government intervention.

In recent times, industrial policies have been geared towards reforming MSMEs. These policies include ECLGS and revised MSME definitions under Aatmanirbhar Bharat. The ECLGS scheme has assisted many MSMEs with collateral-free loans amounting to ₹2.38 lakh crore. Other measures, such as TReDS, have extended non-tax benefits to these small businesses, while digital platforms have strengthened them. The Open Network for Digital Commerce and the inclusion of GSTN on the Account aggregator platform have also helped boost MSMEs' credit access and market reach.

It is important to continue implementing reforms that reduce compliance burdens, improve finance access, and promote responsible growth. State governments should also play their part in advancing market reforms. Industrial credit growth has surged thanks to ECLGS, government incentives, and capacity enhancement. The share of MSMEs in industry credit increased from 17.7% in Jan 2020 to 23.7% in Nov 2022.

Despite the setbacks caused by the pandemic, MSMEs' contribution to GVA in FY21 reached 26.8%. The Samadhaan Portal and RAMP scheme has been instrumental in supporting MSMEs' cash flow and expansion. Digital solutions like e-commerce have also boosted revenues and market access for these small businesses. MSME credit growth has thrived thanks to ECLGS, while other reforms and digital solutions have fueled recovery. All these factors showcase the sector's resilience and growth potential.

ii. MSME Pulse August 2023

The Indian economy has continued to grow and display resilience in economic activities, a trend reflected in the MSME sector. The sector has shown consistent credit growth as the backbone of India's economy. In this edition of MSME Pulse, we explore Commercial credit insights from FY23-Q4, revealing the following findings:

New credit originations for FY23-Q4 reached INR 241K Crore. The 'Micro' segment (with credit exposure below INR 1 Crore) showed a remarkable 23% year-on-year growth in originations, while the 'Small' segment (credit exposure between INR 1 Crore to INR 10

Crores) experienced marginal 1% growth. On the other hand, the 'Medium' segment (credit exposure between INR 10 Crores to INR 50 Crores) saw a decline of 19% year-on-year in originations.

States with higher levels of industrialization witnessed more robust MSME credit growth. An analysis by state highlights Uttar Pradesh, Karnataka, Telangana, and Haryana as the leaders in credit growth, primarily driven by 'microloans. Among these, Karnataka stands out with the highest growth rate of 8%. Notably, credit supply from Public Sector Banks to 'micro-enterprises in Karnataka surged by an impressive 119% year-on-year.

After facing challenges posed by the pandemic, delinquency rates initially increased. However, these rates have gradually decreased over subsequent quarters as MSMEs diligently met their credit obligations. Delinquency rates have declined across all three lender categories, with private banks showing the lowest rate at 1.4%.

iii. Rajya Sabha Q&A

Bhanu Pratap Singh Verma, Minister of State in the MSME Ministry: In FY23, the MSME sector's outstanding credit from scheduled commercial banks increased by 12.3% to Rs 22.6 lakh crore compared to Rs 20.11 lakh crore in FY22. The outstanding amount was Rs 17.83 lakh crore in FY21 and Rs 16.13 lakh crore in FY20. Over the past five years, there has been a 49.6% increase in credit outstanding to the MSME sector, which was Rs 15.10 lakh crore in FY19 (Soni, 2023).

5. CHALLENGES FACED BY MSMEs IN SECURING FINANCIAL SUPPORT: AN ECONOMICS PERSPECTIVE

Although MSMEs have shown promising and progressive performance in the wake of the pandemic, India has not fully leveraged their potential to achieve a \$5 trillion economy. Despite the plethora of schemes to boost the MSME sector, small and medium enterprises face various challenges that impede their ability to take advantage of the resources offered by government policies. As noted, policymakers are aware of the potential of the MSME sector and have taken various measures to boost the sector. However, we observe the gap between policymaking, its implementation, and its effectiveness. To revitalize the small and medium-sized enterprise (SME) sector, especially during the COVID-19 pandemic, it is crucial to pin down the fundamental challenges MSMEs face. This understanding will aid in formulating effective policies and bridging the gap between policy implementation and its impact on businesses,

ultimately supporting the sector's growth. Based on secondary data, the following challenges have been identified.

i. Asymmetric Information and Credit Gap

Asymmetric information can be one of the significant sources of credit gaps in MSMEs. If perfect information is too costly to gather, information asymmetry exists in the market between the parties involved in the financial transaction. Information asymmetry is when one party knows more about the transaction than another. In such a situation, one party's welfare depends on the relevant information the other party possesses and does not share. The costlier it is to get the information for better decision-making, the more significant the information gap will be, which leads to higher information and enforcement costs. There would be distrust, lower satisfaction, and, therefore, lesser trade in such markets, which can be represented as credit gaps in the financial market (Henderson, 2002).

India's Micro, Small, and Medium Enterprises (MSMEs) face a significant obstacle known as the 'credit gap,' which refers to the difference between the credit demand and supply. In an economy, credit demand is the term used to describe the quantity of funds that individuals, businesses, and other entities require or wish to obtain from financial institutions such as banks, credit unions, and lenders. This is an important metric to assess the level of funding needed for various purposes, such as personal consumption, investing in businesses, purchasing homes, and more.

Inquiry volumes Year-over-year (Y-o-Y) growth and other data sources were used to gauge India's credit demand indicators. Inquiry volumes Year-over-year (YoY) growth represents the change in the number of requests related to credit from one year to another. It is expressed in percentage form (Corporate Finance Institute, n.d.). For example, if in 2020 the number of requests is 100 and in 2021 it is 120, then YoY will be 20% from 2020 to 2021. This data source helps us understand trends in credit demand in the MSMEs sector while also evaluating financial activity and borrowing patterns.

Collecting data on year-over-year inquiries for credit loans by MSMEs and the final loan disbursement by the banks is essential for evaluating the gap between loan demand and supply. This process includes everything from inquiry on loans by the borrowers to the initial approval and creation of credit and, finally, allocation of funds to borrowers.

Micro, Small, and Medium Enterprises in India have often faced challenges in obtaining the money they need and the actual financial support they get. This credit gap has consistently hindered the progress of these crucial contributors to the economy. The Reserve Bank of India

formed a committee in December 2018 to focus on Micro, Small, and Medium Enterprises. The committee projected that the credit gap in the MSME sector would be between Rs 20 lakh crore and Rs 25 lakh crore (Reserve Bank of India, 2019). According to the World Bank, India's MSME industry has a credit gap of almost \$380 billion. Recently, an investment banking firm called Avendus Capital estimated the credit gap in the MSME sector to be \$530 billion. The report highlighted that only 14% of the 64 million MSMEs in India have access to credit (PTI, 2020).

After the pandemic, a report by SIDBI and CIBIL revealed that credit demand increased by 33% in FY 23-Q4 compared to the previous year, while inquiries for credit doubled. Credit demand from public and private sector banks increased by 1.3 times the last year's volume, and non-banking financial companies experienced a 1.5-fold expansion in credit demand, positioning them as competitive contenders in the commercial credit market. The driving forces behind the increase in MSME credit demand are improved business operations, enriched credit data availability, and the swift adoption of digital lending practices. In FY 23-Q4, while credit demand surged by 33%, the supply only grew by 11%. As of March 2023, new MSME credit origination in FY 23-Q4 amounted to INR 241K Crores, with commercial loan disbursements expanding by 1.7 times compared to FY 20-Q4 (SIDBI, 2023)

The Reserve Bank of India press release of July 2023 indicated that bank credit growth for Micro, Small, and Medium Enterprises (MSMEs) had slowed down in the first three months of the current fiscal year compared to the previous year (Reserve Bank of India, 2023).

Despite the growing need for credit among Micro, Small, and Medium Enterprises (MSMEs), financial institutions are cautious regarding commercial lending. This is due to various factors and considerations influencing lenders' uncertainty decision-making. In credit markets where borrowers have more information about loan repayment than lenders, there is a risk of non-performing assets dominating the market, making it riskier for lenders to lend money. George Akerlof's article, published in 1970, discussed that the presence of uncertainty leads to information asymmetry in the credit market. He observed that the market with uncertainty has an information asymmetry between the buyers and sellers, leading to the problem of adverse selection, which is the prominent source of market failure. The article discusses how, due to asymmetric information, the market fails to capture the surpluses that could be created through exchange. In other words, if lenders do not know the quality of the borrowers and their creditworthiness, they will be reluctant to offer loans, causing reduced access to credit and economic inefficiencies (Akerlof, 1970).

The government of India has implemented measures to address the credit gap problem. For instance, the Prime Minister's Employment Generation Programme, a credit guarantee scheme, and a ₹50,000 crore equity infusion through Self-Reliant India (SRI) Fund intend to provide funds to borrowers of MSMEs. Additionally, they have launched the Udyam platform and Udyam Assist Platform to bring more MSMEs into the formal sector for Priority Sector Lending benefits. Despite the Indian government's implementation of credit schemes and a 33% yearly increase in credit demand, creditors still hesitate to lend money to MSMEs. (Press Information Bureau, GoI, 2021).

Despite the government's efforts to improve credit growth through various schemes, individual MSMEs face challenges securing bank loans. Unfortunately, many of these businesses are struggling to obtain loans due to banks' risk aversion, which has resulted in a slowdown in credit growth. According to Anil Bhardwaj, the Secretary General of FISME, the credit barriers faced by MSMEs are not purely procedural but rather stem from banks perceiving these businesses as the market for lemons, such as risky borrowers bad loans, and treating them accordingly. The credit gap in India, as observed by Puneet Kaura, Managing Director and CEO of Samtel Avionics, is primarily caused by inadequate loans and delayed disbursement of loans to MSMEs, which puts them at a disadvantage compared to larger enterprises. Kaura believes that the current system favors larger borrowers. Meanwhile, Rohit Arora, co-founder and CEO of Biz2Credit, notes that MSMEs in India face challenges when it comes to obtaining credit from banks and financial institutions due to factors such as collateral requirements, limited credit history, high interest rates, and the informal nature of businesses. Lack of financial records, risk perception, and high non-performing assets (NPAs) in the banking sector further hinder MSMEs' access to loans (PTI, 2023)

ii. *High Transaction Costs and Skewed Loan Disbursement*

Transaction costs encompass three key elements that influence economic interactions:

1. Search and information costs involve efforts and expenses to gather relevant data about potential transactions, including assessing various options and comparing terms.
2. Negotiation and bargaining costs arise from reaching mutual agreements, involving time, resources, and sometimes even expert assistance to finalize terms satisfactory to all parties.
3. Enforcement costs refer to the expenses of ensuring that contractual obligations are upheld, often involving legal procedures and monitoring mechanisms.

These elements collectively shape the decision-making process in economic transactions, influencing the efficiency and feasibility of interactions within markets and business relationships.

The press release of June 2023 on the sectoral deployment of credit by RBI states that in June 2023, industrial credit experienced slower growth at a rate of 8.1% YoY compared to the 9.5% growth in June 2022. Credit for large industries expanded by 6.4%, an improvement from the 3.2% growth seen the year before, while medium enterprises experienced a growth of 13.2%, a decrease from the previous year's 47.8% growth. Credit for micro and small enterprises also increased by 13.0%, a slight decline from the 29.2% growth one year earlier (RBI, 2023). These trends suggest that lenders have shifted their focus toward larger enterprises where the enforcement cost of lending and repayment is lesser than small and medium-sized businesses. The report by TransUnion Cibil of 2022 states that Financial institutions often prefer existing borrowers over new ones due to the high transaction costs involved in enforcing loans. These costs include monitoring, managing legal procedures, and the risk of potential defaults, which are significantly higher when dealing with new borrowers. Established borrowers have proven track records and relationships, making the enforcement process smoother and more predictable. High enforcement costs make these lenders choose borrowers with lower uncertainty and reduce administrative costs.

As it is already known how transaction costs hinder trade, this arrangement of lowering administrative burden by lenders in India creates barriers to fair loan distribution (Herath, G. 1994). In the report by TransUnion, under the 'micro-segment of borrowers', the vintage delinquency rate is 8%, the highest among MSMEs borrowers. Vintage delinquency is the percentage of loans in arrears during a specific time frame from the loan's origination. The 8% delinquency rate indicates that many borrowers in the micro-segment, especially in semi-urban areas, struggle to pay back their loans. Vintage delinquency at 8% is a good enough reason for lenders to avoid lending money to such a category to avoid high transaction costs (TransUnion Cibil, 2022).

TransUnion Cibil report of 2022 also looks into the credit preferences of new-to-credit (NTC) and existing-to-credit (ETC) borrowers. As per the report, 61 percent of the new-to-credit borrowers have opted for smaller loans of less than one lakh rupees. On the contrary, 48% of the existing-to-credit borrowers prefer loans ranging from rupees 10 to 25 Lakhs. This information again proves the point that wherever the transaction costs of lending are lower, the lenders have been provided loans. The new borrowers were offered a lesser amount of loans

than the existing borrowers who already had established their creditworthiness in the market. Lenders are often skeptical about providing large loans to NTC borrowers due to the high search and information costs of finding their credit histories. The report highlights the problems of adverse selection in the credit market, which lenders avoid, affecting their lending decisions and making the loan distribution skewed towards one segment.

6. SUGGESTIONS

In light of such issues, the government has initiated measures to ease the flow and distribution of credit to the MSME sector. From April 1, 2023, the credit limit for Guarantee Coverage under the Credit Guarantee Scheme for Micro & Small Enterprises has been raised from Rs 2 crore to Rs 5 crore. Additionally, the annual guarantee fees have been reduced by 50%. Furthermore, the government has announced a Fund of Funds under the Atmanirbhar Bharat package to inject Rs 50,000 crore equity into MSMEs with the potential and viability to expand. MSME, Government of India.

Two policies are suggested to bridge information between lenders and borrowers and reduce transaction costs to help small borrowers get loans: making registration mandatory for MSME and following the Indonesian model of the UMi program.

i. Compulsory Registration of MSME

Lakhs of MSMEs have still not registered themselves on the Udyam portal. (Soni, S. 2022). It is common for banks to prefer lending to Micro, Small, and Medium Enterprises (MSMEs) that are registered due to their legal recognition, transparent financial reporting, more accessible collateral provision, and access to government incentives. Unregistered MSMEs can still apply for credit, but they may need to improve their documentation and financial track record to increase their chances of successfully borrowing. MSMEs in India do not have compulsory registration, which can enhance their creditworthiness and provide them with more accessibility to credit. Registration with the government gives lenders confidence in providing loans at lower interest rates with government support. Registering through online portals makes the registration process smooth and easy. With its incentive schemes, the government of India can ensure that each MSME is interested in registering with the government portal to take advantage of government support and lower interest rates with higher loan amounts.

ii. Ultra-Microcredit Program of Indonesia (UMi program)

Ultra-Microcredit Program is a social assistance initiative in Indonesia that aims to enhance the economic capacity of individuals, particularly those who own and operate small and underprivileged businesses. Since its launch in August 2017, the UMi program has experienced significant growth in borrower numbers and loans disbursed. From August 2017 to July 2020, the program's loan disbursement increased by 10.4 times, from IDR753 million to IDR7.8 trillion, while its borrower base expanded eightfold, from 307,000 to 2.5 million. The program initially had nine participating NBFIs (two direct and seven indirect mechanisms) but has now grown to include forty-six NBFIs (two direct and forty-four indirect mechanisms). Over the same period, the program's coverage area has expanded from 372 to 464 districts/cities (Adam, Soekarni, & Inayah, 2021).

iii. Other Measures to Build Strong Market Signals for Borrowers

It is evident from the interviews with some of the owners of MSMEs that acquiring funding from small borrowers is still an uphill task, regardless of the government schemes that have been implemented. Moreover, the reason is mainly that lenders consider these small borrowers as bad borrowers (the market for lemons). Akerlof suggested strong market signals can be a good way to avoid the situation of adverse selection and market for lemons (Riley, J. G. 2002) *Credit Scoring Models*: Developing robust credit scoring models specific to Indian MSMEs can enable lenders to assess risk more accurately. This involves analyzing various data points, including financial history, business transactions, and industry-specific factors. (Ramachandran, Obado-Joel, Fatai, Masood, & Omakwu, 2019).

iv. Introduction of Collateral Registries and Awareness Among Lenders

A World Bank report suggested that the introduction of collateral registries for even movable assets has increased the firm's access to bank loans. The study is based on a survey of 73 countries where firms in seven were introduced to movable asset registries. The study concludes that introducing such options has significantly helped firms to access bank loans. Countries like China have established collateral registries, which have helped MSMEs to use movable assets as collateral. It has reduced the uncertainty among lenders in extending credit due to reduced risks associated with non-performing assets. China has observed a significant increase in lending to small and medium-sized enterprises after the introduction of collateral registries. The People's Bank of China, with the help of the World Bank, has established a registry for movable assets of small enterprises. The initiative has facilitated the financing of \$10.4T for small businesses in China. (Love, Martínez Pería, & Singh, 2013).

In India, the government, with the help of the World Bank, tried establishing a registry for movable assets of small enterprises. However, lenders with limited awareness and a traditional attitude tend to prioritize immovable assets. Educating lenders about these systems is another important measure the Government of India must take to encourage responsible lending systems by bringing transparency and lower risk associated with credit extension. Initiatives include training sessions, educational campaigns, case studies, and simplified registry platforms so the system can work without any hassles (IFC, 2018).

7. CONCLUSION

The Government of India has made significant progress supporting its MSME sector through various policies and programs. However, there is a gap between implementing the policies and their impact on the sector. This study explores the ineffectiveness of the policies due to the presence of sources of market failures in these markets, such as information asymmetry and high transaction costs. India has the potential for improvement, but rather than merely initiating new measures, it should prioritize addressing economic challenges such as adverse selection and moral hazard. This can be achieved by bridging the information gap between lenders and borrowers through accurate credit risk assessments and enhancing credit scoring models. It should also focus on streamlining the lending process by promoting digital platforms and strengthening cybersecurity laws to develop trust between the parties involved in the transaction. In the era of information technology, reducing transaction costs is no longer a herculean task. The adoption of better technology and the provision of digital platforms and knowledge of the same to small and medium enterprises can minimize the transaction costs between lenders and borrowers. Simplification of documentation and streamlining lending processes through digital platforms and regulations can reduce administrative costs and foster a more conducive environment for the MSME sector to grow.

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