International Growth Centre

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Helping India's Informal Manufacturing Sector to Grow

For the manufacturing sector in India, the ubiquitous form of ownership is the family. Much of the focus in academic studies, policy discussions and the media is on the large family-owned firms such as the Birlas and Tatas. But there is also another large set of family-owned manufacturing firms: the informal household enterprises. Household enterprise, where a single family owns and manages the firm, as well as provides the labour, is the predominant type of firm in the informal manufacturing sector, and make products as diverse as coir mats, fireworks, furniture and garments[1]. The problem, however, is that these household enterprises are far less productive than firms that employ people from outside the family, with output per worker being around half on average.

This difference in productivity is not surprising: Non-household firms can draw on specialised workers with more skills and training than what may be available in the family. Moreover, non-household informal firms can grow larger in size and reap economies of scale (though limited for a typical firm size in the informal sector) and hence become more productive. The productivity benefit to these small firms of taking on more specialised and able outside workers is similar to the benefits of a much larger family firm like the Birlas and Tatas bringing in managerial talent from outside. The puzzle here is then, given the clear productivity benefits of employing non-family workers, why do so few household enterprises seem to make the transition to employ outside workers and grow in size? What is holding back firm growth in the informal manufacturing sector?

Access to finance

One factor that can help explain why household firms don't make the switch is a lack of access to finance. Household enterprises need external funds to pay the non-family workers' wages, to buy raw materials as inputs and to make investments (e.g. machinery) as the firm grows in size. All firms in the informal sector are reliant on external funds from both formal and informal sources. Recent data from India's National Sample Survey Organisation (NSSO) show that banks and building societies account for around half of loans taken out by household enterprises, but around 60% of loans are taken out household enterprises, but around 60% of loans are taken out by firms with outside workers (2005-2006). The data also show that household firms tend to rely far more on loans from household members and other unregulated money lenders[2]. While financial constraints are a problem for all small firms, regardless of where they are in the world (see for instance Beck and Demirgüç-Kunt 2006 and Ayyagiri et al. 2008), we would expect that finance constraints are particularly important for firms in the informal sector in countries such as India, given that these informal firms do not have credit histories and adequate collateral to offer to lenders, especially banks and co-operative societies.

How important is access to external finance for firm transition from household enterprises to non-household enterprises in the informal manufacturing sector? To address this question, my recent research with Rajesh Raj (Raj and Sen 2012) looks at data from three rounds of the large nationally representative surveys of manufacturing firms in India's informal sector undertaken by the NSSO. These three rounds include close to 300,000 firms and are available for the years 2000-2001, 2005-2006 and 2010-2011. The surveys ask individual firms whether they face constraints in accessing external finance[3]. Around one in three firms report that they face a finance constraint on their operations, with the overwhelming majority of these firms being household enterprises. But this does not in itself establish that finance constraints are crucial determinants of firm growth in the informal manufacturing sector in India. For instance, it is quite possible that the lenders themselves favour the larger firms – that is, those that are not household enterprises and that are more likely to offer collateral and are more profitable than household enterprises. In this case, it might be possible that the connection between large firms and access to finance starts with the banks. In other words, it is possible that larger firms grew big before having access to loans. This would mean that there is some other unidentified factor explaining their lack of growth.

Access to finance, literally

To see what comes first (access to finance or firm growth) we look at the factors that might lead some areas to have more institutional lenders such as banks and co-operatives than others. These factors could be access to major transportation networks such as a National Highway or a Broad Gauge train line, or the availability of educated people to work at the banks. Taking these factors in to account, we can see areas where firms will have more difficulty accessing finance regardless of their size because of being further away (literally having less access to finance). We find evidence that the difficulty that firms face in accessing external finance plays an important role in firm transition across the range of firm types in the informal manufacturing sector in India, and acts as a significant constraint to small firm growth. To put our finding in numbers, a change in the status of the firm from being 'finance constrained' to not being finance constrained will increase the likelihood that the firm will make the switch from a household enterprise to a non-household enterprise by around one quarter. Looking at data from India's districts, we also find that financial development in a given district (in the form of bank offices and bank accounts per person) increases the likelihood that firms in the district will make the transition from household enterprises to non-household enterprises.

Implications for policy

Small firms matter for India's growth. Our research shows that a major constraint for small business in India is access to finance. Until the early 1990s, India's government actively promoted the spread of financial institutions by making it mandatory for banks to open branches in rural, semi urban and remote areas of the country. This policy has been considerably weakened since the financial liberalisation of the 1990s. As we have shown, such a weakening could well have a negative effect on firm growth, especially if commercial banks and other institutional lenders are withdrawing their offices from the more remote regions and districts. It may well be time for the government to step in.

Notes

1. In the Indian context, household enterprises are called 'Own Account Manufacturing Enterprises' or OAMEs for short. Firms that employ non-family labour are called Non-Directory Manufacturing Establishments (NDMEs) or Directory Manufacturing Establishments (DMEs), depending on the number of non-family paid workers employed. NDMEs employ five or fewer paid workers while DMEs employ six or more paid workers.
2. For example, in 2005-2006, friends and relatives provided 21% of all loans to household enterprises, and the corresponding figure for other firms was around 10%. Money lenders provided around 16% of all loans to household enterprises while the corresponding figure for other firms was around 10% -12%. (Based on calculations using the National Sample Survey Organisation's survey of the unorganised manufacturing sector for 2005-2006.)
3. The last round does not directly ask this question, but asks firms which are the two most important constraints they face.

Finance constraints & firm transition in the informal sect…

Further reading

- Ayyagari, M, A Demirguc-Kunt, and V Maksimovic (2008), "How Important Are Financing Constraints? The Role of Finance in the Business Environment", The World Bank Economic Review, 22:483-516.
- Beck, T and A Demirgüç-Kunt (2006), "Small and Medium-Size Enterprises, Access to Finance as Growth Constraint", Journal of Banking and Finance, 30:2931-2943.
- Raj, Rajesh SN and Kunal Sen (2012), "How Important are Credit Constraints for Small Firm Growth? Evidence from the Indian Informal Manufacturing Sector?", Final Report to the IGC Central India Programme.