CHAPTER-3

REVIEW OF LITERATURE

3.1 SIGNIFICANCE OF INSTITUTIONAL FINANCE FOR SSIs

Considering the importance of external finance for the growth of small industries a good number of studies embracing different aspects of the issues involved have been conducted. These studies have examined not only the significance of but also the problems in securing external finance for the small scale industrial sector. Some studies, while assessing the performance of the existing financial system in meeting the requirements of the small firms, have come up with various suggestions for improved and automatic flow of funds to the sector.

Sandesara (1988) has observed that small units are technically less efficient than the larger ones as they use relatively larger quantity of physical input per unit of output, and less profitable because they procure inputs at higher cost and sell output at a lower price. Therefore, generation of internal funds for recycling is almost next to impossibility on the part of the small industrial units. They are to go for institutional finance.

While providing new opportunities for creative entrepreneurs, institutional finance encourages them to explore new avenues for production. Credit support has made a large number of people successful in setting up their productive ventures while stimulating the traditional, under capitalized local entrepreneurial base (de Jong, 1983). Many a study has highlighted a positive association between external financial support, particularly from the banking sector and business performance (Keasey and McGuiness, 1990; Keasey and Watson, 1992).

Decades worth of scholarship has identified inadequate finance to be the major constraint on the operation, maintenance and growth of small scale industries (Elkan, 1988; Dawson, 1994, Morewagae, Seemule and Remple, 1995). Low access to finance by these

1. Impact of credit on industrial development could be measured in a narrow or in a broad sense. The former subsumes credit use in terms of the level, sources and terms of debt while the latter encompasses the effect of credit on profitability, growth, economic independence, technical progress etc. Bhaduri (1973) has examined the broader sense of credit use in the farm sector while Choudhury (1989) has evaluated both the aspects of credit deployment.
units obstruct the start up and growth as well (Allen, 1977), though with varying intensity depending on the stages of operation (Fertuck, 1982). Mazumdar and Nag (1977), in a study conducted in Andhra Pradesh, Kerala and Karnataka have identified the lack of finance to be the major cause of mortality among the small industrial units as inability to raise financial resources often leads to the failure of well coordinated business plans and erodes the profit position of small units. Access to finance determines the operational strategies of the firms (Harper, 1984). Inadequate and delayed availability of finance has been the major cause of sickness of the SSI sector (Seventh Plan Draft Documents) . Small scale units, both in developed and developing counties, encounter a lot of problems in raising finance from institutional sources because of high transaction cost of lending to them (Suhartono, 1988). Smallness of size of these units causes both supply and demand constraints in procuring external finance. As regards the supply side constraints, small units are considered poor credit risk. On the other hand, these firms have a traditional and old fashioned repugnance towards getting into debt (Gupta, 1969). However, institutional finance to the SSI sector is not in commensurate with their needs.

3.2. PROBLEMS IN SECURING FINANCE

3.2.1. A GENERAL OVERVIEW

The small firms find it difficult to secure institutional finance because of their inherent characteristics. Mcmillan (1931) observes that small size of the firms precludes their access to certain sectors of the capital market. Loan accessibility is often reduced as the amount required becomes smaller and for that a small would-be-borrower is rarely granted a loan (Jong and Kleiterp, 1991).

The small firms generally possess little or no idea regarding financial planning and control for which they are always on the wrong foot at the negotiation table (Rhodes, 1983 a ). Most of the small units operate with little or no managerial or technical expertise. Poor management practices of the small scale units make them risky borrowers (Kilby, 1971; Meredith, 1986; Pott, 1986; Mathew and Walker, 1988). These units often find it difficult to check the use of funds as personal and commercial expenses are often mixed up (Jong and Kleiterp, 1991). Erosion of operating funds due to disproportionate withdrawal is almost a structural phenomenon of small industry finance (Je de la Rive Box, 1983). Another drawback of the small units is their ignorance about various free and concessionary services

2. However, de Jong (1983) has observed that the lack of access to credit speaks of scarcity of capital which forces the entrepreneurs to be labour-oriented and innovative and to utilize technology within their cultural, social and economical perspectives.
offered by the government and non-government agencies. (Sing and Gupta, 1977; Sandesara, 1988; Tecson, Valcarcel and Nunez, 1989; Woodcock, 1989). At times, small enterprises do not consider institutional finance beneficial because of their traditional tie up with the indigenous money lenders.

Low fixed asset base of the small units are often not sufficient to provide security for medium and long term loans; instability in their profit deter lending agencies from giving them unsecured loans (Dhar and Lydall, 1961). As asserted by Binks (1979), turnover of the small firms increase in uncertain jumps and is not a continuous process for which profit of the firms keeps on fluctuating and cannot be relied upon to create a strong capital base. The fluctuating and the low profitability of the units make loan sanction to them risky. (Gupta, 1969). Hall and Stark (1986) and Ganguly (1987) observe a strong negative correlation between firm failure rates and firm sizes.

Mainly two kinds of financial market imperfections constrain small business lending. The first is the information asymmetry and the second is the credit market power. The former has a two dimensional aspect; in the first case, the financiers are unable to obtain necessary information regarding the nature and qualities of the project, a precondition for loan sanction. Inconsistent and insufficient information about the functioning of the units, often presented in an unacceptable manner, makes the assessment procedure difficult and lengthy. As a result of this the chances of adverse selection increases and consequently the administrative as well as transaction cost of lending escalates, pushing, thereby, the lending rates up and making the

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3. Many a development bank like Kerala State Financial Corporation has experienced a higher loss rates on loans to small firms than to large ones whereas banks of North-East Brazil find more serious problems with fairly large projects. However, Levitsky (1983), Little (1986) and Rangarajan (1980) have observed that default rate in the case of loans to small units are at times catastrophically high.

4. "Given the probability distribution of the firms’ returns in an efficiently functioning credit market, the expected marginal product from the use of the loan must equal the bank’s opportunity cost of funds plus its variable transaction cost" (Virmani, 1982). Inefficiency will occur when banks and firms have differential expectations about the expected returns of investment. In other words, banks will be more pessimistic than firms due to asymmetries in information and high cost of banks in obtaining information.
borrowed funds unaffordable by the small units /5/. Moreover, small units are often secretive about their profit and asset position and this widens the information gap. In the second case, the financiers are suspicious that the borrowing units may not abide by the contractual agreements necessitating various post-sanction follow up measures: a problem of moral hazards. Absence of any meaningful feedback from the units, except for a series of defaults in the repayment schedule, warns the financier of sickness of the venture. This delays the recovery efforts resulting in lock-up of a sizable amount of funds which in turn retards recycling of finance and erodes profitability of the institution (Kuchhal, 1984). Financial contracts involve default risk because of adverse selection and moral hazard problems associated with the borrowers’ indeterminate type and unpredictable action (Stiglitz and Weiss, 1981).

On the other hand, the credit market power aspect stresses the ability of the financial institutions to act as price makers. These institutions often manage to manipulate the lending terms limiting thereby the scope of the small firms to bargain over margin and security requirements. Moreover, knowing that survival rates tend to increase with firm size, they try to impose stringent conditions on small loans (Cowling and Sugden, 1995).

However, a closer relationship between the borrowers and financing institutions may, to some extent, mitigate the problem. Cowling et al. (1991) argue that longer term funding necessitates stronger relationship between lenders and the borrowers. A close relationship influences the nature of the information provided (Berger and Udell, 1993). Good understanding between the borrowers and the financier can convince the latter of the operational environment, managerial attributes and the future prospects of the ventures to be financed. The owner of the unit has to provide detailed information about the functioning of the units while providing due attention to the suggestions and advice of the financiers. The

5. The real cost of lending to the small scale units is approximately twice that of lending to the large units. For an analysis of appropriate interest rate policies in the LDCs, Khatkhate (1980) may be seen. Saito and Villanueva (1981) in Philippines, Levy (1993) in Sri Lanka and Tanzania, Little (1980) in India have observed that "for any given expenditure on administrative appraisal and surveillance the cost varies in inverse proportion to the size of loan. The amount of appraisal and surveillance needed to attain a given degree of risk is higher for smaller enterprises" Rhodes (1983 a) has also contended that "the younger and smaller the companies, the less willing would be a bank to enter into long term commitments". Experience in many countries have authenticated that financial institutions primarily concentrate on large scale units and pay invariably inadequate attention to smaller ones (Dhungana, 1993).
development of a close working relationship between these two agencies has been identified as a weakness of the traditional Anglo-Saxon banking system (Yao-Su-Hu, 1984; Edwards, 1987). Binks, Ennew and Reed (1992) also extended some support to such a contention in their comparative study of medium sized enterprises in Germany, France and the UK. Using self assessed degrees of constraints Yotopoulos and Floro (1991) and Ennew and Binks (1995) contended that banking relationship do have a significant impact on the extent to which the business feel constrained. A good banking relationship is a crucial element in the provision of finance to business in general (Turnbill and Gibbs, 1987) and small firms in particular. However, a close examination of bank charges, interest rates, loan collateral and willingness of the banks to provide finance reveal that the small and medium industries are at a disadvantageous position in comparison to their large scale counterparts (Singh and Gupta, 1977; Bannock and Morgan, 1988; Hall and Lewis, 1988; Hutchinson and Mckillop, 1992; 1994). Banks appear to be somewhat apathetic towards the SSIs (Owulah, 1990).

The significance of credit market power of the financial institutions are curtailed by governmental regulation of financial markets with subsidized ceiling on the lending rates. But concessionary interest rates fixed by the government do not reflect the real cost of providing finance to small units (de Jong, 1983; Gordon, 1983; Bakhourm et al. 1989). These rates, in turn, make it highly unprofitable for the banks to lend to the small units in competition with other lending opportunities as the effective cost of lending is much higher in the case of the former.

In sum, inherent drawbacks of the small units like lack of standard securities, technical and managerial basics and business expertise stands on the way of the small units reaping the

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6. The effective cost of credit to the borrower or the effective gross return to a financial institution may have three components: the composite interest rate paid by the financial institutions on their liabilities, the rate of return obtained by the owners of the financial institutions on their equity capital and the transaction cost of managing assets and liabilities including administrative cost and expenses to cover risk of default on loans and losses on investment (Saito and Villanueva, 1981). However, a study by Churchill and Lewis (1985), on an American bank shows that though its loan in total to small business were costlier and riskier than to the large units, the former produced more deposits and were more profitable.
full advantage of institutional credit facilities (Rive Box, 1983).

There is no dearth of research works underlining various aspects of financial constraint of the small units. In the present study financial stringency of the small units have been studied broadly under three perspectives: Composition of funds - quality constraint, timely non-availability of funds - time constraint and high cost of funds - cost constraint.

3.2.2. QUALITY CONSTRAINT

Finance is required by the small scale units primarily to meet the initial fixed capital needs as well as subsequent working capital needs to support the ongoing production process. Working capital is necessary to enable small scale units to ensure sustainable flow of products to the market and gives them a free hand in operation by relieving them from the clutches of the suppliers and customers (de Jong and Kleiterp, 1991). Mead (1992) observes that though use of machinery and equipment are conditional upon access to credit, need for working capital is more pressing. Choudhury (1981, 1989) opines that working capital is more important for inducing higher productivity. A study by the National Institute of Small Industry Extension Training (NISIET) has observed that low working capital has contributed to idle capacity in small industries. Inadequacy of working capital leads not only to slow rate of turnover (Mazumdar, 1989) but also inability of the small units to carry adequate stock of raw materials and inventory, thereby causing low productivity (Lycette and White, 1989).

Barooah (1980), Dey (1980) and Deb (1993) have extended support the contention in their

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7. Some researchers have observed that the SSIs are constrained to avail formal finance no doubt, but operational performance of the units often enable them to overcome this obstacle at the micro level. Bates (1990) finds sanction of bank loan to the small scale sector in majority of cases, is conditional upon owner specific features, such as, equity capital input, owner human capital traits and owner demographic traits. Caplovitz (1973), Shapiro (1975), and Natarajan (1989) also attribute viability of small firms to family business back ground.

Many finance theorists trace a linkage between capital structure and financial structure (Scott, 1976; Smith and Warner, 1979; Summers, 1986; for collateral arguments, King, 1974; Auerbach and King, 1983; Broadway, Bruce and Mintz, 1984; Daly et al, 1985; and Meyer 1986 for tax related arguments, Rozeff, 1982 and Easterbook, 1984 for agency cost arguments; and Lintner, 1956 and Bhattacharya, 1979 for signaling arguments). Anderson (1990) does not find any locational impact on short term debt, but observes that firms with high capital labour ratio are more likely (and presumably find it cheaper and easier) to acquire debt than firms with low capital labour ratio.
Leidholm and Mead (1993), in a study of 3500 small scale units of Africa have observed that shortage of working capital was one of the major impediments leading to widespread sickness among the small units and this observation conformed with that of Steel and Webster (1992) in the case of Ghana. Interestingly, enterprises that have experienced higher rates of growth have undergone more pressing need for finance in comparison to those expanding at a slower rate. Therefore, Dhungana (1993) has recommended that working capital should be sanctioned along with the term loan, preferably by a single financial institution.

All the above studies have highlighted the imperative need for working capital for the inception, growth and sustainability of small scale units. For these units initial investment in the form of fixed capital is relatively small and forms a negligible proportion of the total productive capital. Therefore, the need for this category of capital may not be as pressing as that for working capital (National Federation of Independent Business, US, 1984, and Kurwijila and Due, 1991).

3.2.3. **TIME CONSTRAINT**

Timely non-availability of finance is another constraint eroding the viability of the small units. Procedural delay in the sanction of institutional finance aggravates the problem. The age-old and usual method of scrutinizing a loan application is to review financial statements, assess the projected cash flow and evaluate the offered collateral. A few financiers at times apply discriminant analysis to financial ratios in an attempt to distinguish between acceptable and non-acceptable borrowers. (Eisenbeis and Avery 1972, Fulmer, 1984; Johnson and Grace, 1990 and Maniktala, 1991).

8. A study carried out by the Directorate of Export Promotion and Marketing (1972-73) in Orissa reveals that 45.6 per cent of the small scale units under-utilized their capacity due to non-availability of working capital.

9. The time lag between the firms financial requirement and actual increase in productive capital stock may be divided into different components: information lag- the time required to know about various schemes for finance; decision making lag- the time taken to draft plans, arrange necessary documents to apply for it and delivery lag - the time gap between application and disbursement of loan. (Lund, 1971; Jorgenson, 1971; Rowley and Trivedi, 1975 and Nickell, 1978).
However, most of the paraphernalia are costly, lengthy and requires a number of well-trained staff. Levy (1993) has observed that with all necessary information, loan application in Tanzania take an average of six months even with side payments. On reviewing the process of loan sanction in 15 different institutions Dutta (1987) discerns between as many as 31 steps. Sharma (1982) also contends that procedural delay in the sanction of institutional finance inhibits the development of small industries. Therefore, it has been observed that small entrepreneurs are, at times, willing to pay a high price for credit for the advantage of speed and simplicity in the release of loanable funds (Tecson, Valcarcel and Nunez, 1989). The waiting time to avail institutional finance exceeds a minimum of three or four months, whereas a loan of the same amount could be sanctioned within a few days, even within a few hours from the informal sector. Slowness of the banks in processing loan applications has forced many borrower to rely on private money lenders (Stern, 1989).

Moreover, as revealed in a study by the World Bank (1989) in most of the developing countries, due to lack of effective financial market, supply of funds is largely limited to short term resources. A survey conducted by the Reserve Bank of India (1979) highlighted that neither the financial institutions nor the banks met fully the long term financial requirements of the small scale units.

3.2.4. COST CONSTRAINT

As a part of various supportive and promotional policy measures, institutional finance is made available to the small scale units at concessionary rates of interest. However, these loans are sanctioned on the basis of variegated information regarding the organization, functioning and profitability of the units. High cost of collection of such information and varied documents in support of the credibility of the units makes it difficult for the SSIs to secure institutional finance (Berger and Udell, 1993; Constand, Osteryoung and Nast, 1991; Keasey and Watson, 1993).

Some researchers have recorded that high risk borrowers like the small units could avail institutional support for finance by providing adequate collateral or margin deposition for...
loan. Provision of collateral can strengthen their status and can convince the financing institutions that
the borrowing units will perform to the best of their abilities (Bester, 1987). A sound collateral
backing makes the project self select and reduces the evaluation cost (Dempsey and Keasey, 1993).
This is largely because increased collateral deposit at a given rate of interest leads to transfer of risk
along with the imposition of effective cost of finance from the lender to the borrower /11/ (Mckillop and
Hutchison, 1994; Altman, 1985). High collateral or margin money deposition eliminates the problem of moral hazards and adverse selection (Chan and Thakor, 1987). It also goes a long way in reducing the transaction cost of small business lending as banks need not assess the
firm's activities, its characteristics, peculiarities of functioning and performance (Cowling and
Sugden, 1995).

However, Mckillop and Hutchinson (1991) have observed that imposition of collateral
standards are more detrimental to small industry borrowing. Many a bank stresses on high initial
margin money or collateral deposit prior to loan sanction. This is perhaps to exploit their dominance as
the major, at times the single supplier of small business finance (Cowling and Sugden, 1995). This
affects the small firm borrowers significantly (Cowling, Samuel and Sugden, 1991). High average
security ratios on small business lending is often traced. Cowling and Sugden (1995) recorded an
average security ratio two times the loan value while Binks, Ennew and Reed (1988) found the ratio

11. However, empirical evidences do not suggest any concrete example of collateral posting and
risk reduction. Binks et al (1988) observed that 30 per cent of the firms availing institutional
finance were not required to post collateral while Cowling et al (1991) estimated the figure at 21 per
cent. Berger and Udell (1991) observed that nearly 70 per cent of all commercial and industrial
loans in the US are made on a secured basis. In Bangladesh collateral ranging from 120 to 130 per
cents of the loan are demanded by the financing institutions to avoid the risk of non-repayment (Choudhury, 1991). Konlg and Koch (1990) have found the importance of collateral in bank credit in
Colombia. Barro (1976) predicts that posting of collateral leads to reduction in margin money
deposition while Buck, Friedman and Dunkleberg (1991) observe no co-relation between the two.
Risk of an individual loan depends upon the investment portfolio of the lenders (Stanley and Ford,
1986; Ford and Stanley, 1988; Paroush, 1992 and Ford, 1994). Risk element could be reduced to a
large extent by distributing the loan portfolio over a large number of customers or lending for non-
diversifiable purposes. Pyle (1971), Hart and Jaffee (1974), Koehn and Santomero (1980), and have
applied these portfolio theory to the asset decision of the financial institutions. Some variations of this
approach are: prescription of adequate repayment rates to cover delivery and supervision costs
(Kurwijila and Deu, 1991) and different loan pricing models based on cost of funds, origination costs
and compensating balances (Cramer and Sterk, 1982; Brick, 1984; Johnson and Grace, 1990; and
Ferari, 1992). But lack of a systematic procedure for including uncertainty will yield variations in
pricing of risk among banks (Edminster, 1984; Slater, 1986; Snyder, 1988; and Wyman, 1991).
on new loans ranging between 1.5 to 2.0. Binks and Ennew (1993) observed the ratio on overdrafts to be as high as 2.

Transactions charges form a major element in the cost of small industry borrowing. Short term borrowing is found to be costlier than long term loans (Cowling and Cressy, 1993). Natarajan (1989) has attempted to estimate the grease money component of the firm’s cost of borrowing from institutional sources.

3.3. LIMITATIONS OF COCESSIONARY CREDIT

In order to remove the disadvantages of the small industries in processing institutional finance, governments in many countries have provided to them concessionary credit facilities. Though flourishing under political patronage, such schemes are considered by many professionals ‘self-defeating’ (World Bank Policy paper, 1978) on account of the problems they create in the supply and use of funds. Considering the supply aspect, the laws, institutional framework and macro economic policies within which the financiers have to operate leave a little scope for exercising free hand in loan deployment and pricing (Padaverthan, 1983). The prospective as well as existing entrepreneurs in less developed areas have fewer options in obtaining finance. On the contrary, concessionary credit makes the borrower slipshod about the use of funds, causing misallocation of productive resources (Siebel and Parhusip, 1990; Patten and Rosengard, 1991).

Demand for concessionary finance being much larger than available funds, automatic screening devices involving endless paper works and cumbersome procedure develop, as a result of which unnecessary delay is caused in loan sanction. Small units find the application procedure to be too complicated, more so because they lack the necessary information on enterprise record, financial plans and so on (Morewagae, Seemule and Rempel, 1995; in a survey in Botswana, Dutta, 1987; for India, Levy, 1993; for Tanzania). These studies further reveal that small units value smooth and easy availability of finance more than concessionary interest charges.

A number of studies have questioned the efficacy of concessionary credit in supporting the small scale sector. Morewagae, Seemule and Rempel, (1995) on the basis of their study in Botswana do see a financial constraint facing these small industries at the macro level. In their view due to faulty institutional framework and distorted programmes for loan sanction, credit does not reach the needy borrowers. To quote Fry (1988) “Specifically financial repression and the ensuing credit rationing worsen income distribution and increase industrial concentration. The evidence presented indicates that subsidized credit policies discriminate against rather than favour small borrowers”. Concessionary finance naturally attracts and is often absorbed by influential borrowers who can afford institutional finance on commercial terms (Anderson and Khambata, 1985).
In the case of Nigeria, it is observed that faulty government policies in this country has resulted in diversion of funds in favour of inefficient units offering high collateral while those with sound market prospects suffer. Artificially low rate of interest results in laxity of the borrowers in the use as well as repayment of loans. Concessionary rate of interest creates an excess demand for credit resulting in diversion of funds to inefficient, at times, counter productive purposes.

Though offered at a concessionary rate of interest cost of credit is not low for the small scale entrepreneurs. Credit suppliers, generally being profit seekers are likely to add hidden charges raising the effective cost of loans much above the concessionary interest rates (Adams and Nehman, 1979). Concessionary rate of interest does not enable the financial institutions cover their transaction cost comprising administrative cost and risk. As transaction cost varies inversely with loan size the financial institutions ultimately concentrate on low-risk large-scale borrowers (Harris, 1977; Anderson and Khambata, 1985; Olashore, 1985; Tecson, Valcarcel and Nunez, 1989).

Low interest rate is incidental to concessionary credit. Low loan rate ceiling which is insufficient to cover costly small sector advances not only discourages loan sanction but also retards the growth of savings too (Callier, 1990).

Siebel and Parhusip (1990) contend that subsidization leads to restriction of credit mobilization, misallocation of funds and reluctance of the financiers to give small scale units a fair deal. In a comparative study of the institutional financial systems in Japan and Nigeria, Owulah (1988) concludes that in Japan banks have in fact grown with small business. On the contrary those in Nigeria are critical of government regulations and restrictions which militate against their inclination to lead. Targeting or restricting credit to specific groups like small industries sector only results in short term accessibility without any long term productive return. Many instances cite rejection of subsidized finance by the targeted clientele. Oyejide (1991) observes that both the commercial and merchant bank credit allocated to the small and medium enterprises increased progressively in Nigeria during the period of liberalization when interest rate escalated sharply. This shows that profitability

12. It is calculated by the researchers that one rural credit programme in Thailand having a nominal interest rate of 12 per cent per annum actually costs the applicant the equivalent of 54 per cent on a one year loan, exceeding the expected cost of borrowing from an informal lender.
13. Concessionary loans have often been confined to financing of fixed capital assets when the greatest need in small business is for working capital. Lack of working capital often reduces employment generation (Elkan, 1989).
and sustainability of an unit is the final criteria for selection of a client (Rudkins, 1994). Remenyi (1991) observes impressively high on-time repayment rates and low default rates combined with commercial interest changes, is favoured by institutional financiers.

Effective controlling and monitoring system not only escalates the cost of loan to the lenders, but also reduces the practical value of the loan to the client (Kilby, Liedholm and Meyer, 1981). Concessionary credit causes high capital intensity (Bolnick, 1982) in the small scale industry as cheap capital is substituted for labour. When finance is availed at commercial conditions it reflects high cost of capital which forces the entrepreneur to utilize appropriate technology by employing proportionate amount of capital and labour (de Jong, 1983). Therefore, in some cases performance of non-assisted units is better than or at least as good as that of the assisted units (Sandesara, 1988).

Another dark side of concessionary finance is that it makes the cost of borrowing ostensibly low and tempts the borrowers to default the loan as a result of which the present value of the expected costs of bankruptcy of debt financed units also increases with the passage of time (Brennan and Schwartz, 1978/14). Excessively supportive credit system leaves little scope for self actualization of the small units. In a survey of 672 enterprises in Kumasi, Dawson (1990) observes that phenomenal upsurge in the SSI sector over a period of one and half decades has occurred without any official assistance.

In a nutshell, concessionary credit often fails to meet its objectives. Therefore, unsubsidized credit granted on a commercial approach is always more self evaluating (Dhar and Lydall, 1964; Jackelen and Rhyne, 1991) and helps the more efficient units.

Limitations of the financial system, apathetic attitude of financiers and low accessibility of small units to institutional finance has resulted in increased reliance of these units on the informal sector. Liedholm and Mead (1987) reveal that less than 1 per cent of credit of small firms come from formal sources. M.Dijk (1983) has estimated that, in general, proportion of the informal credit ranges from 25 to 33 per cent of all legal financial credit small industries in countries like Korea, India, Pakistan etc. In fact, the convenience, flexibility and accessibility has made the informal sector preferable to the formal one (Bouman, 1981; M.Dijk, 1983; Sandaratne, 1989 and Albee and Reid; 1992, Stewart, 1990; Ahamed, 1988; Ndlela, 1988; Sophie, 1993). Das Gupta, (1989) observes that the share of informal

14. While Brennan and Schwartz (1978) have concluded that high degree of leverage may reduce business survival by raising chances of default, Bates (1991) observes no positive correlation between high leverage and firm failure.
credit is about 73 per cent of the gross credit available in countryside and it works as a shield against allocative inefficiencies of institutional finance (Wogart, 1993). Sharma (1990) attributes reliance of small industries on informal credit to unsatisfactory customer service of the formal sector. Timberg and Aiyar (1980) favour the expansion of the informal sector to help reducing the transaction cost of credit as in this sector, loan is sanctioned purely on the basis of borrowers’ need and integrity, without adherence to any rigid screening procedure/15/.

The experiences of the small scale industries with the informal sector, financing is not without pinches. Abugre (1993) has observed that small enterprises encounter difficulty in obtaining both formal and informal finance as well. The informal sector is dominated by money lenders who are malignant and exploitative, charging exorbitant rates of interest with unfavourable conditions of lending. On the other hand, formal financial systems are limited and are often manipulated by the rich. Niser (1987) observed that 70 per cent of the small units in Nigeria obtain most of their investible funds from personal savings/16/. With meagre profit to recycle not only the small units, the economy as a whole is caught in a vicious circle of lack of capital leading to industrial backwardness, and industrial backwardness via its effect on the level of income leading to lack of capital (Alexander, 1963).

Investment pattern of the small industries in Orissa tells no different a story. The weak capital structure is marked by predominance of funds generated internally and from informal sources. Despite low living condition, low per capita income and consequent low savings, the share of the internal sources of finance in small scale units of the state is 31.2 per cent on an average, which is higher than the all India level (28.2 per cent). It is also above the limit prescribed by the IDBI. Moreover, share of the non-institutional sources of credit in the financial structure of the small industrial units of the state has remained around 11.9 per cent, compared to 10.2 per cent at the national level. Reliance of the smaller and traditional units on the informal sources, with an interest rate ranging from 48 to 60 per cent per annum, is more than that of the large industries (Biswal, 1984).

15. Christen (1989) and Salas, Weiland and Stearns (1991) hold the view that financial institutions in developing countries should operate with a strategy followed by informal sector practices. Grameen Bank of Bangladesh, Bank Rakyat Indonesia (BRI) Unit Desa System, Indonesia and Prodem of Bolivia have succeeded primarily due to this.

**WHY THE STUDY**

Realizing the importance of the small scale industries for an economy, the obstacles on the way of its development have been examined exhaustively. These studies reveal the impediments to be micro-specific in nature and are largely influenced by the socio-politico-economic dynamics of the region. Therefore, no standardized panacea having universal applicability could be prescribed. Various supportive and developmental policy measures do favour industrialization but drawn at the central level these measures hardly take care of the region specific rigidities and constraints. However, almost all the studies are unequivocal about the role of infrastructural and financial bottlenecks in slow industrialization in relatively back-ward areas.

A good deal has been written about the functioning of the financial markets in the underdeveloped countries. These studies have not only been analytically illuminating in examining various aspects of the financial constraints of the small industries but have also provided exemplary solutions. But as stated above, these findings and prescriptions have not succeeded in initiating a process of first industrialization in a richly resource endowed but back-ward state like Orissa. Plentiful physical resources in the state have remained unharnessed due to lack of financial capital.

Functioning of the financial market in the state is imperfect for which availability of capital to the small scale sector is scarce and diffused. Undependable entrepreneurial talent has added to the problem. Administered ceiling on interest rates accompanied by various capital investment subsidies has failed to solve shortage of capital of these units. This poses a riddle before the academia, policy makers and financial institutions: why is the flow of funds from the institutional sources to the small scale sector inadequate and uncertain? Is it due to the hesitation of the financial institutions or defective policy implementation or the deficiencies in the SSI sector itself? What is the right step to overcome these hurdles? The present study is an attempt to throw light upon some of these issues.

**OBJECTIVES OF THE STUDY**

The study broadly aims at:

1. evaluating the role of financial institutions in financing the SSI units in the state;
2. examining the various approaches, such as area specific, need based or performance based, adopted by the financial institutions in extending finance;
3. underlining the constraints of the SSI units in securing institutional finance;
4. ascertaining the cost of borrowing for the SSI units and
5. assessing the repayment performance of the SSI sector.
LIMITATIONS OF THE STUDY

The study is based mainly on the data collected from the small scale entrepreneurs through well structured questionnaires. The financial problem of the sector has been discussed from the demand side only. Not much insight has been given to the supply aspect, i.e. the problems encountered by the financial institutions in extending support to this so called risky sector.

The study throws light on the cost of concessionary finance to the borrowers but the significance of this financial support for the SSI units has not been looked into.