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Do Programs Mandating Small Business Lending Disincentivize Growth?: Evidence from a Policy Experiment

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1. Background

It is well recognized that firms in emerging markets, especially small firms, face significant credit constraints.[2] The 2013 World Bank enterprise survey finds that 41% of small firms in the least developed countries perceive that lack of access to finance is a major impediment in achieving high growth. In middle and high income countries, a still significant 30% and 15%, respectively, report access to credit as a problem. The financing frictions faced by small firms are of broad economic and policy interest because small firms are an important source of employment in almost all countries of the world and India is no exception. In 2015, the SME (Small and Medium Enterprises) sector had 36 million units employing 80 million people and accounted for 45% of the manufacturing output and 40% of India's exports.[3] Given its importance in employment, the SME sector is politically sensitive and is subject to periodic interventions. One such intervention in India is the mandate on banks to direct 40% of their credit to the priority sector.[4] We examine the impact of priority sector lending on SME growth in India.

2. Issue at Hand

Despite the existence of priority sector lending for over three decades, Indian firms, even to this day are considerably smaller and employ less workers compared to comparable countries in both east and the west. We ask if such a state of affairs is an unintended

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2 Please refer to our full working paper for relevant citations.

3 http://www.smechamberofindia.com/about_msme_in_india.php

4 Priority sector includes agriculture, SMEs, low cost housing, education loans below a specified limit, among others.

consequence of the priority sector lending program. Our main point is that while policy mandates push credit to small firms, they can inhibit enterprise growth. The intuition is as follows. The financial resources supplied by the directed lending program are scarce. Indeed, this scarcity of credit is the very reason for the directed credit program to exist. If current program beneficiaries grow, they no longer qualify for priority credit and can thus face diminished access to credit for future growth. Under pressures to meet priority sector lending targets, lenders need to replace firms that grow and exit directed credit programs. Exit by larger firms poses greater challenge as they have greater quantitative effect on lending volumes. Slowing the growth of these firms allows banks more time and head room to meet program quotas, avoid the shortfall penalties (Fines are imposed if a bank fails to lend the mandated amount to the priority sector), and defer the search costs of finding replacement borrowers. Firms at the upper threshold and their bankers may find it mutually beneficial to slow growth trajectories to accommodate adjustment costs of exit from program eligibility.

3. Research Design

The priority sector program rules specify that a firm is considered as an SME only if its total investment in plant and machinery does not exceed a threshold. This limit was revised upward from INR 10 million to INR 50 million in September 2006. Firms which increase their total investments in plant and machinery beyond INR 50 million lose the priority sector tag in the year when the threshold is crossed.

The new limits assign firms to the priority sector program for reasons not connected with normal business or economic situation. Some firms are closer to the exclusion criterion of INR 50 million compared to others and hence face an impending threat of moving out of the priority sector. If financial constraints bind, willingness to stay inside the priority sector limit is likely to be higher for such firms when compared to firms which are far away from the upper threshold. Therefore, we examine whether firms that are closer to the upper threshold slow down their investments in plant and machinery when compared to firms which are far away. We then test for other real side consequences such as output and profitability, trace out sources of heterogeneity that help to pin down channels. We use firm level data provided by Center for Monitoring Indian Economy (CMIE) for conducting our analysis.

4. Results

We find that the growth rate of investment in plant and machinery of SMEs that are close to the upper threshold of INR 50 million is lower by 2.9% to 5.1%, relative to firms that are far away. We then examine the economic activity levels of SMEs that are closer to the upper threshold. The idea is to examine if the slowdown in plant and machinery growth is a result of an accounting reclassification by firms wishing to preserve the priority tag. Thus, the test serves the purpose of differentiating between accounting adjustments in plant and machinery and changes in real activities of SMEs. We find that SMEs that are closer to the upper threshold reduce capital expenditure by 31% in the post regulation period. We exploit the fact that the SME cutoff applies to manufacturing firms and that our data records the power consumption of firms. Power is, of course, a key input into manufacturing and a slowdown in power consumption is a unique signal of real effects. We find that power consumption goes down by 12.5% for the SMEs near the upper threshold relative to those which are far away.

We perform two additional tests. First, we obtain priority sector lending volumes from bank financial statements. In India, borrower financial statements give data on bank relationships with borrowers. We classify SMEs based on the priority sector lending of the banks they borrow from. For example, an SME is classified as SBI-funded SME if it receives priority credit from SBI. We hypothesize that chances of losing access to credit are higher for near threshold SMEs that borrow from banks under pressures to meet priority sector lending targets. For such priority credit-target-challenged banks and threshold borrower combination, the pressure to slow growth of the SME should be higher. We find such a result. The converse viewpoint is from the firm's side. Among the threshold firms, the threat of losing access is likely severe among the more credit constrained firms. Extant research shows that age and size are two important determinants of credit constraints; younger and smaller firms tend to be more credit constrained. Thus, our second additional test asks if slowdown among firms at the threshold is concentrated within young firms. We find that this is the case. [5]

5 We could, in principle, also sort on total assets, which is the definition of size in the finance literature. However, this specification is awkward given that a subset of total assets, viz., plant and machinery, is already used to assess program qualification. Nevertheless, in unreported results, we find similar results.

In the final part of the paper, we examine the effects of lending mandates on the size distribution of new firms. For this purpose, we use the data from Annual Survey of Industries (ASI) maintained by the Ministry of Statistics and Program Implementation (MOSPI). We find new establishments clustering around the INR 50 million mark around the year of the change. More interestingly, a large proportion of existing SMEs begin to grow and cross the lower threshold INR 10 million mark. Thus, statutorily set financing limits that are ad-hoc from an economic viewpoint determine the sizes of startups. Credit supply influences the nature of firm formation.

5. Proposed Solution

The problem that we point out in this paper is likely to persist as long as the directed lending program categorizes firms as SMEs based on a threshold and financial constraints bind. In the long run, the issue can be completely addressed if steps are taken to ameliorate financial constraints faced by SMEs. While initiatives such as the recently launched MUDRA bank for SMEs certainly help in this regard, a permanent solution lies in ensuring overall institutional development. This entails development of a sound credit infrastructure that reduces credit constraints.

However, in the short run, a slight modification in the program design recently implemented by the Reserve Bank of India is likely to reduce the distortionary effects pointed out in this paper. As per the new rules, a firm continues to be classified as a SME for 3 years after crossing the upper threshold of the SME definition. Due to the above change, SMEs near the threshold do not face the threat of being excluded from priority sector tag immediately after crossing the threshold. Banks, on the other hand, are spared of the efforts to find a new borrowers as soon as the current priority sector borrowers cross the threshold.

6. Critique of the Proposed Solution

Admittedly the above solution only postpones the problem by the number of years of extension. In spirit, the modified design can be represented as pushing the threshold three years back. A critic may argue that if firms can find alternative market financing within three years of crossing the SME threshold, then they should be able to find such financing immediately after crossing the threshold if they start search efforts three years before. Put simply, if a firm that crosses the threshold in year x and can find financing before year x+3, then the same firm should be able to find financing in the year x if the search effort is initiated in the year x-3. Analogous arguments can be made regarding banks as well. However, it is important to note that it may not be possible for firms to perfectly predict the year in which they are likely to cross the threshold and work backwards. To that extent, our proposed short term solution may reduce the distortionary effects pointed out in this paper. As pointed out above, long term solution lies in ensuring overall financial development.

7. Conclusion

In sum, we highlight an important and unintended cost of small business lending mandate which aims at improving access to finance for small firms. While newly eligible firms at the lower thresholds are free to expand, firms at the upper threshold barrier can slow, particularly for credit constrained firms and priority lending-target constrained banks. Programs intended to help one set of firms constrain others. These findings contribute to the literature on firm size and growth. It has been found that in countries such as India and Mexico, many establishments are born small and remain small while U.S. establishments grow 6 to 9 times during the first forty years of their life. Our findings suggest that access to finance may be a contributing factor to the small size phenomenon.