SMEs—The Creative Leaders of India: In Search of an Enabling Environment

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Abstract

Poverty is perhaps the greatest threat to human rights, at least in most developing economies. The curse of poverty weakens the system and defeats all socio-political processes that are targeted at ensuring human rights. Therefore, if the goal of realizing human rights has to be achieved, the challenge will be to reduce poverty.

Historically, state-funded poverty alleviation programs in developing countries like India have generally proved to be inept. Their efficacy is often doubtful. Studies show that such programs have failed to live "up to the market" and are too burdened by bureaucratic controls. At the same time, the small and medium enterprises (SME) have played a crucial role in evolving an alternative pathway that is more market-oriented and spirited for poverty alleviation and income generation among the marginalized groups. SMEs are the creative leaders who have an enormous potential to "eradicate poverty through profits" and "enabling dignity and choice through markets." Such ventures have a potential to empower "the bottom of the pyramid" and ensure that the puzzle of realizing human rights is solved. But the creation and sustainability of such creative leadership is threatened by numerous bottlenecks that have not been removed by the traditional support programmes. It is time that we delve into innovating measures that support the creation, sustainability and growth of these creative leaders who play a crucial role in removing the curse of poverty and inequality, and ensuring human rights. An appropriate support system needs to be in place.

Development and Human Rights

A "welfare state" committed to the development of its economy has to ensure economic and social security for its population. The basic principle of human rights is not fulfilled unless the state grants certain inalienable entitlements in the form of social and economic rights. And it should be supplemented with a firm commitment from the governments to ensure such rights across time and across space.

On a closer scrutiny of the basic principle of human rights, at a micro level, a person is entitled to the right to work and generate income to support his family—present and future. At the macro level, the human right principles ensures a nation's collective right to economic development. All other principles of human rights are defeated unless this basic principle is ensured. Employment generation would ensure income generation and hence reduce the incidence of poverty—one of the major challenges confronting all developing nations.

For long, there has been a perceived dichotomy between human rights and economic development. However, if one adheres to the basic principles of human rights, this dichotomy vanishes. Mary Robinson in her speech at the Preston Auditorium, Washington D.C. in 2001 says:

> Lawyers should not be the only voice in human rights, …equally, economists should not be the only voice in development. The challenge now is to demonstrate how the assets represented by human rights principles, a form of international public goods, can be of value in pursuing the overarching development objective, the eradication of poverty.

By itself poverty is a global problem of huge proportions. One in five people in the world live in abject poverty.[1] About 50% of the world population survives on less than USD 2.00 a day. As per the World Bank definition of the poverty line for underdeveloped countries like India, this

1 Clare Short, Poul Nielson, Mark M. Brown, and James D. Wolfensohn. *Linking Poverty Reduction and Environmental Management Policy Challenges and Opportunities* (DFID, Directorate General for Development European Commission, UNDP and World Bank, v. Washington, D.C.; The World Bank, 2001).

is USD 1.00 per person per day. In India 75% of the population survives on less than USD 1.00 a day.[2]

The United Nations Committee on Social, Economic and Cultural Rights, 2001 (Poverty and Human Rights: UNESCO's Anti-Poverty Projects) defines poverty as "a human condition characterized by sustained or chronic deprivation of the resources, capabilities, choices, security and power necessary for the enjoyment of an adequate standard of living and other civil, cultural, economic, political and social rights." By this definition, the denial of human rights is inherent in poverty. Poverty denies a person the choice of alternatives—economic, social and cultural—that can better his life. Poverty ensures that all principles of human rights are violated. Thus human rights and poverty are not mutually exclusive—as human rights cannot be ensured without alleviating poverty.

Eradicating poverty must therefore be the first goal of this new millennium, as without achieving this task it will be a very tall order to achieve the remaining Millennium Development Goals.

Challenges Facing India

Since the late twentieth century, India has emerged as a dominant economic force in South Asia. Today the Indian economy has become the second fastest growing economy in the world. However, several development issues still have to be resolved if the country is to emerge as the true leader of many a developing nation.

Poverty is one of the most distressing problems facing the Indian economy. The poverty line, according to the Government of India, is defined as approximately USD 9.00-13.00 per person per month. About 75% of the Indian population survives on less than USD 1.00 per day. The Indian government is committed to the United Nation's Millennium Development Goal of poverty reduction by 2015. In fact, eradication of poverty has long been an integral objective of the Indian Plan process. Since the Fifth Five Year Plan (1974-79) the government has made poverty reduction a primary goal of the Indian development process. One of the major objectives of the Sixth Five Year Plan, which commenced

2 http://www.wakeupcall.org/administration_in_india/poverty_line.php

in 1980, was to undertake measures for progressive reduction in the incidence of poverty and unemployment. The Planning Commission in the Sixth Plan Document (1980-85) realized that "it will not be realistic to rely solely on the growth process to find a solution to this problem." It therefore suggested specific policy measures to influence the composition of output in favour of mass consumption goods in order to stimulate the labour intensive rural sector and small-scale industries. To this effect, the Sixth Plan launched the Integrated Rural Development Programme (IRDP) that aimed at distribution of several income earning assets among the poorest households in order to bring them above the poverty line. The National Rural Employment Programme (NREP) was also introduced to provide wage employment to the rural population who did not possess adequate income earning assets. Over the years the Plan process continued to upgrade and introduce better employment generation cum poverty reduction schemes. The Eleventh Plan (2007-2012) intends to generate 70 million new work opportunities and reduce educated unemployment to below 5%. The Plan document also proposes to raise the real wage rate of unskilled workers by 20% and reduce the headcount ratio of consumption poverty by 10%.[3]

Despite the various poverty alleviation schemes, poverty reduction targets are yet to be realized in India. Widespread poverty has generated income disparity in the Indian social structure. In a socialist state each member of society is entitled to equal opportunities in occupation, education, social security, and others. Hence it is imperative for "Socialist" India to reduce income inequality and make grassroots access to employment opportunities the means by which the quality of life can be improved. One important cause for this income inequality is uneven industrialization across regions. The resultant regional disparities and income inequalities has led to conflict, which needs to be resolved if overall development is to be achieved. Therefore the challenge for India is to create employment opportunities at the grassroots level, ensure sustainable income generation schemes, and reduce spatial inequality and conflict.

3 Planning Commission, Government of India: Five-Year Plans. http://en.wikipedia.org/wiki/Five-Year_Plans_of_India, http://planningcommission.nic.in

SME Development
An Alternative Pathway for Poverty Reduction

According to conventional wisdom on development, it is industrialization that brings about a plethora of opportunities for generating employment and income. The benefits of industrialization are characterized by both "spillover" and "cascading" effects. In India, rapid industrialization has proved to be a key constituent in economic growth and development.

However, there exists a debate on whether to rely on large corporations or small and medium enterprises (SME) as engines of growth and development. With globalization, the large corporations, with access to global markets, are increasingly having the option to shift to greener pastures in the international arena. They use capital-intensive technologies—causing widespread retrenchment and lay-offs. At the same time, these economic entities are increasingly generating a demand for skilled personnel. To gain competitive advantage, most of them, reluctant to put all their eggs in one basket, are reducing dependence on any particular country or region. Trans-national corporations are diversifying their operations to more than one country to reduce country risk and leverage the cross-subsidy advantage. Thus on a closer look, it appears that the large corporations are actually situated far away from the core of the country.

The possible pathway for generating employment and income among the grassroots lies in promoting the innumerable SMEs who have the ability to achieve this objective and better the socio-economic health of the country. India has to draw inspiration from the experiences of Japan, China, EU and the ASEAN tigers who had taken up SME development as a means of achieving the goals of sustainable development.

SMEs—The Creative Leaders

Not only in India, but also across the world, the SME sector makes a tremendous contribution to the economy. Such contributions have multiple facets and dimensions. SMEs generate new jobs in the economy and, thus, contribute positively to employment generation and poverty reduction. Further, it is claimed that this additional employment comes with relatively low investments in capital compared to the large enterprises, and therefore, has a lot of relevance for those economies that are characterized by surplus labour and paucity of capital.

According to the Micro, Small and Medium Enterprise Development Act (MSMEDA), 2006, the micro, small and medium enterprises in India are defined as follows:

Table 1: Definition of SME in India

Nature of the Enterprise	Micro Enterprise	Small Enterprise	Medium Enterprise
Manufacturing sector	Investment in plant & machinery does not exceed INR 2.5 million (USD 62.5 thousand)	Investment in plant & machinery more than INR 2.5 million (USD 62.5 thousand) but does not exceed INR 50 million (USD 1.25 million)	Investment in plant & machinery more than INR 50 million (USD 1.25 million) but does not exceed INR 100 million (USD 2.5 million)
Service sector	Investment in equipment does not exceed INR 1.0 million (USD 25 thousand)	Investment in equipment is more than INR 1.0 million (USD 25 thousand) but does not exceed INR 20 million (USD 500 thousand)	Investment in equipment more than INR 20 million (USD 500 thousand) but does not exceed INR 50 million (USD 1.25 million)

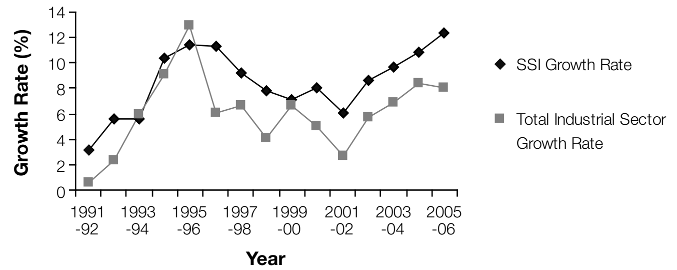
According to the 3rd All India Census of Small Scale Industries (SSI) 2001-02, there are about 10.52 million SSI units in the country. About 55% of these units are based in rural areas. Six hundred seventy-two different kinds of activities, as per the National Industrial Classification (NIC) 1998, are pursued by the small industries sector.

According to the date of the initial production as recorded in the census, it appears that almost 74% of the small-scale units came into existence after 1990. Such a high percentage of SME growth is perhaps explained by the "new-found synergy" among the economic policies aimed at globalization and liberalization that initiated an era of increased incentives. Small firms have added to the flexibility of the industrial

structure and promoted economic dynamism. Flexibility is enhanced through the SME's suppleness in substituting factors of production and their ability to adjust faster to the economic shocks.[4]

The gross output in the SSI sector is approximately USD 70.56 billion. This sector is one of the fastest growing sectors in the Indian economy. During the period from 1991-92 to 2005-06, the growth rate of the SSI sector has remained well above the overall industrial growth rate of the economy (diagram 1).

Diagram 1: Growth Rate: SSI Sector vis-a-vis Total Industrial Sector (1991-92 to 2005-06)



Source: *History of Small Industries Development Organization (1954-2004)*

SMEs are believed to be the "seedbed" for industrial growth. These entities generate entrepreneurial psyche in the society, which, in the long run, contributes to sustainable economic growth and development. SMEs facilitate technology transfer and innovation, which are key determinants for economic success in this globalization era. SMEs also promote competition within the economy while providing flexibility to the overall industrial structure. This competition and flexibility are essential parameters for spearheading greater economic dynamism.

Studies by David Birch[5] showed small businesses as engines of jobcreation in most economies.[6] In India, the small business sector

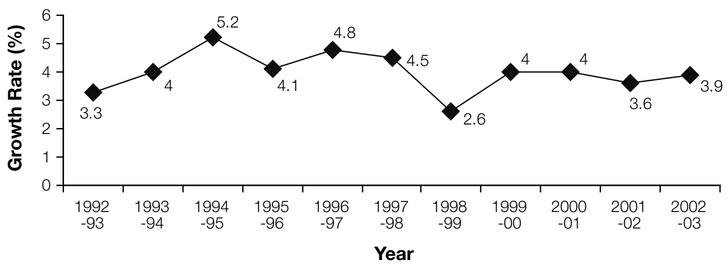
4 Z. Acs and D. Audretsch. *Innovation and Technological Change: An International Comparison* (Ann Arbor: University of Michigan Press, 1993).

5 D.L. Birch. *The Job Creation Process* Final Report to The Economic Development Administration. (MIT Program on Neighborhood and Regional Change. Cambridge: The World Bank, 1979); *Job Creation in America: How Our Smallest Companies Put the Most People to Work* (New York: Free Press, 1987).

6 Birch's study about the US economy shows that in the 1970s, firms with less than 100 employees had

absorbs a sizeable proportion of the population in the working age group. As per the 3rd SSI census, total employment in this sector is 24.93 million, with per unit employment being 2.37 persons. The sector also exhibits an impressive growth rate in employment. The growth rate of employment in the Indian SSI sector is shown in diagram 2.

Diagram 2: Growth Rate of Employment in the SSI Sector: 1992-93 to 2002-03



Source: *Ministry of Commerce & Industries, Government of India.*

Comparing this data with the overall growth rate of employment in the economy, it appears that the SSI sector acts as an engine for fuelling the growth of employment in the economy. During 1987-88 to 1993-94, the overall growth rate of employment in the economy was 2.43%, while the growth of employment in the SSI sector was close to 4%. During the period from 1993-94 to 1999-2000, the overall employment growth rate was 0.98% while the employment in SSI sector grew at close to 4% per annum. There is no denying the fact that the small-scale sector absorbs a major proportion of the population in the working age group.

During the 10th Plan, it was expected that the SSI sector would continue to create new job opportunities for the increasing work force.[7] While the large enterprises were expected to create 1.43 million new jobs, the SSI sector has been envisaged to create 3.86 million new jobs. Thus, the small industries sector in India continues to be a major driver for employment in the economy.

generated 80% of the new jobs.

7 See, Employment Generating Growth (2002), Planning Commission, Government of India

However, one area of caution is that given the high mortality rate in the small industry space, a sizeable number of jobs might get "destroyed" every year. The "net job creation" is therefore important. In many economies, it has been found that it is the large corporations who contribute more positively to the net job creation compared to the small business segments.[8,9] Another area of concern is the quality of jobs created by these small-scale industrial units, particularly with respect to the wage differentials. The wage differential between large firms and SMEs for similar job categories has been found to be about 35% in the advanced countries[10] and about 50% in the developing countries.[11]

In India, the SSI sector contributes to more than 30% of the total exports, both directly and indirectly. High transaction costs in dealing with the international markets might have deterred some small firms to directly export,[12] as they face the burden of cost of acquiring and processing information, and have difficulty in coping with export opportunism and other contract enforcement problems. However, as indirect exporters, the SMEs add critical flexibility and provide "just-in-time" benefits to the supply chain of the larger exporters, thereby reducing the overall cost of the value chain. This cost efficiency is a critical success factor for competitive advantage in the international markets.

In India, the SMEs are closer to the "bottom of the pyramid" and they contribute to employment and income generation, closing the rural-urban gap, reducing spatial inequalities, changing the power structure, and resolving conflicts between income groups and across regions.

The SMEs are the creative leaders who have the potential for poverty

8 T. Biggs and M. Shah. "The Determinants of Enterprise Growth in Sub-Saharan Africa: Evidence from the Regional Program on Enterprise Development." *RPED Discussion Paper* (The World Bank, 1998).

9 Authors discuss about surveys in the five countries of sub-Saharan Africa, which show that over a three year period in the early 1990s, large enterprises with over 100 employees were a dominant source of net job creation in the manufacturing sector. These were mostly countries where there had been net job addition during the period. In Ghana, 56% of the net job creation was by large enterprises, in Kenya the figure was 74%, in Zimbabwe it was 76%, and in Tanzania the figure was 66%. Only in Zambia, where there was net job decrease during the period, the small firms performed better than their large counterparts.

10 C. Brown, J. Hamilton, and J. Medoff. *Employers: Large and Small* (Cambridge, MA: Harvard University Press, 1990).

11 The World Bank. "Workers in an Integrating World." *The World Development Report* (Washington D.C.: The World Bank, 1995).

12 B. Nooteboom. "Firm Size Effects on Transaction Costs." *Small Business Economics* (vol 5. no 4., 1993).

eradication, thereby helping the country to cross the first hurdle for ensuring human rights principles.

SME Growth Constraints in India

During the period from 1990-91 to 1999-2000, the number of SSI units grew at a CAGR of about 5.75%.[13] However, a typical phenomenon that characterizes this segment is a high growth rate accompanied by high morbidity. Assuming sickness to be an indicator of morbidity, on an average, 8-10% of the SSI units were reported sick during the same period.

The results of the 3rd All India Census of SSI reveal that the bottlenecks related to marketing and access to finances are the key reasons for this sickness. The sector as a whole is fairly weak in terms of bargaining power vis-à-vis its customers. The phenomenon is strengthened by the fact that many players in this segment cater to the large companies and, hence, are fairly small (in size and capacity) with respect to such customers. Most customers have the options of switching small suppliers and also purchasing from the international market. Muniappan[14] points out that the predominant internal factors for sickness include diversion of funds, taking up economically non-viable projects, time/cost overruns during the project implementation stage, business failure, inefficient management, strained labour relations, inappropriate technology and/or technical problems, and product obsolescence. Among the external factors contributing to sickness are: recession, non-realization of receivables, inputs/power shortage, price escalation, accidents and natural calamities.

Because of the high incidence of sickness and morbidity, the financial institutions perceive investment in SMEs as risky. Most SMEs in India have no access to the equity market and rely heavily on the loans from commercial banks and other institutions, together with the informal sources of finance. The finances arranged from informal markets are highly priced, which affects the profitability of the units. On the other hand, the perception of high risks among the formal channels of finance has forced the institutions to embark upon a collateralized lending policy.

13 Small Industry Development Organisation, Government of India

14 G. Muniappan. *The NPA Overhang, Magnitude, Solutions and Legal Reforms* (Reserve Bank of India, 2002).

The outcome of such a policy is that the loan amount becomes a function of the collateral security provided by the SME, notwithstanding its actual requirements. This implies that small business entities, with less than the required collateral security, suffer from shortage of finances—working capital and/or term finance required for capital expenditures. The Indian SSI sector has been traditionally working with low capacity utilization—about 50 to 55%—considerably lower than the corresponding figures in Europe and China. In spite of the fact that the Reserve Bank of India has declared lending to the SSI to be priority sector lending, the share of SSI credit in the net bank credit has been continuously decreasing for the past few years. This declining trend, when compared with the surge in the advances to the home loan segment, reveals an interesting fact. There might exist a possible trade off between advances to SSI and other relatively safer avenues of priority sector lending in India.[15] The perception of risk in investing in the SSI/SMEs has also resulted in this sector facing an increased cost of credit. There is a general consensus among the bankers that SSI advances are priced, on an average, 200 basis points over and above the prime lending rates.[16]

The inadequate and untimely finances made available to the SSI/SME sector limit the scope of growth and development of the units. As a result most players in this sector cannot undertake activities pertaining to product/process development and R&D, which could have improved the situation. At the same time the lack of finance also inhibits a host of budding entrepreneurs from setting up a possibly viable business. Consequently, many of these creative leaders die a premature death and even more never see the light of the day.

Scope for Future Research

It is imperative that the first step in creating an enabling environment for fostering growth in the SME sector in India is improving the SMEs' s access to finance. Researches concerning the role of credit-guarantees

15 S. Sen and S. K. Ghosh. "Basel Norms, Indian Banking Sector and Impact on Credit to SME & the Poor." *EPW* (March 19, 2005). p. 1167.

16 S. Sen and S. K. Ghosh. "Basel Norms, Indian Banking Sector and Impact on Credit to SME & the Poor." *EPW* (March 19, 2005). pp. 1167-1180.

and insurance need special attention. Such institutional arrangements would, perhaps, have the ability to improve risk perceptions among the organized financial sector and make finance accessible to the SMEs. In India, equity markets have traditionally been an arrangement for the large enterprises. Learning from the Australian experience (New Castle and Bendigo Stock Exchanges), the scope for setting up stock exchanges specifically meant for the SMEs may be explored. This would not only lessen the SMEs' reliance on the debt market but would also transform many SME units into public limited companies with stress on corporate governance and corporate social responsibility. In their effort to achieve SME-led growth, venture capital financing has been a very popular mode of financing in places like China, Hong Kong, Japan, Korea, Singapore, and Taiwan. Research is required to explore the possibility of introducing a similar model in India with public-private participation.

Conclusion

To realize the Millennium Development Goals and human rights principles, a developing country like India must first alleviate poverty through a sustainable income generation programme. SMEs are the creative leaders who have an enormous potential to "eradicate poverty through profits" and "enabling dignity and choice through markets." Such ventures have the potential to empower "the bottom of the pyramid" and ensure that the conundrum of realizing human rights is solved. However, these entities are constantly reeling under constraints, particularly, access to finance for growth and development. A sound poverty-alleviation programme has to be co-related with a holistic SME development plan. It is time that we delve into innovating measures that support the creation, sustainability and growth of these creative leaders who play a crucial role in removing the curse of poverty and inequality, and ensuring human rights.

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