

## ACCESS TO CREDIT TO MICRO, SMALL AND MEDIUM ENTERPRISES AND ITS DETERMINANTS IN INDIA : AN INTER-STATE ANALYSIS

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### Abstract

*An attempt has been made in the study to shed some lights on inter-state variation in the access to credit to promote entrepreneurial activity in India. In addition, some of the socio-economic determinants of varying level of financial access to enterprises across Indian states have been identified in the study.*

*Key Words: MSME, Entrepreneurial finance, Multiple regression, India*

*Jel Classification : L26, H81*

### Introduction

Entrepreneurship constitutes the main driving force in the process of economic development of the country as they bring resources together in an unusual combination by introducing innovation in the process of production. Micro, small and medium enterprises (MSMEs) contributes significantly to the manufacturing output, employment and exports of the country. It is estimated that in terms of value, the sector accounts for about 45 per cent of the manufacturing output and 40 per cent of the total exports of the country in 2011-12. The sector has a potentiality of generating employment of about 595 lakh persons in over 261 lakh enterprises throughout the country (Ministry of MSME, 2012). In addition, micro-enterprises helps the process of economic diversification, utilization of otherwise dormant resources, balanced regional development, production of and demand for wage goods, equitable distribution of income and widening the base of entrepreneurial supply (Awasthi, 2004). In order to achieve the objectives, graduating from micro to small and to medium enterprises is needed as it has a favourable impact on per unit value of major economic parameters, i.e., employment, investment and output (Ministry of MSME, 2011).

However, the micro-entrepreneurs are bound to operate their enterprises on a micro level and are less inclined to undertake innovation due to paucity of funds in the imperfectly developed credit market in the economy. Provision of adequate supply of credit promotes a sense of sustainable entrepreneurship and, thereby, helps in graduating from micro to small and medium

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enterprises (Ahirrao and Chaugule, 2010; Bharti and Shylendra, 2011; Kiiru, 2007; Rosengard, 2004). It can ultimately accelerate the path of rural industrialization of the economy. In order to accelerate the path of rural industrialization, it is necessary to establish a linkage between enterprise development and access to credit. Provision of timely disbursement of credit and shorter repayment period are considered to be the essential characteristics of finance, particularly for micro and small enterprises (International Finance Corporation, 2012). Even though 78 percent of the credit demand of enterprises is provided by self-finance and informal sources of credit, it is argued that small banks (RRBs, Co-operative Bank, SFCs, SIDCs) and micro finance institutions are the most promising sources of finance owing to their closed proximity with rural economy and better understanding of the enterprise potential and financial performance.

In fact, the importance of micro finance is embedded in the definition of micro enterprise as “firms owned by the self-employed poor that use micro finance” (Schreiner and Leon, 2001). Available empirical evidences suggest that micro finance is an important component in micro enterprise finance and both of them share common objectives of poverty alleviation and creation of employment opportunities for the rural poor. Further, micro credit enables a micro entrepreneur to build capacity, trust and innovation (Ahirrao and Chaugule, 2010; Bharti and Shylendra, 2011).

Access to credit is conditioned upon several socio-economic variables. A few studies (Kohli, 1997; Eastwood and Kolhi, 1999; Nikaido et al, 2012<sup>1</sup>) have tried to identify the determinants of bank loans for small enterprises. Some of the crucial factors affecting access to institutional credit are identified as firm size, collateral, past record of informal borrowings, status of registration, education and gender of the owner of an enterprise etc. Most of the studies are either using panel data over the period 1965-78 (Kohli, 1997; Eastwood and Kolhi, 1999) or unit level NSS data on unorganized manufacturing enterprises (Nikaido et al, 2012). However, inter-regional variation in the access to credit by the enterprises is conceptualized by considering regional dummy variable. Northern and eastern regions of India are found to be less likely to receive institutional credit as compared to firms located in southern India (Nikaido et al, 2012). Under this backdrop, an attempt has been made in this paper to examine the inter-state variation in the access to credit by the enterprises mainly by using the latest Fourth All India Census of MSME, 2006-07. In addition, the role of enterprise characteristics and state specific characteristics are identified in this paper to explain the dynamics of inter-state variation in the access to credit to enterprises.

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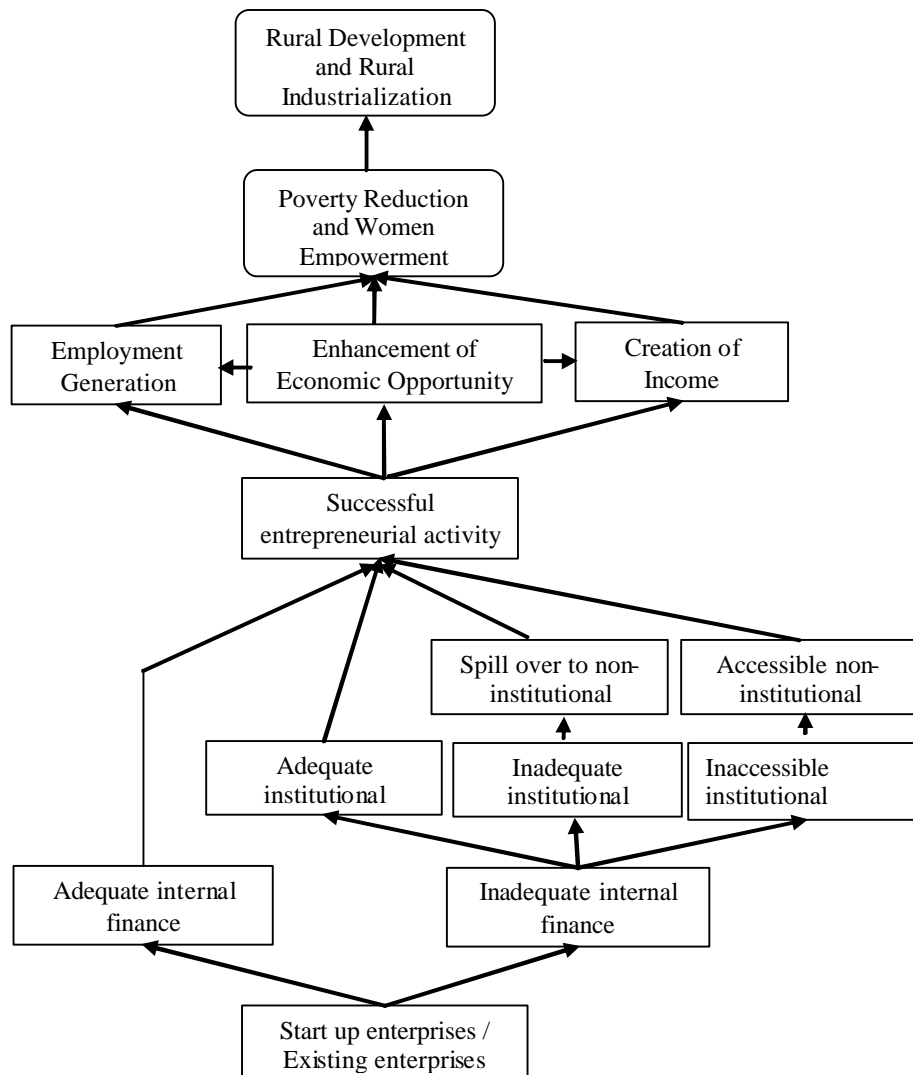
<sup>1</sup> Ravi (2009) examined the impact of specific government policy interventions on the performance of entrepreneurship measured by total number of firms, total output, total employment and the total exports from the MSME sector in 35 states and union territories of India.

### **Conceptual framework**

Entrepreneurship development through access to finance has an important bearing on the rural industrialization and thereby, ultimately, promotes rural development. However, this causality is a complex process. There might be indirect channels by which one reinforces the other. Capital is recognized as the most important pre requisites to establish an enterprise. In general, start ups of enterprises have been funded by own internal resources but for the expansion of firm they have the requirement of credit (Kuzilwa, 2005). The demand for credit can be appropriated by institutional sources, non-institutional sources or both. Credit rationing in formal financial institutions often compels the entrepreneurs to spill over their excess demand to informal sources of finance. Non-institutional sources of credit are found as the viable source of entrepreneurial finance to those of potential collateral poor entrepreneurs.

The practice of sustainable entrepreneurial activity is expected to widen the horizon of diversified economic opportunities and, in turn, has an important bearing on employment generation and enhancement of income generation activities. The enhancement of economic opportunities through entrepreneurship development has indirect effect upon the attainment of education and health opportunities and this, in turn, enhances the capability. It is seen that the livelihood promotion entrepreneurship development programmes make a short term impact on poverty by creating self-employment whereas growth-oriented micro-enterprise development programmes make long term impact on poverty (Asian Development Bank, 1997). Moreover, rural entrepreneurship is needed as it is well recognized that entrepreneurship precedes industrialization. Rural industrialization is viewed as the effective means of accelerating the process of rural development (Khanka, 2007). The causal link between entrepreneurship development through access to credit and rural development is conceptualized in figure 1.

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**Figure 1: Linkage between Entrepreneurship Development through Access to Credit and Rural Industrialization**

**Enterprise development and access to credit in India**

A landmark enactment in the MSME sector in India, the Micro, Small and Medium Enterprises Development (MSMED) Act was enacted in 2006. The previous nomenclature of “small scale industries” was renamed into “micro, small and medium enterprises”. A broader range of enterprises, viz., medium, khadi and village industries commission and retail trade enterprises were included under the purview of the sector. It is the prerogative of the government to

improve the access to institutional credit for SSIs through the branch licensing policy and priority sector lending policy (Nikaido et al, 2012). In the pre-liberalisation era, bank authorization policy encouraged commercial banks to open branches in rural and semi-urban areas, while an increasing number of bank branches in urban and metropolitan areas is visible since the late 1990s. In this backdrop, to improve the access to banking services for SSIs, several committees, viz. Nayak Committee (1992), Abid Hussain Committee (1995) and the Kapur Committee (1998) recommended in favour of establishing of at least one specialized branch for SSIs in each district. Ganguly Committee (2004) was in favour of adoption of a cluster-based approach for financing the sector, i.e., establishing specialized SSI branches in identified clusters. Priority sector lending is considered as another policy directives to advance credit to hitherto neglected sectors in the pre-liberalised era. As a consequence, it is reported that the share of SSIs advance in net bank credit increased from 8.5 percent in 1969 to 16.9 percent in 1989 (Report of Trend and Progress of Banking in India). Considering the adverse impact of priority sector lending on the profitability of commercial banks, Narasimham Committee recommended to reduce the target for the priority sector to 10 percent from 40 percent<sup>2</sup>. Consequently, the share of SSIs advance in net bank credit by public sector banks has been decreasing since 2000s. In this context, to channelize direct credit to the MSME sector, an RBI regulation<sup>3</sup> in April 2011 excluded loans sanctioned by banks to NBFCs for on-lending to micro and small enterprises from priority sector targets. Presently, it is not mandatory on the part of NBFCs to comply with the guidelines of priority sector lending, but the potentiality to develop innovative credit channels in a cost-effective manner can serve the needs of enterprises. The activity of another institution, known as NBFC-MFIs, which are though, actively involved in serving unregistered micro-enterprise sector is limited due to constraints in accessing capital and other stringent regulatory requirements. Similarly, small banks such as RRBs, UCBs, SFCs, SIDCs have an extensive network of banking outreach throughout the country to serve more enterprises than they are serving till now. With the advantage of extensive branch network of public banks across the country, public banks accounted for 70 percent of the banking debt to the MSME sector, while the private and foreign banks account for 22 percent, and small banks such as regional rural banks, urban co-

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<sup>2</sup> Unlike agricultural sector, no sub-target for SSIs has been fixed and medium enterprises remained outside the scope of priority sector. Within micro and small enterprises, 40 percent of total MSEs advances has been allocated to manufacturing enterprises having investment up to 5 lakh and to service enterprises having investment in equipment up to 2 lakh. Another 20 percent of the total MSE advances is allocated to manufacturing enterprises with investment in plant and machinery between 5 to 25 lakh and to service enterprises with investment in equipment between 2 to 10 lakh (Nikaido et al, 2012).

<sup>3</sup> The regulation can be seen as the implementation of the recommendations of Nair committee. It was recommended that commercial bank loans to NBFCs for on-lending to specified segments may be considered for classification under priority sector (International Finance Corporation, 2012).

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operative banks account for 8 percent of banking finance. However, the institutional mechanisms of formal financial institutions are observed to be biased in serving the credit needs of small and medium enterprises vis-à-vis micro enterprises on the consideration of transaction cost. In the presence of credit rationing of such institutions, the unmet demand for enterprise finance spill over to the informal financial sector. In fact, informal financial sources and self-finance retains a predominant share (78 percent of the sector's debt) of enterprise finance in the sector. Informal sector consists of both institutional sources (5 percent) such as moneylenders and chit funds, and non-institutional sources (95 percent) such as family, friends and family business. Even though informal sources of finance exhibits a high rates of interest, certain characteristics of loan such as timely disbursal of credit, shorter duration times cater to the needs of micro and small enterprises (International Finance Corporation, 2012).

Distribution of enterprises that have taken loan and the amount of loan are presented in Table 1. It is reported that only 12.77% (1,99,706 enterprises) of the total registered enterprises has obtained loans either from financial institutions or non-financial institutions or both. A classification of enterprises suggests that size of the enterprises is proportional to the access of loan. It is evident that 37.04 percent of medium enterprises has an access to credit, while the percentages for small and marginal enterprises merely 23.38 and 1.18 percent respectively. It is interesting to note that about 85.16 percentages of registered enterprises have an access to institutional sources of credit only.

**Table 1 : Characteristics of Enterprise Loan by Type of Enterprises**

Characteristics	Type of enterprises			Total number
	Micro	Small	Medium	
No. of enterprises availing loan (in lakh)	1.81	0.18	0.01	2.00
Amount of loan taken (Rs. crore)	17244.9	22854.7	6420.63	46520.23
No. of enterprises availing loan from Institutional sources (in lakh)	1.56	0.14	0.00	1.70
Amount of loan from Institutional sources (Rs. crore).	13757.22	16562.25	4375.08	34694.6

Source: Fourth All India Census of MSME 2006-07.

A state-wise information in regard to access to enterprise loan either from financial institutions

or non-financial institutions or both is presented in Table 2<sup>4</sup>. Out of 33 states and UTs of India, only in 9 states (Punjab, M.P, U.P, Jharkhand, T.N. Bihar, Nagaland, Gujarat, Manipur), the registered enterprises have lower access to credit in relation to national average. In respect of access to institutional credit only, an inter-state disparity is quite prominent as 15 states are observed to be lying below the national average.

**Table 2 : Classification of States according to Access to Loan  
(Registered Enterprises)**

Percentage of enterprises availing loan		Percentage of enterprises availing institutional loan	
More than national average (>12.77%)	Less than national average (<12.77%)	More than national average (>85.16%)	Less than national average (<85.16%)
Tripura, Sikkim and Odisha, Maharashtra, W.B, H.P, Uttarakhand, Haryana, Kerala, Goa, Chhattisgarh, Puducherry, Rajasthan, Ar.Pr., Assam, A.P, Mizoram, Delhi, Chandigarh, A&N, Karnataka, J&K, Meghalaya	Punjab, M.P, U.P, Jharkhand, T.N. Bihar, Nagaland, Gujarat, Manipur	Tripura, Sikkim and Odisha, Maharashtra, W.B, H.P, Uttarakhand, Haryana, Kerala, Goa, Chhattisgarh, Puducherry, Rajasthan, Ar.Pr., Assam, A.P, Mizoram	Delhi, Chandigarh, A&N, Karnataka, J&K, Meghalaya, Punjab, M.P, U.P, Jharkhand, T.N. Bihar, Nagaland, Gujarat, Manipur

Source: Author's calculation based on Fourth All India Census of MSME 2006-07.

### Determinants of Access to Credit

#### Model Specification

The study used Ordinary Least Square Estimation technique to identify the determinants of access to credit by the enterprises. In this estimation technique, the number of enterprises having access to loan, the number of enterprise having access to institutional loan and amount of loan received by the enterprises are used as the dependent variables. The specification of the empirical model is given by

$$ACCESS_i = \partial_0 + \partial_1 ME_i + \partial_2 OWNERSHIP_i + \partial_3 OUTPUT_i + \partial_4 EXPORT_i + \partial_5 NSDP_i + \partial_6 LR_i + \partial_7 BANK + e$$

where  $\partial_i (i = 1, 2, \dots, 6)$  are the respective coefficients and ACCESS represents the

<sup>4</sup> A state-wise variation in enterprise development across states of India by considering penetration of enterprises, employment generation and productivity is analyzed in appendix.

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dependent variable of the empirical specification. The description of explanatory variables and hypothesis (as specified by expected sign) in both the empirical specifications are presented in Table 3.

**Table 3 : Hypotheses: Expected sign of the explanatory variables**

Independent Variables	Description	Data Sources	Dependent variables		
			Number of enterprise having access to loan	Number of enterprise having access to institutional loan	Amount of loan received by the enterprises
Number of microenterprise (ME)	The number of microenterprise measured in units	Census of MSME (2011)	+/-	+/-	+/-
Female ownership (OWNERSHIP)	The number of enterprises owned by female in units	Census of MSME (2011)	+/-	+/-	+/-
Gross output (OUTPUT)	Gross output of the MSME of the state (value in Rs. Crore)	Census of MSME (2011)	+	+	+
Volume of export (EXPORT)	Volume of export of the MSME of the state (value in Rs. Crore)	Census of MSME (2011)	+	+	+
Net state domestic product (NSDP)	NSDP at current prices of the state in 2006-07 (Rs. Crore)	Economic Survey of India (2008-09)	+	+	+
Literacy rate (LR)	Number of 7+ literate population of a state as a proportion of 7+ population of the state (per hundred)	Census of India (2011)	+	+	+
Outreach of bank (BANK)	Scheduled commercial bank branches of the state on March 2007	Basic Statistical Return (2007)	+	+	+

**Results and Discussion**

The determinants of access to credit has been conceptualized by considering seven broad factors, three from each aspect of state specific characteristics (literacy rate, bank branches



and NSDP) and four aspects of enterprise characteristics (number of microenterprise, female ownership status of the enterprise, gross output of the enterprises and value of the export of goods produced by the enterprises). To examine the impact of these factors on the access to credit to the enterprises we have made a linear regression analysis taking the number of the enterprises having access to loan, the number of the enterprises having access to institutional loan and amount of loan received by them as the dependent variable and the enterprise related information and state specific characteristics as the independent variables. The regression results are shown in Table 4.

**Table 4 : Regression Result of Determinants of Access to Credit**

	Number of enterprises having access to loan		Number of enterprises having access to institutional loan		Amount of loan received by the enterprises	
	<i>Coefficient</i>	<i>t-ratio</i>	<i>Coefficient</i>	<i>t-ratio</i>	<i>Coefficient</i>	<i>t-ratio</i>
CONSTANT	-19235.9	-1.9058*	-18217.3	-1.9763*	265.28	0.2307
ME	-0.0506305	-1.1375	-0.0377084	-0.9276	-0.0196429	-3.8737***
OWNERSHIP	422.371	2.6409**	334.692	2.2915**	56.771	3.1159***
OUTPUT	0.229354	2.2824**	0.194842	2.1232**	0.0609755	5.3265***
EXPORT	-1.64207	-2.4632**	-1.53466	-2.5207**	0.0968055	1.2747
NSDP	0.0583653	1.7740*	0.0490746	1.6333	0.0012269	0.3273
LR	233.015	1.8671*	220.931	1.9385*	3.40027	0.2392
BANK	4.68194	3.3325***	4.09262	3.1897***	0.238904	1.4927
Observations: 32	R-squared	0.762424	R-squared	0.738298	R-squared	0.937212

Source: Author's calculation using Gretl econometric software

Note: \*, \*\*, \*\*\* indicates significant at 1, 5 and 10 percent level of significance

The empirical results identified ownership status of the enterprises and the gross output of such enterprises as two crucial determinants of access to loan in three sets of regression models. Female owned enterprises are having more access to credit than male owned enterprises. Access to credit is also observed to be directly related to the size of the firm measured by the volume of onlpio. Higher the output level produced by the farm, larger is the loan amount received by the enterprise. This result is further substantiated by the fact that microenterprises have received lower amount of loan compared to small and medium enterprises. However, from the results it can not be said that micro-enterprises are excluded from access to credit in general. Surprisingly, empirical evidence suggests that enterprises linked with export industries are observed to be in a disadvantageous position in meeting their credit needs. Even their appropriation of higher amount of credit is not justified in statistical sense.

Some of the state specific characteristics have a significant bearing on the access of credit by the enterprises in the first set of regression model. Formation of human capital plays an important role in the development of enterprises of a state. Literacy rate is found

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to be positively associated with the number of enterprises having access to loan. The result is found statistically significant at 10 per cent level of significance. Economic condition of the state is another important state specific characteristic which can influence access to loan to the enterprises. In fact, economic status of the state, as measured by the net state domestic product of the state, may develop demand side impetus for the development of such enterprises, and thereby, strengthen credit demand for enterprises in the state. However, economic condition of the state may not significantly enhance greater access to institutional credit. A positive and significant coefficient of outreach of commercial bank branches signifies that states with poor institutional credit delivery mechanism fail to satisfy required credit requirements and thus find it difficult to start up or running enterprises in the state. However, the expansion of bank network does not ensure larger amount of loan received by the enterprises of a state.

### Conclusions

A gradual transformation from micro to small and to medium enterprises has favourable implications for per unit value of major economic parameters, i.e., employment, investment and output. In the process of transformation, access to credit is considered as important barriers in the imperfectly developed credit market in the economy. The policy of banking outreach in unbanked areas and priority sector lending are instrumental in channelization of credit to SSIs in pre-liberalisation era. However, a reversal of the policy in recent times is reflected in the implementation of specialized branch for SSIs, cluster-based approach for financing the sector and reorientation of priority sector lending policy. Consequently, the share of SSIs / MSEs advances in the total priority sector advances has been decreasing. Empirical results using Multiple Regression Analysis suggest that the ownership of enterprises and gross output among the enterprise-related characteristics and literacy rate, bank outreach of the state among the state specific variables significantly enhance the accessibility of entrepreneurial finance of the state.

### APPENDIX: ENTERPRISE DEVELOPMENT IN INDIAN STATES

A comprehensive index on enterprise development (IED) is constructed that will capture information on several indicators of enterprise development viz. penetration of enterprises (share of working enterprises of the state as a proportion of the share of total enterprise of the state), generation of employment opportunities (share of employment generation in MSME of the state as a proportion of share of unemployment population of the state) and productivity of such enterprises (share of gross value added of MSME of a state as a proportion of share of NSDP of the state)<sup>5</sup>. The values of each indicator across the states of India along with their ranks are presented in Table A.1.

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<sup>5</sup> The comprehensive index on enterprise development (IED):  $IED_s = \frac{\sum_{i=1}^3 I_{is}}{3}$  where Indicator of penetration of enterprises ( $I_1$ ), Indicator of employment generation of MSME ( $I_2$ ), Indicator of productivity of MSME ( $I_3$ )

**Table A.1**  
**Indicators of Enterprise Development of Indian States**

State	Indicator of penetration of enterprises	Indicator of employment generation	Indicator of productivity	Index of Enterprise Development
Andhra Pradesh	1.343 (1)	0.605 (16)	0.456 (17)	0.801 (15)
Arunachal Pradesh	0.975 (15)	0.262 (19)	0.310 (20)	0.516 (20)
Assam	0.941 (18)	0.520 (17)	1.217 (8)	0.893 (14)
Bihar	1.018 (11)	0.084 (22)	0.247 (22)	0.450 (22)
Chhattisgarh	0.764 (22)	0.934 (11)	0.387 (18)	0.695 (17)
Gujarat	1.149 (2)	10.479 (1)	1.494 (4)	4.374 (1)
Haryana	0.988 (14)	2.944 (5)	1.467 (5)	1.799 (5)
Himachal Pradesh	1.025 (8)	1.150 (9)	2.207 (2)	1.461 (7)
Jharkhand	0.947 (17)	0.223 (21)	0.372 (19)	0.514 (21)
Karnataka	1.023 (10)	2.344 (6)	1.133 (9)	1.500 (6)
Kerala	1.061 (5)	1.006 (10)	0.930 (12)	0.999 (12)
Madhya Pradesh	0.996 (12)	0.696 (15)	0.621 (15)	0.771 (16)
Maharashtra	0.765 (21)	1.539 (8)	0.942 (11)	1.082 (10)
Meghalaya	1.045 (7)	0.473 (18)	0.295 (21)	0.605 (18)
Mizoram	1.073 (3)	5.053 (2)	0.899 (13)	2.342 (3)
Odisha	1.065 (4)	0.699 (14)	0.978 (10)	0.914 (13)
Punjab	0.892 (19)	4.768 (3)	2.290 (1)	2.650 (2)
Rajasthan	1.025 (9)	1.582 (7)	0.794 (14)	1.134 (9)
Tamil Nadu	1.046 (6)	3.864 (4)	1.272 (7)	2.061 (4)
Uttar Pradesh	0.889 (20)	0.874 (12)	1.324 (6)	1.029 (11)
Uttarakhand	0.993 (13)	0.837 (13)	1.809 (3)	1.213 (8)
West Bengal	0.963 (16)	0.251 (20)	0.470 (16)	0.561 (19)

Source: Author's calculation based on Census of MSME (2011), Employment and unemployment survey (2011-12), Economic Survey (2012-13), Note: The figures in the parenthesis represent the corresponding ranks of the state.

A wide inter-state disparity is visible in the individual indicators of enterprise development. In respect of the penetration of enterprises, the share of working enterprises in states like Andhra Pradesh, Gujarat, Meghalaya, Mizoram, Odisha, Kerala and Tamil Nadu is observed to be, on an average, higher than the share of total enterprises which include working, closed and

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non-traceable units. The states in the lower end of the tail are mainly confined to the north-eastern, central, northern and eastern region. In the context of the generation of employment opportunity, the share of employment in MSMEs is found to be ten times the share of unemployment in the state of Gujarat. In another five states (Mizoram, Punjab, Tamil Nadu, Haryana and Karnataka), the MSME sector has been able to address unemployment problem in these states by generating employment opportunities in this sector. However, actual generation of employment opportunities by the sector may not ensure their better performance in value addition of output. The composition of the enterprises in Punjab and Himachal Pradesh is more skewed in favour of relatively large sized enterprises, and thereby the shares of gross output of these states observed to be double compared to the share of NSDP of the states. A poor rating of productivity of such enterprises are observed in central, eastern and north-eastern states. The comprehensive measure of enterprise development suggests that Gujarat occupies the leading role in the development of enterprise and it is followed by Punjab, Mizoram and Tamil Nadu. Arunachal Pradesh, Jharkhand and Bihar belong to the lower stratum in the ladder of enterprise development.

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