

## Research Article

# Urban Informal Producers and Nature of Their Credit Structure: An Indian Case Study

Bhagirathi Panda, Ph.D

Visiting Asia Fellow, Regional and Rural Development Planning,  
School of Environment, Resources and Development,  
Asian Institute of Technology, Thailand.

**Abstract** In developing countries, credit is one of the most important requirements of Informal Production Units in the Urban Sector. This paper examines the issue of the nature and availability of credit to the Urban Informal Production Sector in the context of a micro level field study undertaken in the city of Cuttack in India during 1995-96. It reconfirms findings of earlier studies that lack of credit is the most important constraint inhibiting the growth of Urban Informal Production. Access of the Urban Informal Producers to formal sector credit is limited. This is primarily due to the distortions in the views and lending practices of the formal sector financing institutions and lack of education (thus empowerment) with the entrepreneurs of this sector. Finally, the paper suggests that to promote a healthy growth of this sector, (i) credit delivery mechanism particularly of the formal sector financial institutions requires an overhauling and improvement, (ii) education level of the informal sector entrepreneurs needs to be enhanced and (iii) a separate Informal Sector Financing Institution (ISFI) in lines of Small Industries Development Bank of India (SIDBI) needs to be established by the Government.

## Introduction

Of late, in the literature of Development Economics, Urban Informal Sector has gained importance because of its rapid growth especially in developing economies. In these economies, despite rapid industrial growth, the formal or the modern sector has not been able to provide employment to all the surplus and marginal labour force in urban areas. Further, public sector employment in such economies has also gone down considerably. This is due to the fact that employment elasticity in relation to aggregate output growth has been diminishing over the years. It is here that employment creation in the urban informal sector assumes significance to overcome urban poverty, unemployment and environment degradation. This is also the reason for the promotion and development of urban informal sector as a strategy of development in such economies.

A study of the dynamics of urban informal sector is enormous and many-sided. However, in this paper a modest attempt is made to study exclusively its credit structure, for the simple reason that availability of easy and cheap credit is one of the important inputs for the growth of this sector. A review of available literature on the need and nature of credit structure of Urban Informal Producers (hereafter called UIP) reveals the following conditions:

1. Lack of credit is the most important constraint facing UIPs (Sethuraman, 1981; H. Schmitz, 1982; Romatet, 1983; Levistky, 1989; Tokman, 1989; Lubell and Zavour, 1990; ILO, 1991; IAMR, 1995).
2. Access of the local informal producers to formal source of credit is limited (Chandravarkar, 1989; Mayer, 1988; Tokman, 1989; Singh, 1994). This is attributed to the typical structure and operation of the Urban Informal Production Units (hereafter, called UIP units) like smallness and non-registration status of the units etc.; and organic deficiencies in the operation and lending policies of the formal sector credit providing institutions such as complicated lending procedure, insistence on collateral, fixed working hours, formality and rigidity in operation and above all indifference of employees of these institutions towards the informal sector producers.

The present paper examines these issues and explores new insights on this problem based on a field study that was undertaken in 1995-96 in the city of Cuttack in the province of Orissa in India.

The paper is divided into four sections. The first section gives a brief introduction on the subject; the second section explains the methodology, the third section presents the results of the study based on the analysis of the collected relevant data; and the fourth section summarizes the findings, derives conclusions and suggests measures for policy formulation.

### **Methodology and the Case**

The study focuses on the class-I town of Cuttack in Orissa. This town has been deliberately selected for this study because it happens to be the commercial capital of the province of Orissa and accommodates 77.44 % of its total main workers working in the informal sector (Census of India, 1991). The informal production sector in this town is also fairly representative in the sense that it includes multiple production activities undertaken by the people of the town in this sector. More than four thousand units of shops and commercial establishments were registered under the Orissa Shops and Commercial Establishments Act in 1995. The town exhibits a predominantly urban character, a spurt in commercial, industrial, educational and cultural activities.

The study is essentially primary data based. Primary data in respect of UIP units were collected from the sample enterprises for the year 1995-96 by means of administering a schedule-cum-questionnaire through personal interview method. UIP units are defined as all those manufacturing and repairing units in Cuttack town with a total employment size of ten or less including owner/operator, paid and unpaid household workers/members.

The universe of UIP units is derived by pulling together the lists of such manufacturing and repairing units provided by (i) Assistant Labour Commissioner, Cuttack; (ii) Directorate of Industries, Cuttack; (iii) Municipality of Cuttack and (iv) Street Counting. Due care is taken to overcome the problem of overlapping by identifying the units common to all or some of the aforesaid

sources and including them only once in the universe. Initially a sample of 180 units (10% of the universe) was selected from the universe by means of simple random sampling. However, for various practical reasons 156 units could be finally surveyed.

## Analysis and Results

### Credit Constraint and Need

Analysis of data reveals that about 90% of sample producers view lack of credit as their most important constraint. 52% of them reduced their output level because of lack of credit. About 90% of these producers felt the need for credit. Almost all of them think that their sales turnover will increase if credit is available to them. Analysis of data in Table 1 shows that the average sales turnover (1995-96) of UIP units having borrowings from all sources is nearly 7.6 times more than the average sales turnover of UIP units without having any kind of borrowing. Average sales turnover of UIP units having borrowings from only formal financial institutions is 9.5 times higher than the average sales turnover of UIP units without having any borrowings from formal financial institutions. It also further shows that, average sales turnover of the units, who have exclusively borrowed from formal sector credit institutions, is nearly 6 times more than that of the average sales turnover of units who have borrowed exclusively from informal financing sources. These derivations support the earlier finding that lack of credit and particularly formal sector credit is one of the most important constraints for the growth of UIP sector.

**Table 1: Average Sales Turnover of UIP Units by Various Indebted/Non-indebted Statuses**

<i>UIP Unit Status</i>	<i>Average Sales Turnover (Rs. '000)</i>
Indebted Units	672.6
Non-indebted Units	88.3
Indebted only to formal financial institutions	1330.6
Not indebted to formal financial institutions	139.6
Indebted only to informal sources	226.5
UIP as whole	399.2

*Source: Sample Data*

### Credit Needs and the Role of Banks

To judge the role of the banks, the entrepreneurs of sample UIP units were asked whether they ever sought a loan from the bank and if sought, whether they faced any problem. About half of the enterprises had never sought a bank loan. When asked about the reasons for not seeking a loan from the bank, two thirds of them (not seeking a loan) viewed complicated lending procedures of the banks as the reason, 16.3 % viewed insistence on collateral as the reason, 7.5% thought their ignorance about banking loans was the reason, 2.5% assigned non co-operation by the banking authorities as the reason and another 7.5 % mentioned about other factors. The entrepreneurs were also asked if they had faced any problem while seeking bank loan. 95% of those who had sought bank loans told that they had to face one problem or the other, whereas only 5% told that they did not face any problem.

**Table 2: Sources of Funds of Enterprises for Working Capital**

<i>Sources</i>	<i>Number</i>	<i>Percent</i>
Own Savings	156	100.0
Friends & Relatives	11	25.6
Moneylenders	40	25.6
Nationalised Banks	12	7.7
Urban Cooperative Bank	11	7.1
Other formal financial institutions	4	2.6

*Source : Sample Data*

### Source and Nature of Credit

Table 2 shows that next to own savings sources, largest number of UIP units (25.6 %) depends on moneylenders for their working capital needs. However, the average interest charged by the moneylenders per annum is as high as 72%. On the other hand, average annual interest charged by the formal sector financial institutions comes to 14%. Difficulty in getting formal sector finance, especially bank finance, compels the UIP units to go for informal finance. In addition, informal financing is flexible and simple. 60% of the UIP units having borrowings from informal sources have borrowed without any fixed collateral. The transaction process is simple without much paper work and there is no fixed transaction hour unlike the banks and other formal

financial institutions. Regarding the most important factor which makes the informal lender advance credit to the UIP units, 70% of them mentioned that it was their credit worthiness measured in terms of past loan repayment record and future potentiality that governed their receipt of informal finance and its size.

### Education Level and Access to Credit

Table 3 reveals that in total 38 (24.4 %) UIP units out of 156 are having access to various formal financial institutions for credit. Out of these 38 units, 20 (52.6%) are having entrepreneurs with education level of class X or above and 16(42.1%) are below class X. Only 2(5.3%) such indebted enterprises are having illiterate entrepreneurs. This implies that entrepreneurs with higher education level are having better access to formal credit institutions. Education thus plays a role in determining the access of the urban informal entrepreneurs to formal sector finance.

**Table 3: Enterprises Indebted to Formal Financial Institutions by Education Level**

<i>Education level</i>	<i>Enterprises indebted to formal financial institutions</i>	
	<i>Number</i>	<i>Percent</i>
Illiterate	2	5.3
Below Class X	16	42.1
Class X & Above	20	52.6
UIP as a whole	38	100.0

*Source: Sample Data*

### Summary, Conclusion and Policy Implications

This micro study reconfirms the earlier finding that lack of credit is the most important constraint for majority of the UIP units. A quarter of the sample enterprises borrow capital from private moneylenders at an average interest rate of 72% as their access to formal sector financial institutions for capital is very limited. Further, informal financing from private moneylenders is flexible and simple. Lack of education also restricts the scope of these entrepreneurs to have access to formal sector finance.

As stated above, a quarter of the sample informal enterprises 72% per annum. The moneylenders consider these entrepreneurs

borrow capital from private moneylenders at an average interest of bankable. 90% of these UIP units are prepared to have credit, paying a higher rate of interest than that is normally charged by the formal sector financing agencies. However, majority of them do not have access to these formal sector-financing institutions. Does this paradox reflect an underlying reality of unstable and risky conditions of production with the UIP sector (and hence repayment defaults) or does it imply distortions in the views and lending practices of those in charge of the formal credit institutions? When, of the units, not seeking formal sector credit, 66.3% view complicated lending procedure as the reason for not seeking credit and when value added per rupee of fixed capital<sup>1</sup> in this sector is 7 times higher than that of the formal production sector; the inference is that the above paradox is more a result of the distortions in the views and lending practices of the banking authorities than being suggestive of risky conditions of production in the UIP sector.

Rapid and healthy growth of the UIP sector requires improving the credit delivery system. This can be achieved by: (i) overhauling and improving the existing lending procedure and policy of the formal sector credit institutions (especially the banks) in favour of the UIP sector. This includes removing all types of non-economic biases and unfounded economic apprehensions of the formal sector financing institutions, (ii) developing appropriate mechanism to improve the education (thus empowerment) level of the entrepreneurs of this sector, and, (iii) establishment of a separate informal sector financing institution (ISFI) in the lines of Small Industries Development Bank of India (SIDBI).

#### Note

1. Value added per rupee of fixed capital in UIP units is calculated to be Rs. 3.25 whereas in case of formal production units the same is Rs. 0.47.

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