Rajiv Gandhi
Institute for Contemporary Studies

Policy WATCH

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Growth with Employment

In this issue

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RAJIV GANDHI
INSTITUTE FOR CONTEMPORARY STUDIES

Editorial

The Rajiv Gandhi Institute for Contemporary Studies (RGICS) works on five themes:

1. Constitutional Values and Democratic Institutions
2. Growth with Employment
3. Governance and Development
4. Environment, Natural Resources and Sustainability
5. India's Place in the World.

This issue of Policy Watch deals with the theme Growth with Employment. We carry three articles, two focussing on the future of the Indian economy, given the huge uncertainties caused by the Trump Tariffs and even as we are grappling with those, the news that India has registered a record USD 100 billion trade deficit with China. The third article is about inter-state inequality and how it militates against productivity growth and job creation in the poorer states. This is now probably one of the biggest policy challenges facing India.

The very first article is by Arun Maira, who served on India's Planning Commission after a long career in the private sector, mostly in consulting. His new book 'Reimagining India's Economy: The Road to a More Equitable Society' is about to be launched in May 2025.

Arun Maira argues that India's negotiators must be guided by a long-term strategy to build depth in India's own industrial capabilities, which have lagged far behind China. He advises "The US and China are India's largest trading partners… Whereas India runs a large trade deficit with China, it has a merchandise surplus with the US, which is also India's largest market for software services. New Delhi must tread carefully not to annoy either the US or China… it has become imperative for us to create our own industrial capabilities, regardless of any US pressure to abandon Make in India."

In a companion piece, he advises us that the history of Japan's and China's industrial growth must guide us. "Japan built its industries strategically after the Second World War. Industry and trade policies were coordinated by MITI (Ministry of International Trade and Industry, in collaboration with Japan's industry builders. By 1990 Japan had become the factory of the world for a range of manufactured products—automobiles, electronic products, precision machinery, etc."

Arun Maira powerfully argues for strategy that combines Growth with Employment: "Economies develop through a process of learning new capabilities. A country's domestic enterprises learn to do what they could not do before. Workers within those enterprises learn new skills. India needs a fundamental shift in its view of a labour market. Workers are not just resources for production in a 'flexible labour market' to be used and discarded when no longer required. They can be a country's 'appreciating assets', as Japanese workers became, by learning new skills on the job, and enabling enterprises to innovate and compete at higher levels of technology."

While Arun Maira deals with the prospects of Growth with Employment in the context of the international trade, our third article deals with inter-state inequality while encouraging productivity growth and job creation.

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We reproduce a major piece of work by Dr NC Saxena, a distinguished civil servant and development thinker who is also a Distinguished Fellow of the Skoch Foundation a policy think tank that recently conducted its 100th Summit. We are publishing this article with the kind concurrence of Skoch Foundation.

Dr Saxena make the point that wealth created by sustained high rates of growth in India remains unevenly distributed at macro-level as well as in terms of significant inter-state regional disparities. Low growth rates in poorer states have further widened the disparity in the provision of public services. The polarisation has divided the country into two distinct groups of rich states and poor states.

The goal of equitable economic development is to enable income levels of poorer states to reach the levels of the richer states. For this, the incomes of poorer states must grow faster than those of the rich for a long time. Poorer states have weak capacity for the delivery machinery because of which basic public services, such as primary education and public health care suffer a great deal. Dr Saxena makes a strong case for allocations of the consolidated fund of India to states on the basis of population as well as poverty considerations. Based on the observation that fertility rates come down with improved education and health, which require public spending by the states, he asserts “If poorer states are denied funds for education and health, and then be punished for not controlling their population, it would become a vicious cycle leading to a spiraling growth in inter-state inequality.”

He concludes that inter-state inequality is not only detrimental to poverty reduction, but also to economic growth. The issue of inequality is a concern of humanity and well-being, including the right of people to have a life of dignity and access to basic goods and services. Inequality has a negative impact on social cohesion and on the quality of institutions. “Given that in the long-run, efficiency and greater equity are complementary, governments should take appropriate measures to ensure that the reduction in inequality and disparities in life chances are accorded greater prominence in the design of development policies and strategies.”

The fourth article is by the undersigned, jointly with Pranay Bhagava a finance and livelihoods specialist. In this article we begin by reiterating that employment in India will largely come from the non-farm MSME sector. As data from the Annual Survey of Unincorporated Sector Enterprises shows a vast majority of MSMEs are 6.5 crore "own account enterprises" which can barely create subsistence self-employment. The main source of additional employment is the roughly one crore Hired Worker Enterprises. However these HWEs suffer from access to finance both for start up and growth. This paper offers some solutions based on a pilot project that both the authors have been involved with.

We hope the readers find these articles interesting and useful. We look forward to feedback.

Vijay Mahajan
Director, Rajiv Gandhi Institute for Contemporary Studies

1. India's economic strategy must keep the big picture in mind

Arun Maira

Source: Image

US President Donald Trump has declared war against the world to ‘Make America Great Again.’ Its ‘reciprocal tariffs,’ currently paused till early July, have been imposed on all countries that treat the US ‘unfairly’ according to Trump. These include a 49% tariff on imports from Cambodia and 37% on those from Bangladesh, countries whose per capita incomes are 3% of the US’s. High tariffs have even been imposed on tiny Pacific island-nations. However, America’s real concern is the remarkable growth of China’s economy.

The history of wars for ideological hegemony was supposed to have ended in 1991 with the collapse of the Soviet Union and weakening of Russia. The economic ideology of free markets and privatization had defeated the strategy of central planning and industrial policy for building domestic capabilities. To comply with the winning order, Russia pursued ‘big bang’ reforms, with disastrous consequences for its economy. Russia’s GDP shrank by nearly 40% between 1991 and 1998; industrial output dropped; and poverty rose, with 30% of the population living below the poverty line by the mid-1990s.

China and India took different paths after 1991. India was compelled to take a loan from the International Monetary Fund (IMF) in 1991 with conditions attached. It was forced to abandon industrial policies. India also joined the World Trade Organization (WTO) when it was formed in 1995; China joined later, in 2001. India signed the global Information Technology Agreement in 1997 to reduce import duties on IT products to zero; China signed up only in 2003. But Beijing did not succumb to US pressure. It pursued a centrally guided ‘socialist market economy’ to build its capabilities before joining the global game.

As philosopher George Santayana said in The Life of Reason: The Phases of Human Progress, “Those who forget history are doomed to repeat it." A comparison of the economic histories of India, China and Vietnam since 1990 should give India’s free-market reformers pause.

In 1990, India’s per capita GDP, at about $370, was comparable with China’s $318, while Vietnam was much poorer, with a figure of $130. India’s GDP has increased by an impressive 1,000% or so between 1990 and 2024; China’s by roughly 4,500% and Vietnam’s by 6,800%. India’s GDP per capita has increased 7.7 times since 1990, China’s 41.8 times and Vietnam’s 48 times.

Per capita GDP is what matters to citizens. Incomes have grown much faster in China and Vietnam, and their currencies have remained stronger—China’s much more so. They did not succumb to US pressure to give up their socialist moorings and policies to build domestic industries when they joined the global trade system. History suggests that India gave up too soon on industrial policy and moved too fast to liberalize trade.

India, the world’s largest electoral democracy, has a difficult relationship with the US. The US seems to expect India to consistently side with it against any authoritarian country unwilling to toe its line. The US was displeased with India’s neutrality between the Soviet Union and the West during the Cold War. Trump now seems willing to make up with Russia, but not with China, which has caught up with the US in advanced technologies and become the world’s second- largest economy.

The US and China are India’s largest trading partners, with trade worth over $100 billion with each. Whereas India runs a large trade deficit with China, it has a merchandise surplus with the US, which is also India’s largest market for software services. New Delhi must tread carefully not to annoy either the US or China. Given the latter’s disposition towards India, on territory for instance, it has become imperative for us to create our own industrial capabilities, regardless of any US pressure to abandon ‘Make in India.’

Source: Image

In 1990, the manufacturing sectors of India and China were similar. India had acquired better capabilities in the production of machinery, electrical equipment, commercial vehicles and other capital goods. India-made trucks and power equipment were exported to many countries. After India turned to the IMF for financial assistance, however, the Washington Consensus formula came to bear. While China resisted US ideology, India embraced market principles. Now India, like the US, is importing a large range of manufactured products from China, including high-tech ones.

Trump wants Indian duties reduced across the board, which would enable US companies and farmers to export more to India. America's highly subsidized large-scale farmers have been eyeing India as a market. We must resist this because millions of much poorer Indian farmers and workers need higher prices for their produce to improve their standard of living. The India-US trade negotiations underway have a stated aim of $500 billion in annual trade by 2030. This must not be achieved through a huge influx of imports from the US.

Indian manufacturers hope that US restrictions on Chinese imports, which face a three-digit tariff barrier, will make space for them to replace China in US supply chains. Other countries, meanwhile, fear that Chinese manufacturers will aggressively sell their products in their markets instead.

Some Indian businesses want to re-export Chinese wares. To import and sell is easy. Learning to make in India is harder. India's manufacturers and government must withstand American bullying on behalf of US business interests and work harder together to build India's own industrial capabilities.

Source: Image

This article appeared first in The Mint and is being reproduced with gratitude.
https://www.livemint.com/opinion/online-views/trump-trade-policy-us-reciprocal-tariffs-india-us-trade-relations-china-economic-growth-make-in-india-strategy-india-gdp-11744812878846.html

In a companion piece, Arun Maira further writes:

2. Make in India to make India’s economy stronger

Arun Maira

Source: Image

Trump’s trade tantrums to Make America Great Again have upset the global trade regime. His principal target is China. Some countries are scrambling to make deals with the US. India’s negotiators must be guided by a long-term strategy to build depth in India’s own industrial capabilities, which have lagged far behind China.

The history of Japan’s and China’s industrial growth will guide them. They are in much stronger positions to negotiate trade deals with the US than India. The US needs their manufacturers, and they prop up the US economy by investing their huge trade surpluses in US treasuries.

	Japan	China	India
Manufacturing sector	**$995b**	**$4.7tr**	**$469b**
	(19% of GDP)	**(25% of GDP)**	**(13% of GDP)**
Merchandise Exports	**$717b**	**$3.4tr**	**$437b**
Of which, Manufactured*	**$600b (82%)**	**$3.1tr (92%)**	**$297b (68%)**
Currency Reserves	**$1.23tr**	**$3.24tr**	**$676b**
US Treasuries	**$1.1tr**	**$761b**	**$226b**

*Japan and China’s exports contain more high-tech and complex products with domestic value addition than India’s.

Japan and China built their strong manufacturing industries strategically. Free trade, based on the theory of competitive advantage, benefits everyone in the long run. If every country were to produce only what it can produce better than everyone else, and buy from others what they can produce better, all should benefit from access to the best and cheapest products in the world. The problem with this theoretical view is that competitive advantages are not static, except for commodities.

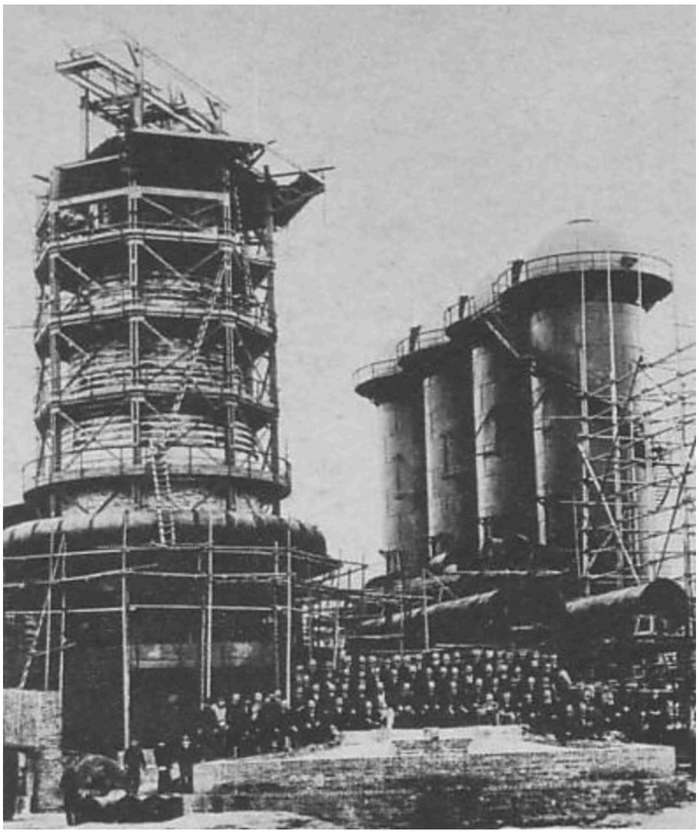
Industrialization is a process of enterprises learning capabilities they did not have before. Trade management is a game of preserving competitive advantage. Every country that has industrialized effectively (including the US in the 19th century), protected its industries while growing its industrial capabilities. Industrially advanced countries protect their monopolies of intellectual property. They prevent developing countries' enterprises from learning capabilities by raising bogeys of 'protectionist' government policies.

Going from less free to more free trade involves the reduction of import duties in steps. In any developing economy, assemblers of finished products—the simplest form of manufacturing— are more numerous than producers of components, who are in turn larger than producers of machinery. Assemblers who sell final products to the public have greater brand visibility and popular support than producers of machinery at the back of the production process. When an economy grows with more consumption, assemblers grow faster. They plead for more import of components to continue supplying products at lower costs to consumers.

Producers of components, in turn, plead for freedom to import machines to reduce their own costs of production. This inverted import strategy favouring importers and assemblers weakens a country's industrial capability with long term consequences for its industrial competitiveness. India abandoned industrial policies prematurely in the 1990s. China's capital goods sector has become many times larger than India's, and China's exports of high-tech manufactured products are 48 times more!

Japan built its industries strategically after the Second World War. Industry and trade policies were coordinated by MITI (Ministry of International Trade and Industry, in collaboration with Japan's industry builders. By 1990 Japan had become the factory of the world for a range of manufactured products—automobiles, electronic products, precision machinery, etc. China, not even in the picture then, became an even larger factory for the world by 2010, by strategically navigating the new rules-based WTO and TRIPs trade regime that replaced the development-oriented GATT in 1995.

'Free' trade is never 'fair' trade. The most powerful countries set the rules and change them when they do not suit them any longer. After WTO, industrial policies were forbidden because they 'protect' domestic industries. TRIPS protected US and Western companies' intellectual property, with which they control value creation in global supply chains. The US says China has cheated and 'stolen' intellectual property. The truth is Chinese industries learned how to produce what they could not before, and to do it as well as US industries.

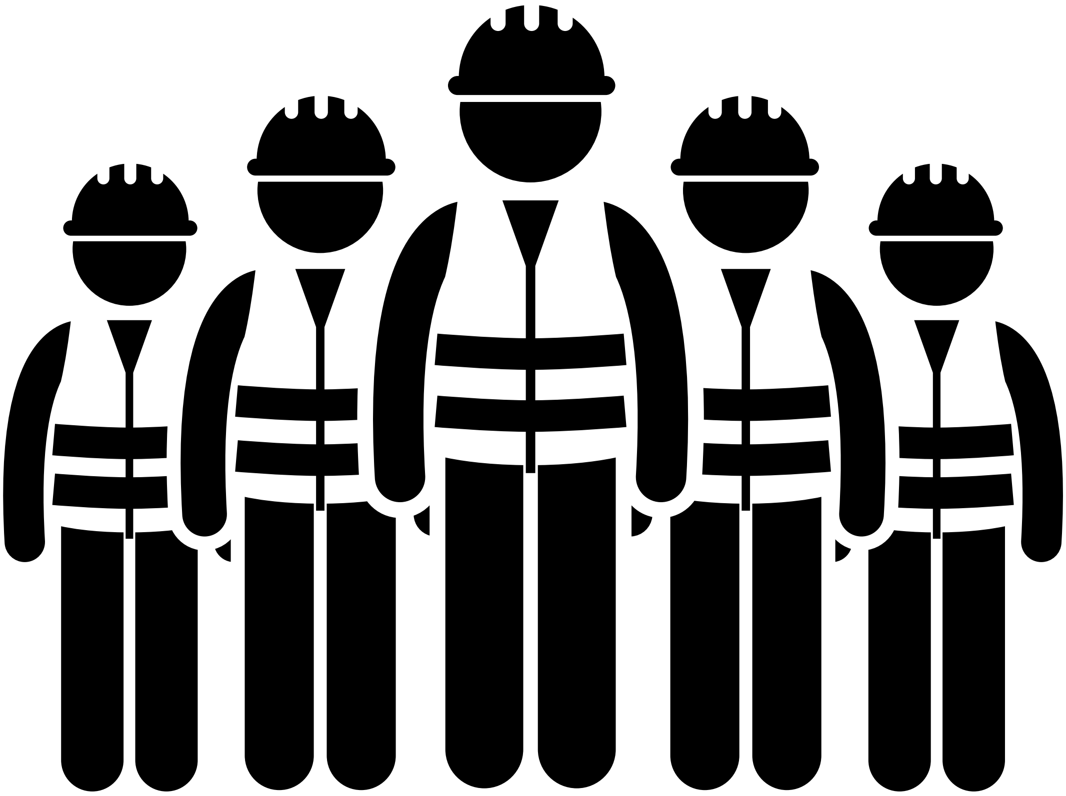


Source: Image

India is at cross-roads: should it comply with Western trade pressures or build its industrial strengths. India can be a huge market attracting foreign and domestic investors, provided incomes increase in the country, with more people employed in jobs with potentials for improving their skills. Economies develop through a process of learning new capabilities. A country's domestic enterprises learn to do what they could not do before. Workers within those enterprises learn new skills.

India needs a fundamental shift in its view of a labour market. Workers are not just resources for production in a 'flexible labour market' to be used and discarded when no longer required. They can be a country's 'appreciating assets', as Japanese workers became, by learning new skills on the job, and enabling enterprises to innovate and compete at higher levels of technology.

This article appeared first in the Business Standard and is being reproduced with gratitude.
https://www.business-standard.com/opinion/columns/make-in-india-to-make-india-stronger-trade-policies-strategy-must-align-125041501425_1.html



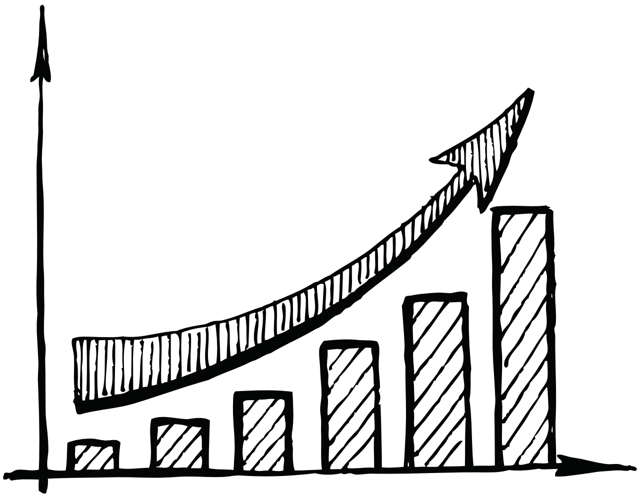
3. Unequal economic growth of Indian states - 1960-2024

Dr Naresh Chandra Saxena [1]

Introduction

There is sufficient evidence to show that India's economic growth in the last sixty years has accentuated the already existing inter-state disparities.

The gini coefficient of per capita incomes in the states has steadily increased from 0.25 in 1960-61 to 0.35 in 1991-92 (Panagariya et al., 2015), and further to 0.40 in 2023-24 (Sanyal and Arora 2024).



After 1991 the structural reforms increased inequality rapidly, as states with an initial higher level of per capita income with better infrastructure and governance experienced a higher growth rate and vice versa. In 1960, the richest state, Maharashtra was only twice as rich as Bihar, but in 2024 it was almost five times richer than Bihar, which continued to be the poorest. In general, If you draw a straight line from Kanpur to Kanyakumari, the States to the right of it are not doing well eco- nomically.

An interesting overall observation is that the maritime states have clearly outperformed the other states, with the exception of West Bengal. Even the coastal state of Odisha which was traditionally a laggard state has seen improved performance in the last two decades.

We discuss below the performance of a few major states (figures largely based on Table 7, 8 and 9 taken from RBI 2024 and Sanyal and Arora 2024). [These tables appear at the end of the article.]

3.1 Growth rates

Central states - The per capita income of Uttar Pradesh (UP) was very close to the all-India average in 1951, when it was Rs 259 in UP against Rs 267 of All India, short by Rs 8 only. The state's per capita income was thus 97 per cent of the national per capita income in 1951 but gradually fell to 68 per cent of this average in 1971–72, remained close to this level till 1991–92 (Srivastava and Ranjan 2019), and then fell to 50.8 per cent in 2023–24 (Table 9).

In the 1960s, undivided Uttar Pradesh was the largest economic powerhouse in the country, with a share of 14.4 per cent in India's GDP in 1960-61. However, its share started to decline thereafter, which continued even after bifurcation.

[1] Distinguished Fellow, SKOCH Development Foundation, Former Secretary, Government of India

Share of UP (bifurcated) in national GDP flattened out at around 8.2 per cent in 2020- 21, before increasing marginally to 8.4 per cent in 2023-24, as against its share of 16.5 per cent in population. A similar pattern is observed in its performance in terms of relative per capita income[2], which fell from 82.4 per cent in 1961 to 50.8 per cent in 2023-24.

During 1993-94 to 2017-18, UP's per capita income recorded the slowest annual growth rate of 3.72 per cent per annum, worse than even Bihar (4.52 per cent), Madhya Pradesh (4.39 per cent), and Odisha (5.69 per cent).[3] More recent data on the four years of the present regime (2017-21) shows that UP's per capita income increased only by 1.8 per cent per annum as against the national average of 2.7 per cent (Indian Express, 22nd September 2021).

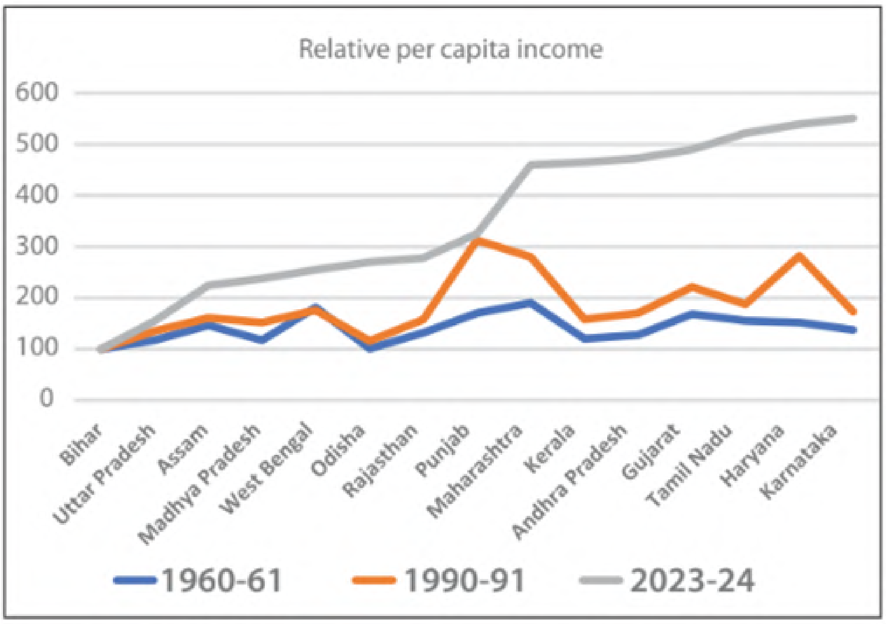


Figure 1: Relative per capita Income of Major States

The relative per capita income of undivided Bihar was 70.3 per cent in 1960-61. It started declining thereafter and bottomed out at 31 per cent in 2000-01 for the bifurcated state of Bihar. The state lagged behind during Sri Laloo Yadav and his wife's regimes but improved considerably during the initial years of Nitish Kumar as Chief Minister. The share of per capita income in Bihar in the All-India average rose from 33 per cent in 2004-05 to 42 per cent in 2013-14 due to superlative growth in the road construction and power sector. However, the pace could not be maintained, and its relative per capita income fell from 35.4 per cent in 2010-11 to 32.8 per cent in 2023-24. Agriculture, the bedrock or Bihar's economy on which the large majority of households depend, has performed poorly. In Jharkhand, political instability and the inability of the coalition to work together over a long period led to its poor performance.

Madhya Pradesh has experienced a notable turnaround in its relative per capita income since 2010, following a five-decade period of decline (82.4 per cent in 1960-61 to 60.1 per cent in 2010-11). Its relative per capita income increased from 60.1 per cent in 2010-11 to 77.4 per cent in 2023-24.

[2] Relative per capita income is calculated as the ratio of the per capita Net State Domestic Product (NSDP) of the state as a per centage of the all-India per capita Net National Product

[3] Author's estimation based on Reserve Bank of India (Handbook of Statistics on Indian States) annual data

Similar improvement was observed in Chhattisgarh too and its relative per capita income rose from 76.2 per cent in 2010-11 to 80.0 per cent in 2023-24. As regards Rajasthan, its share in national GDP has been consistently rising, albeit slowly, from 4.4 to 5.0 per cent during 1960-2024 as against 5.7 per cent as its share in population in 2011.

EASTERN STATES: Inter-se ranking of states had also changed in the last sixty years. West Bengal, which was a rich, industrialized state in the 1960s had slid down the ranks. Though poverty declined quite satisfactorily in West Bengal during the left regime due to land reforms and spread of surface irrigation, de-industrialisation between 1998-1999 and 2004-2005 reduced the number of people employed in the industrial sector. West Bengal, which held the third-largest share of national GDP at 10.5 per cent in 1960-61, now accounts for only 5.6 per cent share in 2023-24, much less than its share in India's population at 7.5 per cent in 2011. It has seen a consistent decline throughout this period. West Bengal's per capita income was above the national average in 1960-61 at 127.5 per cent, but its growth failed to keep pace with national trends. As a result, its relative per capita income declined to 83.7 per cent in 2023- 24, falling below that of even traditionally laggard states like Rajasthan and Odisha.

Assam, which initially had a per capita income slightly above the national average (103 per cent in 1960-61), meanwhile experienced a decline in its relative per capita income and reached 61.2 per cent in 2010-11. Since then, Assam's relative per capita income has been on the rise, reaching 73.7 per cent in 2023-24.

The other eastern state, Odisha, was also seeing a consistent decline in terms of relative per capita income from 1960s to 1990-91 (70.9 to 54.3 per cent), has seen a significant turnaround since then. Its relative per capita income increased from 54.3 per cent in 1990- 91 to 73.2 per cent in 2010-11 to 88.5 per cent in 2023-24.

Odisha was one of the most fiscally stressed States in the early 2000s, with a debt-GSDP (Gross State Domestic Product) ratio of 57.3 per cent in 2002-03 – well above the consolidated debt-GDP ratio of 32.1 per cent for all States. The interest payments to revenue receipts ratio was 34.2 per cent in 2002- 03, imposing a significant strain on the State's finances. Over the subsequent two decades, there has been a turnaround in the fiscal position of the State, with the debt-GSDP ratio declining to 16.0 per cent in 2023-24 – the lowest among the Indian States. The Odisha FRBM (Amendment) Act 2016 made it mandatory for the State to generate revenue surplus, contain the gross fiscal deficit (GFD) within 3 per cent of GSDP[4], and maintain debt within 25 per cent of GSDP. The State has managed to stay within the limits prescribed by the Act. Odisha is the only State to register a revenue surplus (1.7 per cent of GSDP) during the pandemic year of 2020-21, which increased to 6.5 per cent of GSDP in 2021-22 on account of higher realization of non-tax revenue (RBI 2024).

Source: Image

[4] Gross Fiscal Deficit as per cent of GSDP was 8.9 in Bihar, 1.7 in Gujarat, 4.0 in Madhya Pradesh and 2.9 in Odisha in 2023-24 (RE).

NORTHERN STATES: Punjab and Haryana, which were once part of the same state, have experienced diverging economic trajectories. Punjab's GDP share grew during the 1960s, mainly due to the Green Revolution, but then plateaued at around 4.3 per cent until 1990-91. It began to decline thereafter, finally reaching 2.4 per cent in 2023-24. Haryana's share of India's GDP now exceeds that of Punjab, and its relative per capita income has reached 176.8 per cent, compared to Punjab's 106.7 per cent in 2023-24.

WESTERN STATES: Maharashtra and Gujarat have consistently performed well throughout the study period. Maharashtra has maintained the highest share of India's GDP for almost all of the period. Gujarat's share remained at broadly the same levels until 2000- 01, before beginning to increase rapidly - from 6.4 per cent in 2000- 01 to 8.1 per cent in 2022-23. Both Gujarat and Maharashtra have had per capita incomes exceeding the national average since the 1960s.

Initially, Gujarat lagged behind Maharashtra, with a relative per capita income of 118.3 per cent compared to Maharashtra's 133.7 per cent in 1960-61. This disparity persisted until 2010-11, when Gujarat surpassed Maharashtra. By 2023-24, Gujarat's per capita income has risen to 160.7 per cent of national average, as compared to 150 per cent for Maharashtra.

SOUTHERN STATES: Before 1991, southern states did not show exceptional performance, as the share of these four states in national GDP was 23.3 per cent in 1990-91 as against their share of 21.8 per cent in population. However, since the economic liberalization of 1991, the southern states have emerged as the leading performers, and their share in national GDP went up to 31.6 per cent in 2023-24.

Kerala, which was only slightly better-off than UP in terms of per-capita income in the 1960s, recorded impressive growth and became more than three times richer than UP by 2024 (see Figure 1). When the economy is liberated and controls on investment and movement of resources are lifted, comparatively developed regions are likely to attract more investment including foreign investment, leading to rise in regional inequality in the process (Devi and Sharma 2024).

Thus, the economic order of different states has not remained unaltered over time. The average annual growth rate during the last ten-year period of 2013-24 of five States with lowest per capita NSDP was 4 per cent as against 6 per cent of five highest per capita NSDP States (Table 7), thus increasing inter-state disparities.

3.2 Why do some grow and some stagnate?

The question of why some societies generate growth and change, and others stagnate, was at the heart of nineteenth-century sociology, especially in the works of Karl Marx and Max Weber. This tradition has been carried forward in India too to explain population densities and social structure in terms of ecological variables of rainfall and irrigation, as well as to explain association between oppressive power structures in eastern India and its agricultural involution in the 20th century (Beteille 1974, Epstein 1973, Ludden 1984).

Historically till the early 19th century, the eastern region was more prosperous than the west and peninsular India. Due to better rainfall, more fertile soil, more rivers, and plentiful availability of groundwater, it was easier to dig wells and irrigate crops.

Better productivity not only reduced mortality but also attracted migration from less fertile regions, leading gradually to high population pressure in eastern India. When labour became available in plenty, landowners did not have to do manual work themselves, they became lazy, and left the hard onerous task of operating land to the tenants and sharecroppers.

Gradually a tradition to associate status with leisure emerged in which performing manual work was considered polluting and a sign of low ritual status. High co-relation between caste and landownership in the eastern region helped in the evolution of feudal customs, which determined everyday discourse and almost became part of the religion.

On the other hand, In semi-arid west and south India, nature was harsher, soil was infertile, labour was difficult to find, and landowners had to work themselves on the fields to eke out a living. This made them more enterprising. The situation started changing in their favour from the mid- 19th century onwards, when canal irrigation was introduced in north-west India. Besides, the British land tenure settlement brought the west and southern India under a ryotwari system, in which property rights were assigned to individual farmers.

Public investment by the colonial government in terms of canals, roads, and schools was more pronounced in the ryotwari areas and northwest provinces, whereas this task was often left to the zamindars in eastern India. Manufacturing, primarily in cotton textiles, too was largely in West and South India, such as Bombay, Ahmedabad, Madras, Madurai and Coimbatore, with Kanpur and Calcutta being a few exceptions. The British improved infrastructure in peninsular India to facilitate revenue collection from farmers. Also, the British invested a great deal in ports to increase exports.

On the other hand, in the zamindari and taluqdari areas of Uttar Pradesh, Bengal, Bihar, Orissa, and Central Provinces, land taxes and property rights were assigned to landlords, who did little towards development, and depended on coercion to collect land revenue.

In the east, absentee landlords often owned rights to numerous villages and developed extensive bureaucratic organisations and policing forces to oppress local villagers to farm the land under exploitative sharecropping or wage contracts, so well described in the works of Munshi Premchand and Sharat Chandra Chattopadhyay.

Kusum Nair (1979), in her study of the Bihar and Punjab farmers of India in the 1970s, found that the Bihar landlords spent more time in complaining to the government against non- running of the canals, but took no interest in getting their own tubewells repaired, which would have been more cost-effective. The typical Punjabi cultivator, on the contrary, worked very hard and ‘appears to have been born to the ethic of utilising irrigation for production and profit’.

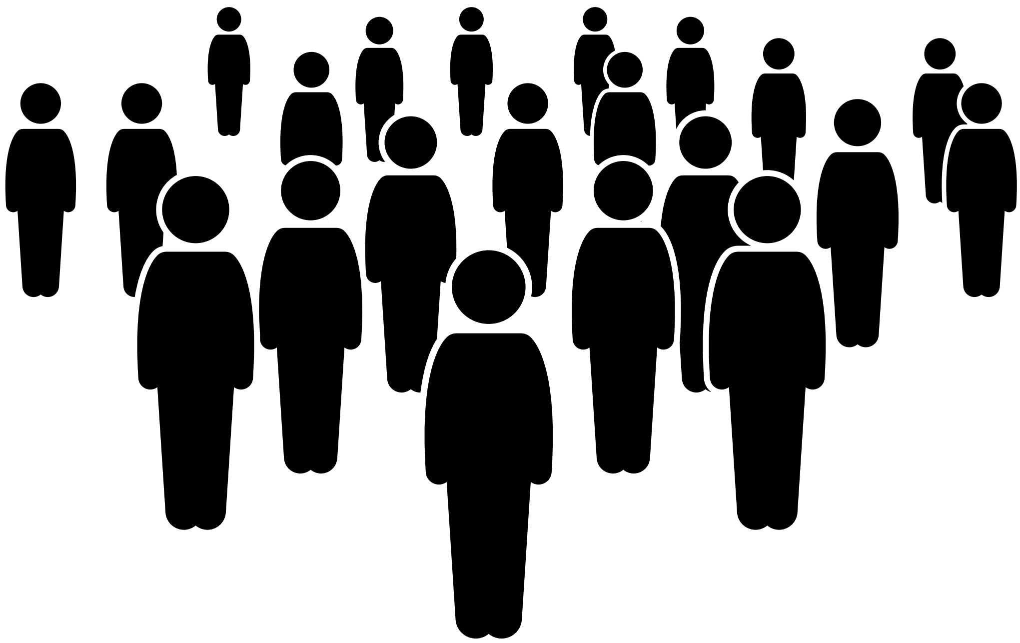
In addition, there emerged radical movements of social reform in Kerala, Tamil Nadu and Maharashtra, concerned with fighting against the caste system and social hierarchy, which also improved female literacy and the status of women. These led to higher level of literacy in these states (partly due to the activities of Christian missionaries in south India). In 1961 literacy in Kerala (55 per cent), Tamil Nadu (36 per cent), and Maharashtra (35 per cent) were far ahead of the national average of 28 per cent, or an average of 21 per cent across the four big states of the Hindi heartland – Bihar, Uttar Pradesh, MP and Rajasthan.

Before 1991, southern states only showed average performance. However, since the economic liberalisation of 1991, the southern states as well as Maharashtra and Gujarat have emerged as the leading performers. After 1991 the structural reforms increased inequality rapidly as these states with initial higher level of per capita income with better infrastructure, skills and governance achieved higher growth rate. The poor benefited in these states due to strong government action, spurred by informed citizen action building on high literacy in Kerala, and acute political rivalry between DMK and AIADMK in Tamil Nadu which led to announcements of a number of populist programmes by successive governments.

A more pro-poor regime in Kerala and Tamil Nadu interacted with a more efficacious citisenry, creating what Amartya Sen rightly called a “virtuous” cycle (Chakraborty 2005). This created both a supply of and demand for a variety of successful pro-poor public policies, including land reforms, higher investments in education and health, better implementation of policies, and greater gender equality.

On the other hand, the capacity to implement inclusive and pro-poor policies has always been limited in the Hindi speaking and eastern states. Basic universal services in schooling, health care, child immunization, public food distribution, and social security in the BIMAROU states appear to have been somewhat neglected, with no particular efforts to measure outcomes and ensure results.

By the 1980s, electoral competition in Uttar Pradesh and Bihar had become intensely socially polarised, with voting decisions overwhelmingly based on a candidate’s caste identity. Public spending on education and health accounted for 45 per cent of public expenditure in Kerala in the 1990s, while it was less than 30 per cent in the Hindi speaking states, with the exception of Himachal Pradesh and Uttarakhand which have a high literacy levels, due to numerical dominance of upper castes in these hilly states.



Thus, although the zamindari areas were historically more productive than ryotwari areas before the colonial rule, acute pressure on land and the introduction of British institutions reversed the fortunes of these regions over time.

Better growth of the western and coastal regions during the colonial period as well as in the first few decades after independence can be attributed to various elements of the agrarian structure, such as lower population density, better road and rail communication, extensive canal irrigation, greater urbanisation, small-scale proprietorship, and - as an old official Report expressed it - peasantry of `a better and more virile stamp' (GOUP 1933).

On the other hand, with long traditions of zamindari or taluqdari rule, the quality of state level bureaucracy that the Hindi heartland inherited was generally low. Virulent patronage politics politicised the bureaucracy in post-independence years, further diluting the state's developmental capacity.

For some three to four decades following Independence, a narrow political base, personalistic factionalism, and a less-than-professional state level bureaucracy characterised the nature of state power in this region of India (Kohli 2010). Land reforms too were very poorly implemented in the Hindi-heartland states, especially Bihar.

This picture of inertia inverts global trends. Everywhere, poorer regions are climbing up. Martin and Sunley (1998) hold that regional disparities are unlikely to be persistent, since such inequalities will set in motion self-correcting movements in prices, wages, capital, and labour, which impart a strong tendency towards regional convergence.

No Chinese province has been stuck at the poverty levels of three decades ago.[5] This is precisely how it should be, according to what economists call "convergence": a region with poor income and consumption data sees fast growth on those counts if its markets are linked to those of richer regions (Mazumdar et al. 2017).

India's economy has those linkages, yet paradoxically its states show a polarising picture of divergence, which may be the outcome of lack of revenues, lower efficiency in utilisation of public capital, and also of infrastructural disparity across the states. Besides poor governance, the fact that the poorer states did not receive equitable share in central finances is also an explanatory factor behind their poor performance, as explained below.

[5] http://www.indialivetoday.com/bihar-described-bi-mar-squalor-states-india/185133.html

3.3 Fiscal capacity of states

As expected, states' own revenue collection is far better in the richer states. For instance, Bihar with a population of 10.5 crores was able to collect only Rs 49,700 crore as taxes in 2023-24, whereas Gujarat with less population of 6.0 crores collected Rs 1,38,848 crores. Thus per capita tax collection in Gujarat was almost five times of Bihar. To add to Bihar's woes, per capita total transfers[6] from GOI to poorer states is often much less than for richer states. This explains why per capita social sector expenditure in Bihar was less than one-third when compared to Tamil Nadu in 2004-05, though it has improved to 63 per cent in 2023-24, as shown in Table 1.

Table 1: PER CAPITA SOCIAL SECTOR EXPENDITURE (in Rs)

State	2004-05	2013-14	2023-24
Bihar	588	3358	12160
Tamil Nadu	1891	7655	19328
Ratio	31 %	44 %	63 %

Similarly, per capita capital expenditure in UP was only 71 per cent of similar expenditure in Karnataka in 2023-24, though ideally speaking poorer states should spend more than developed states if inequality is to decline.

Table 2: PER CAPITA CAPITAL EXPENDITURE (in Rs)

State	2004-05	2013-14	2023-24
Karnataka	1527	3518	12592
Uttar Pradesh	726	2129	8894
Ratio	48 %	61 %	71 %

Thus, the correlation between central devolution with either state's fiscal capacity or its GSDP is extremely weak with the result that the overall per capita expenditure for the poorer states is far less than for the relatively prosperous states. Obviously to correct this imbalance, one needs to make central devolution of funds more equitable, both through the Finance Commission (FC) as well as from the Central Ministries.

Tax collection in West Bengal has always been very poor at about 5 per cent of GSDP as opposed to 15 per cent for Tamil Nadu (Saxena 2013). This has also led to huge borrowing by the West Bengal government (often from private parties such as Peerless Insurance and Haldirams) which means much of the state revenues are used up in paying interest on state debt. West Bengal's debt as a ratio of state's GDP is around 35 per cent of its GDP as against around 20 per cent for most other major states.[7]

[6] Includes both, from Finance Commission and the Ministries

[7] http://www.oecd.org/eco/surveys/economic-survey-in-%20dia.htm

3.4 Finance Commission

Throughout 1980 to 2020, starting from the 7th FC till the 14th FC, the Finance Commissions have been mandated to use the 1971 population for the purpose of computing state shares. Poorer states like Bihar, UP, and Rajasthan have not been able to control population growth and therefore suffered a great deal when compared with Kerala and Tamil Nadu. For instance, Kerala's share in India's population is now 2.8 per cent, but for the purpose of central devolution of funds the share is calculated at 4 per cent, which was the position in 1971. Its impact can be seen in Table 4, which shows how Kerala's share in 14th FC devolution was 2.5 per cent though its share in India's poverty was only 0.9 per cent. Some poor states, such as UP, Bihar, and Odisha have been losing their share in central taxes between the 12th, 13th and 14th FC, as shown below.

Table 3: Share in total devolution in various FC Awards[8]

	Population Share in 2011	Share in poverty 2011-12	12th 2005-10	13th 2010-15	14th 2015-20	15th 2020-25
BIHAR	8.6	13.3	11.0	10.9	9.7	10.1
ORISSA	3.7	5.1	5.3	4.8	4.6	4.5
UP	16.6	22.2	20.7	19.7	18.0	17.9
TOTAL (3 STATES)	28.6	40.6	37.0	35.4	32.3	32.5
KERALA	2.8	0.9	2.2	2.3	2.5	1.9

Thus, if all the states were to get FC funds on the basis of their share in poverty, Kerala would have received only 0.9 per cent of total devolution, however it received almost three times its share in poverty. On the other hand, the poorer states not only got much less than their share in poverty, these three states have lost almost 5 percentage points in share in taxes between 2005 and 2020, which adversely affected their development expenditure.

[8] Calculated by the author based on various FC reports

Freezing the population criterion to a level that was 40 years ago, resulted in a significant dilution of the equity principle. Fortunately, the TORs of the 15th and 16th FCs corrected this injustice, as GOI asked them to ‘use the population data of 2011 while making its recommendations’. The southern states obviously have seen this change as against their financial interests, though the arguments advanced by them do not have much substance.

Decline in fertility occurs when women are educated and employed in non-agricultural activities. This results in late marriages and a desire to limit the number of children. The fertility rates for southern and western states were low because of higher female literacy rates, better infrastructure, and faster industrialization and urbanisation. If poorer states are denied funds for education and health, and then be punished for not controlling their population, it would become a vicious cycle leading to a spiralling growth in inter-state inequality.

Thus, if all the states were to get FC funds on the basis of their share in poverty, Kerala would have received only 0.9 per cent of total devolution, however it received almost three times its share in poverty. On the other hand the poorer states not only got much less than their share in poverty, these three states have lost almost 5 percentage points in share in taxes between 2005 and 2020, which adversely affected their development expenditure.

In addition to direct central transfers through the FC, which are not equitable, there are two other ways richer states benefit at the cost of poorer states. First, credit deposit ratio of richer states is often more than one, and for poorer states is less than 0.58. This implies that private money saved in the bank accounts of Bihar and UP is spent by the banks in Maharashtra and Tamil Nadu[9]. Thus the flow of private money is ironically from the poorer to the richer states. Second, subsidy from GOI on fertilisers and petro products are largely used in advanced states, as a greater part of its consumption takes place there.

Source: Image

[9] For Bihar it was 0.29 in 2011-12, but for Tamil Nadu it was 1.15, Source: Data-book for Use of Deputy chairman, Planning Commission, Government of India, 10th March 2014. Available at: http://planningcommission.gov.in

3.5 Transfer through the ministries

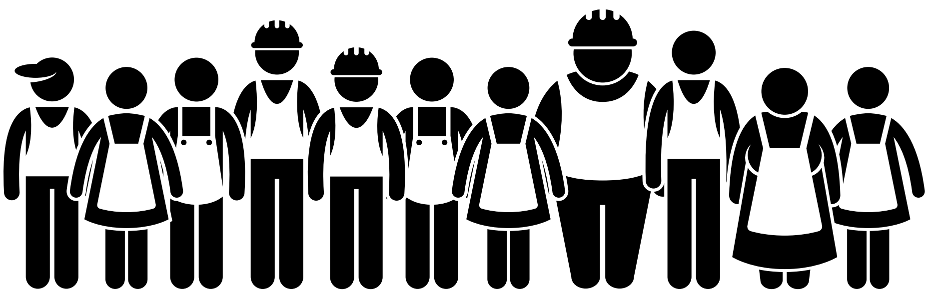
It is often argued that since the FC awards are formula based and cater to the needs of the entire population of a state, these cannot fully compensate the lack of financial resources with the poorer states. Therefore, theoretically speaking, transfers through the Ministries through centrally sponsored schemes (CSS) with flexible guidelines should be more progressive, as these are directly targeted to reduce poverty, and improve human development. Ironically the picture is just the reverse, and CSS transfers help the richer states more than they help the poorer states. The Economic Survey 2014-15 has contrasted equity in CSS transfers with FC transfers and admits (p. 134) that per capita CSS transfer is often higher to the richer states than for the poorer states. For example, taking average for the period 2017-22, Bihar and Uttar Pradesh received from GOI about Rs 1,600 per capita, whereas Telangana and Tamil Nadu received over Rs 2,500. (Chakrabarty and Singh 2024).

To give another example, GOI transfers more funds per rural poor under NREGA to the richer states than to the poorer ones, although the scheme is supposed to provide employment to the poor unskilled workers. The number of rural poor in Bihar is six times the similar number in Tamil Nadu, but expenditure on NREGA in Tamil Nadu during 2021-24 was twice that of Bihar. This design flaw can easily be fixed by allocating resources to the states in NREGA proportionate to the number of rural poor in that state, just as it is done in PMGSY.

Similar inequity is observed in releases of central funds under the National Health Mission (NHM). Although per capita release should be significantly higher in poorer states to compensate for their poor health infrastructure and limited state revenues, it is seen that this principle is hardly observed, as shown in Table 4, which shows that releases to Tamil Nadu per poor were almost four times more than for Bihar.

Table 4: Releases under NHM for 3 years 2015-189

State	2015-16	2016-17	2017-18	Total in crore Rs	Population in 2011 lakhs	Total number of poor (in lakhs)	Release per person	Release per poor
Bihar	1,270	1,041	1,557	3,868	1,040	358	372	1080
Tamil Nadu	1,110	789	1,294	3,193	721	83	443	3847
INDIA	18,158	18,424	25,465	62,048	12100	2698	513	2300



3.6 Do the poor states have necessary manpower for better delivery?

Insufficient revenues with the poorer states result in not only weak infrastructure, such as schools without buildings and deficient power generation, but also in inadequate number of government staff.[10] This in turn affects these states' capacity to draw tied plan funds from GOI Ministries, or submit utilisation certificates in time. Thus, shortage of staff results in weak governance that further limits their access to GOI resources; each factor being the cause as well as the effect of the other resulting in a vicious cycle. Therefore, it is instructive to look at inter-state availability of regular government employees.

Table 5 compares the situation in Bihar with undivided Andhra Pradesh, two states with comparable population.

Table 5: Number of govt servants ('000)

	ANDHRA PRADESH	BIHAR
Central Govt	185	95
State Govt	396	200
Quasi Govt. (Central/State PSUs)	176	47
Local Bodies	281	37
Total	1038	379

Table 6 compares the number of state government employees (including state PSUs and local bodies) in Bihar with Tamil Nadu.

Table 6: Number of state government employees

	TAMIL NADU	BIHAR
Population 2011 (crores)	7.2	10.4
Total number of state Govt. servants (lakhs)	10.41	2.84
No of govt servants per 1000 population	14.4	2.7

Thus as compared to the global average of more than 30, Bihar has only 2.7 employees per thousand population. No wonder all schemes are in disarray there! State-wise position is given in Figure 2.

[10] This section draws heavily from the author's book, Saxena, Naresh Chandra 2024: What Ails the IAS & Why It Fails to Deliver? An Insider's View, Atlantic

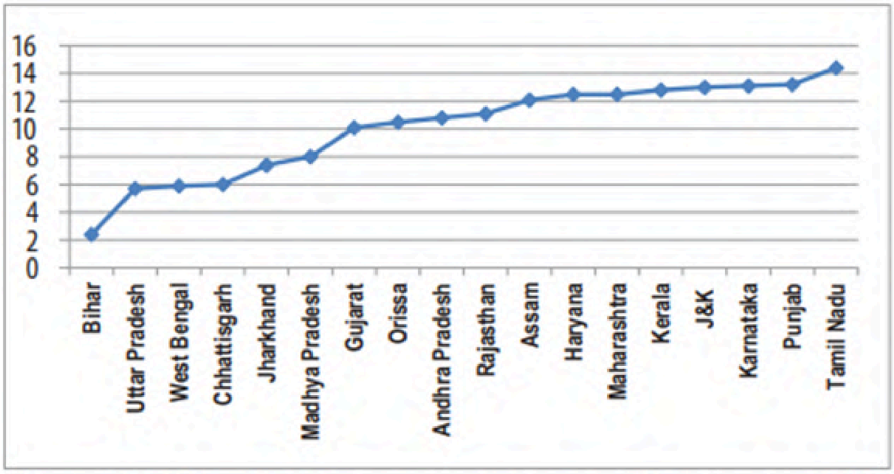


Figure 2: No. of state government employees per 1000 population

With limited revenues it is just not possible to increase staff in social sector programmes on a regular basis, and therefore there is no escape from hiring ill-paid contractual employees, leading to a bizarre situation that a para teacher gets far less than a regular peon or driver. The control over social sector flagship programmes in the coming years is likely to be transferred to the states, where politicians would find demand from contractual employees to be regularised difficult to resist. The extra fiscal burden due to regularisation would mean that further expansion of line staff would be halted at the cost of satisfactory delivery of social sector programmes. Budget cuts on non- wage component (medicines, text books, repair of buildings) have already reduced efficiency in delivery for many programmes.

India is awfully short of government servants when compared to the world average - it is 1.2 per cent of the population in India whereas in East Europe it is 6 per cent, and in Asia it is 3 per cent. The skill-mix is also wrong in our country. We have too many orderlies, clerks, drivers and peons, who are not needed now, but we are very short of doctors, nurses, teachers and even policemen. So, people who are needed in the line positions are missing while people who are not needed in support positions are too many. Therefore, support functionaries need to be reduced and line functionaries need to be increased. There should be incentives for clerks and orderlies to become teachers and constables.

3.7 Recommendations and summing up

To sum up, wealth created by sustained high rates of growth in India remains unevenly distributed at macro-level as well as in terms of significant inter-state regional disparities. Low growth rates in poorer states have further widened the disparity in the provision of public services. The polarisation has divided the country into two distinct groups of rich states and poor states (Hari and Hatti 2015). The goal of equitable economic development is to enable income levels of poorer states to reach the levels of the richer states. For this, the incomes of poorer states must grow faster than those of the rich for a long time. However this hasn't quite happened in India, although some poor states such as Odisha have done well lately when compared with their own dismal past record.

Poorer states have weak capacity of the delivery machinery because of which basic public services, such as primary education and public health care suffer a great deal. Unfortunately, state governments do not discourage reporting of inflated figures from the districts, which renders monitoring ineffective. As data are often not verified or collected through independent sources, no action is taken against officers indulging in bogus reporting.

Similarly, there are no indicators for assessing the quality of programme outcomes. For instance, one would like to know how many newly constructed toilets are being used, and what impact has it has had on peoples' health and hygiene.

Results from a 2018 survey (Gupta et al. 2019) in four states: Bihar, Madhya Pradesh, Rajasthan, and Uttar Pradesh show that although rural latrine ownership increased considerably during 2014-18, open defecation remains very common; approximately 40 to 50 per cent of rural people in these states defecated in the open in late 2018. Pratham, a voluntary organisation, has evolved a simple test in education at a low cost which judges the extent of learning in primary schools. Their findings show that the actual learning levels of students are abysmally low.

Niti Aayog should evaluate all flagship programmes periodically through independent and competent professional organisations. Today Ministries, such as Tribal Affairs, Food & Public Distribution, and Women & Child Development are content with release of funds or foodgrain with little knowledge of its impact on the poor. They must measure and monitor outcomes that would put pressure on weak states to improve their performance. Technology should be used to monitor not only attendance but performance of field staff.

Central Indian states must focus on improving the productivity of rainfed areas, as primary sector is associated with the reduction of inter-state and inter-region income inequality. We need to build efficient irrigation systems and water conservation strategies in rainfed regions, through conjunctive use of surface and groundwater.

The main thrust of the programmes to combat the impact of climate change in rainfed areas should be on activities relating to rainwater harvesting, soil conservation, land shaping, pasture development, vegetative bunding, and water resources conservation on the basis of the entire compact micro-watershed which would include both cultivated and uncultivated lands. Agriculture in semi-arid regions has to move away from traditional crop centric farming to agri-pastoral-farm forestry systems (fruit trees, shrubs, perennial grasses and small ruminants).

If rain is captured with peoples' participation drought can be banished from India in ten years maximum. Unfortunately, the slogan of 'more crop per drop' has so far remained an empty rhetoric, 'an ideology without a methodology'.

Poorer states have also not liberalised controls over small and medium scale industries. Many politicians in these states are themselves involved in business. They run or control flour mills, rice shellers, liquor shops, real estate, brick-kilns, fair- price shops, and licences in essential commodities like coal, sand, and quarry businesses. However, all these industrial activities are heavily regulated through laws, rules, and regulations which debar an ordinary person to survive in these businesses unless he has active support from politicians. Controls give immense power to the bureaucracy to harass the common people and collect bribes from them. Thus politicians have a vested interest in continuation of controls which not only enrich them but give them powers to distribute patronage, and eliminate competition from better entrepreneurs but with no access to politicians. Such controls are inimical to faster growth.

Monopoly-based growth increases inequality, due to which gains to the poor are limited. Other things being equal, one percentage point of growth leads to a smaller reduction in poverty in a very unequal country than in a less unequal one. And if inequality rises during the growth process, benefits to the poor become even less. The impact of the same amount of growth on poverty reduction is significantly greater when initial income inequality is lower (Ghosh and Kaustubh 2025). The higher the initial level of inequality in a country or the greater the increase in inequality during the growth spell, the higher the rate of growth that is needed to achieve any given rate of poverty reduction.

Successful policies aimed at correcting market failures, facilitating the accumulation of physical and human resources by the poor and backward groups, adequate allocation of central funds to the poorer states, and the provision of safety net programmes to all vulnerable sections of the population are essential pre-requisites for reducing inequality.

Inter-state inequality is not only detrimental to poverty reduction, but also to economic growth. The issue of inequality is a concern of humanity and well-being, including the right of people to have a life of dignity and access to basic goods and services (Sekher and Chakraborty 2016). Inequality has a negative impact on social cohesion and on the quality of institutions. Given that in the long-run, efficiency and greater equity are complementary, governments should take appropriate measures to ensure that the reduction in inequality and disparities in life chances are accorded greater prominence in the design of development policies and strategies. Dealing with inter-state inequality while encouraging productivity growth and job creation, is now probably one of the biggest policy challenges facing India.

Source: Image

Table 7: Per Capita Net State Domestic Product (Constant Prices)

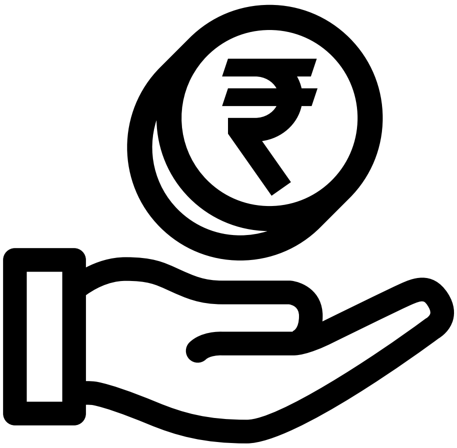
	Base: 2004-05			Base: 2011-12		
	2004-05	2013-14	Annual rate of growth %	2013-14	2023-24	Annual rate of growth %
Andhra Pradesh	25,959	42,170	5.5	72,254	1,35,806	6.5
Uttarakhand	24,726	59,161	10.2	1,12,900	1,59,306	3.5
Himachal Pradesh	33,348	54,494	5.6	98,816	1,61,192	5.0
Kerala	32,351	58,961	6.9	1,07,846	1,61,957	4.2
Maharashtra	36,077	69,097	7.5	1,09,597	1,63,820	4.1
Tamil Nadu	30,062	62,361	8.4	1,02,191	1,79,732	5.8
Telangana	24,409	48,881	8.0	96,039	1,83,854	6.7
Haryana	37,972	67,260	6.6	1,19,791	1,85,490	4.5
Karnataka	26,882	46,012	6.2	1,01,858	1,86,038	6.2
Gujarat	32,021	63,168	7.8	1,02,589	1,90,342	6.4
Bihar	7,914	15,506	7.8	22,776	32,174	3.5
Uttar Pradesh	12,950	19,233	4.5	34,044	50,875	4.1
Jharkhand	18,510	28,882	5.1	43,779	65,062	4.0
Madhya Pradesh	15,442	26,853	6.3	42,548	66,441	4.6
Jammu & Kashmir	21,734	31,448	4.2	54,783	79,059	3.7
West Bengal	22,649	36,293	5.4	53,815	79,622	4.0
Assam	16,782	23,392	3.8	43,002	80,440	6.5
Rajasthan	18,565	31,836	6.2	61,053	90,831	4.1
Chhattisgarh	18,559	28,373	4.8	61,409	92,101	4.1
Odisha	17,650	24,929	3.9	54,209	98,331	6.1
Punjab	33,103	49,529	4.6	93,238	1,30,002	3.4

Table 8: State Share of National GDP

State\UT	Share in 2011 popln	1960-61	1990-91	2010-11	2023-24
Andhra Pradesh	4.2	7.7	7.6	4.6	4.7
Telangana	2.9	.	.	3.8	4.9
Assam	2.6	2.6	2.4	1.6	1.9
Bihar	8.6	7.8	6.0	2.9	2.8
Jharkhand	2.7	.	.	1.8	1.5
Madhya Pradesh	6.0	6.3	6.9	3.8	4.5
Chhattisgarh	2.1	.	.	1.7	1.7
Gujarat	5.0	5.8	6.4	7.5	8.1
Haryana	2.1	1.9	3.1	3.8	3.6
Karnataka	5.0	5.4	5.3	5.9	8.2
Kerala	2.8	3.4	3.2	3.8	3.8
Maharashtra	9.3	12.5	14.6	15.2	13.3
Odisha	3.5	2.9	2.5	2.9	2.8
Punjab	2.3	3.2	4.3	3.3	2.4
Rajasthan	5.7	4.4	4.7	4.9	5.0
Tamil Nadu	6.0	8.7	7.1	8.4	8.9
Uttar Pradesh	16.7	14.4	12.6	8.7	8.4
Uttarakhand	0.8	.	.	1.2	1.1
West Bengal	7.5	10.5	7.9	6.7	5.6

Table 9: Relative per capita income

State\UT	1960-61	1990-91	2010-11	2023-24
Andhra Pradesh	89.9	79.9	108.7	131.6
Telangana	.	.	123.9	193.6
Assam	102.9	75.5	61.2	73.7
Bihar	70.3	46.9	35.4	32.8
Jharkhand	.	.	64.3	57.2
Madhya Pradesh	82.4	71.4	60.1	77.4
Chhattisgarh	.	.	76.2	80.0
Gujarat	118.3	103.9	143.4	160.7*
Haryana	106.9	132.4	173.7	176.8
Karnataka	96.7	81.1	115.2	180.7
Kerala	84.6	74.1	129.5	152.5
Maharashtra	133.7	131.2	157.1	150.7
Odisha	70.9	54.3	73.2	88.5
Punjab	119.6	146.7	128.8	106.7
Rajasthan	92.8	73.9	82.6	91.2
Tamil Nadu	109.2	87.9	145.3	171.1
Uttar Pradesh	82.4	63.3	49.4	50.8
Uttarakhand	.	.	136.6	141.3
West Bengal	127.5	82.4	87.5	83.7



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4. SME Financing – How to Bridge the Persistent Demand Supply Gap?

Vijay Mahajan and Pranay Bhargava

4.1 Introduction

Although 45% of jobs in India are in agriculture and allied sectors, most non-agricultural employment is generated in the unincorporated sector enteprises. Therefore, it is essential for the government to adopt growth oriented policies for this sector, commonly referred to as micro, small and medium enteprises (MSMEs). However, while efforts have focused on supporting crores of microenterprises, India has overlooked millions of small enterprises that offer higher growth and employment potential.

In the Economic Survey 2025, the unincorporated MSME sector received limited attention, presenting an opportunity for greater engagement at the policy level. One of the few MSME-related highlights in the Economic Survey is the Self-Reliant India (SRI) Fund, positioned as an equity funding initiative with a ₹50,000 crore corpus (₹10,000 crore from the government and ₹40,000 crore from private equity and venture capital). However, in practice, these funds primarily channel investments into venture capital (VC) and private equity (PE) firms, which target high-growth startups in sectors like healthcare, agritech, and climate tech, leaving millions of micro-enterprises underfunded and overlooked.

The Budget 2025 has prioritized increasing consumption spending, yet sustainable consumption growth is only achievable if the country generates more jobs. The Budget introduced a ₹5 lakh customized credit card for micro-enterprises registered on the Udyam portal, with a first-year issuance target of 10 lakh credit cards. This initiative represents a small but positive step toward flexible financing for unincorporated enterprises.

However, two key limitations must be addressed: firstly, a loan remains a loan—unless the financial instrument is linked to business cashflows, it does not provide the risk capital essential for startups and high-growth enterprises. Secondly, the target of 10 lakh enterprises represents just 1.36 percent of India's total unincorporated sector enterprises - as per the Annual Survey of Unincorporated Sector Enterprises (ASUSE)[11] 2023-24, there were 7.34 crore unincorporated enterprises, indicating the limited reach of the initiative.

Source: Image

This paper argues that India must move beyond tinkering with loan schemes and adopt flexible finance models to address the capital constraints faced by unincorporated enterprises. Traditional loans, even with relaxed terms, fail to accommodate cashflow variability and market-driven revenue fluctuations— two fundamental realities of small enteprise operations. The solution lies in revenue-based and profit- sharing financial instruments that adapt to business cycles, offering risk-sharing mechanisms that align financial sustainability with entrepreneurial success.

In the spirit of movng forward, this paper goes beyond a critique of existing policies and products and presents a more effective growth stratgey for this sector. Instead of focusing on 6.34 crore Own Account Enterprises (OAEs), which constitute 86.4% of total enterprises in the unincorporated sector in India, India must formulate policies to target a distinct, smaller subset—1 crore Hired Worker Enterprises (HWEs). These HWEs, which account for 13.6% of the 7.34 crore enterprises in the unincorporated sector, should receive capital and other forms of support to facilitate their growth and scalability. This approach will ensure a sectoral transition from OAEs to HWEs, leading to higher employment generation, increased output, and improved productivity and earnings.

We also outline the most suitable financing mechanism for HWEs—Flexible Financing with Repayment based on Cashflows (FFRC). This approach ensures repayment structures align with enterprise cash flows, offering the financial flexibility necessary for sustainable growth.

[11] Ministry of Statistics and Programme Implementation. Annual Survey of Unincorporated Sector Enterprises (ASUSE) https://www.mospi.gov.in/

4.2 Unincorporated Sector Enterprises – OAEs and HWEs

The Annual Survey of Unincorporated Sector Enterprises (ASUSE) segments the enterprises in unincorporated sector into two categories: Own Account Enterprises (OAEs) and Hired Worker Enterprises (HWEs). According to the ASUSE 2023-24, there are 7.34 crore unincorporated enterprises in India, out of which 6.34 crore are OAEs and 1.0 crore are HWEs.

Own Account Enterprises (OAEs) in unincorporated sector are typically operated by the owner, often assisted by a family member. With modest investments ranging from ₹50,000 to ₹2,50,000, these enterprises play a crucial role in providing self-employment at a subsistence level to millions. According to ASUSE 2023-24, India had 6.34 crore OAEs, employing 7.65 crore workers—an average of 1.2 workers per OAE, comprising the owner and, occasionally, a part-time family worker.

Source: Image

As per ASUSE 2023-24, only 31% of OAEs operate from permanent structures, reflecting their informal nature. With an annual average output of ₹2.62 lakh, most OAEs function as mom-and-pop “kirana” shops or food stalls. Owners in this category often exhibit low growth aspirations,prioritize immediate earnings, and are risk-averse, making them less inclined to adopt innovations. They typically target hyperlocal markets, engaging in trade with minimal value addition.

The enormous growth of the microfinance sector over the last two decades has ensured that this OAEs are well-financed. According to the Microfinance Institutions Network (MFIN), as of September 30, 2024, there were 14.1 crore microfinance loans outstanding across 8.1 crore unique borrowers, totalling ₹4.08 lakh crore —with an average loan size of ₹50,370 per borrower.

Since microfinance loans cater to agriculture, animal husbandry, housing, and non-farm micro-enterprises, not all of this financing is directed at OAEs. However, the data suggests that OAEs have ample access to credit. In fact, a new problem has emerged—over-lending. An excessive number of micro-lenders are now competing for borrowers, leading to a surge in loan delinquency issues across multiple states. As we write this paper, the microfinance industry is experiencing a historic non-performing asset (NPA) crisis. According to Business Standard (January 17, 2025):

"Credit information bureau CRIF-Highmark data indicates that in Q2 FY25 (September 2024), delinquencies increased across all Days Past Due (DPD) bands. DPDs measure how many days a borrower is late on loan payments. Delinquencies spiked across all loan sizes and lender types— including universal banks, small finance banks, and NBFC-MFIs. The 31–180 day DPD level rose from 2.2% in September 2023 to 4.8% in September 2024."

Thus, from perspective of employment, GDP growth, and financial stability, the focus should shift to **Hired Worker Enterprises (HWEs)**, which we discuss in the box below.

Sources of data: MFIN[12] and Business Standard[13]

Hired Worker Enterprises (HWEs) in unincorporated sector, typically operate in large villages, small towns or district towns. As per ASUSE 2023-24, 1 crore HWEs employed 4.41 crore workers, averaging 4.4 workers per enterprise, or 3.4 hired workers excluding the owner. With investments typically ranging from ₹5 lakh to ₹25 lakh, these enterprises play a crucial role in the economy.

Source: Image

However, despite their significant contributions, HWEs remain heavily underfunded. These businesses often rely on bank financing for working capital while using their own resources for fixed capital investments, leaving a significant gap in their ability to scale effectively. Their operations span higher-order aggregation, trading, distribution, medium to large-scale services, and primary and secondary processing, all of which demand substantial infrastructure such as shops, buildings, transport, and machinery.

As per ASUSE 2023-24, 85.4% of HWEs operate out of permanent structures. The average market value of land owned by HWEs is ₹10.0 lakh with fixed assets valued at ₹11.59 lakh, and total fixed assets, including hired ones, reaching ₹19.39 lakh. Despite this strong asset base, the average loan outstanding per enterprise is just ₹2.73 lakh—an amount that represents a modest 27.3% of land value, 23.6% of owned fixed assets, and 14.1% of total fixed assets. This low borrowing-to-asset ratio reflects a systemic under-leveraging of their fixed assets.

[12] https://mfinindia.org/microfinance/IndustryPortfolio

[13] https://www.business-standard.com/industry/banking/mfi-sector-stress-cyclical-pushing-up-npas-sbi- executive-125011701189_1.html

Even with an average gross output of ₹18.26 lakh per annum, a three-month working capital cycle would require approximately ₹4.56 lakh per enterprise. However, with an average loan outstanding of just ₹2.73 lakh, HWEs face significant working capital constraints. The average loan to HWEs accounts for just 15.0% of their gross output value, indicating a clear mismatch between their financial needs and the credit support they receive.

HWE owners are entrepreneurs characterized by high achievement motivation, good time management and planning skills. Yet, their growth is stymied by inadequate access to capital, despite the solid foundation provided by their owned assets, land, and operational revenues. This under-funding limits their ability to invest in storage, aggregation, and value addition, all of which are essential for targeting local and non-local markets.

The loan outstanding and asset ownership data in ASUSE 2023-24 reveals that HWEs are severely underfunded. The credit requirement per HWE ranges from ₹10 lakh to ₹20 lakh, averaging ₹15 lakh, resulting in a sector-level credit gap of approximately ₹15 lakh crore for about 1 crore HWEs.

HWEs embody the aspirations of grassroots entrepreneurs who drive regional markets—often with limited capital, resources, and institutional support. Despite their importance, these enterprises struggle with severe financial constraints, leaving them unable to scale or compete effectively.

Source: Image

4.3 Three case studies on how financing constrains or unlocks the growth potential of HWEs

The stories of Mira, Sathyalakshmi, Aakash, and Rehan illustrate both the entrepreneurial potential of this sector and the systemic barriers that hinder growth. From Mira's determination to build a regional organic oil brand, to Sathyalakshmi and Aakash's resilience in identifying a market gap, to Rehan's persistence in rebuilding his business after bankruptcy—each case highlights the challenges of accessing capital and navigating an ecosystem where rigid financial models and systemic mistrust persist.

4.3.1 Case study 1: Rehan – An aspiring entrepreneur achieves local success

Background

Rehan, a former construction worker in Japan, returned to India with dreams of entrepreneurship. Starting in the real estate sector with no prior experience, he faced setbacks, loss and significant financial challenges. Determined to pivot, Rehan launched a kids' clothing business in Hyderabad (Telangana), which gained early success. Rehan found unwavering support from his wife in managing operations of their kids' clothing wholesale trading business. However, the COVID-19 pandemic brought his business to a halt, leaving him bankrupt.

Despite owning assets worth ₹3.2 lakh—including land (₹1.5 lakh) and fixed assets (₹1.7 lakh)—Rehan struggled to secure adequate financing from traditional lenders. A microfinance institution offered his wife a joint liability group (JLG) loan of ₹15,000, which fell far short of their business needs. With his business capable of achieving ₹2.50 lakh in sales turnover, Rehan rightfully deserved a minimum of ₹2.50 lakh loan based on ₹50,000 for working capital (20% of turnover) and ₹2 lakh for fixed capital (at least 60% of fixed assets and land). Considering the growth potential of his business, Rehan needed ₹2.50 lakh for working capital and ₹2.50 lakh for fixed capital, totalling ₹5 lakh.

The Intervention

Rehan's breakthrough came when the IIMA Ventures-incubated Micro-Equity Fund provided him with ₹5 lakh in Flexible Financing with Repayment based on Cashflows (FFRC) four years ago. This innovative financing model, structured as a profit-sharing arrangement, allowed Rehan to align repayments with his business cashflows, unlike rigid EMI-based loans. This flexibility reduced financial strain during uncertain times, enabling him to focus on rebuilding and scaling his business.

Impact of Flexible Finance

The flexible finance model proved transformative for Rehan's business:

• Business growth: Rehan now achieves a monthly sales turnover of ₹3 lakh to ₹4 lakh reflecting consistent growth.

• Household stability: His family enjoys a stable monthly income of ₹40,000 to ₹60,000, ensuring financial security.

• Impressive returns for lenders: The profit-sharing model delivered over 18% annual IRR for the Micro Equity Fund over four years, proving effective flexible financing.

The Road Ahead

Encouraged by his recovery, Rehan is now planning to scale his operations from hyperlocal to a city-wide level. While not overly ambitious or driven by high aspirations, Rehan and his wife aim to continue operating at the local market level. By maintaining limited storage and limited value addition, they intend to keep risks low while steadily growing their business.

4.3.2 Case Study 2: Sathyalakshmi & Aakash – from financial hurdles to success

Sathyalakshmi, originally from Sangareddy, Telangana, gained hands-on experience in tailoring and apparel stitching while apprenticing with her mother for three years. Her husband, Aakash, ran a retail outlet for second-hand sewing machines and ancillary units.

Together, the husband-wife duo possessed complementary skills that laid the foundation for their entrepreneurial journey.

As the COVID-19 pandemic unfolded, they identified a surge in demand for masks as a market opportunity. However, instead of entering mask production like many others, they saw a larger gap in the market—a shortage of sewing machines and ancillary parts in Sangareddy district.

The Startup Phase

To address this demand, they partnered with Usha, a leading sewing machine manufacturer, to distribute sewing machines locally. However, Usha could not supply sewing machine oil, a critical component for smooth machine functioning, due to supply chain constraints. To fill this gap, Sathyalakshmi and Aakash decided to invest in manufacturing sewing machine oil.

They required ₹5 lakh to start their business: ₹3 lakh for machinery and working capital to produce sewing machine oil, and ₹2 lakh as working capital to act as wholesalers and distributors of Usha sewing machines.

Challenges Faced

With savings of only ₹50,000 and Aakash's retail assets worth ₹4 lakh, they approached multiple banks under the Prime Minister's Mudra Yojana (PMMY) for a loan of ₹5 lakh. Despite Aakash's five years of business experience, their loan application faced numerous obstacles:

• **Bribes and bureaucratic hurdles:** One bank demanded a bribe to process the loan, while others insisted on collateral.

• **Lack of awareness of PMMY:** Two banks did not even recognize the Mudra scheme, causing further delays.

• **Lost opportunity:** As their loan pursuit dragged on for six months, a competitor emerged in a neighbouring district, attracting customers and threatening their market position.

Despite these setbacks, the couple remained undeterred. They were determined to establish the sewing machine distribution and oil manufacturing business to meet unmet local demand.

The Intervention

In late 2022, after exhausting traditional financing options, Sathyalakshmi and Aakash approached the IIMA Ventures-incubated Micro-Equity Fund. The fund assessed their entrepreneurial potential and provided ₹5 lakh in flexible financing. The financing included ₹3 lakh for fixed assets and ₹2 lakh for working capital. Unlike rigid EMI loans, the repayment structure was linked to their monthly business profits, reducing financial strain and aligning with their cashflow variability.

Impact of Flexible Financing

By 2023, the couple had successfully set up their sewing machine oil manufacturing unit and became the largest wholesale distributor of sewing machines in Sangareddy district. Their business achieved:

• Sales turnover: ₹38 lakh in annual revenue. Employment creation: Three hired workers.

• Community impact: Training local women in sewing machine operations, contributing to skill development and livelihood generation.

The Road Ahead

Having established a successful operation, Sathyalakshmi and Aakash now plan to expand their distribution network to neighbouring districts and introduce additional sewing machine accessories. With continued access to flexible financing, they aim to achieve greater scalability and contribute to regional economic growth.

4.3.3 Case study 3: Mira – A high-aspiration entrepreneur's journey is held up

Background

Mira's ambition is to transform her agri-food processing business into a regional brand, manufacturing organic oils such as groundnut, sesame, and coconut oils in Anantapur, Andhra Pradesh. However, Mira's journey has been far from easy. As a woman entrepreneur from an underprivileged community (backward caste) operating within the informal economy, she has faced numerous systemic and social challenges. These factors amplify her risk profile compared to entrepreneurs from more privileged backgrounds, placing her metaphorically "several laps behind" in the entrepreneurial race.

Challenges Faced

Mira's disadvantages manifest in the following ways:
• Disproportionately high time value of money: For Mira, immediate access to funds holds significantly greater importance than delayed gratification, especially compared to a privileged entrepreneur. This is due to financial pressures stemming from unemployment, inflation, low-income activities, and the responsibility of supporting multiple dependents.

• Lack of social conditioning, resources and network: Unlike entrepreneurs from business-oriented communities such as Marwari, Chettiar, and Parsi,[14] Mira lacks inherited business acumen, financial support from a close network, and community connections that could provide mentoring and access to opportunities.

The Startup Phase

Venturing into the organic oil manufacturing sector, Mira needed ₹25 lakh to start her business—₹15 lakh for machinery and infrastructure and ₹10 lakh for working capital. Despite owning assets worth ₹22.07 lakh, including land (₹10.72 lakh) and fixed assets (₹11.35 lakh), Mira struggled to secure adequate financing. A local bank offered her a loan of just ₹2.4 lakh, forcing her to purchase only one second-hand machine and operate with minimal working capital, leaving her in a precarious position.

Despite these hurdles, Mira displayed remarkable financial discipline: She maintained accurate books of accounts using computerized systems. She operated from a permanent structure with dedicated space for factory operations, storage, and packaging. She leveraged technology, including CCTV, barcode scanners, RFID tags, and MIS systems, to streamline inventory management and operations. She utilized digital payment platforms (UPI, POS, payment gateways) for supplier payments and customer transactions. Finally, Mira registered on the Udyami portal and with GST, filing returns regularly. Her disciplined approach earned her the title "Queen of Business," a testament to her resilience and entrepreneurial acumen.

The Road Ahead

Mira continues to seek ₹25 lakh in financing to scale her business regionally and diversify her product line. This includes: ₹10 lakh for working capital: To ensure smoother operations and manage seasonal variations in demand. ₹15 lakh for fixed capital: To invest in modern machinery and expand infrastructure, enabling greater efficiency and capacity. Mira's ambition is to compete with larger players in the organic oil market while creating employment and driving local economic growth.

[14] "Indian Entrepreneurial Communities: The People Who Set-up Their Businesses" by Vishnu Patankar and Suresh Kallur, featured in IOSR Journal of Business and Management (2018)

4.4 Diagnosing the causes for the gap: Why HWEs are short of funds

The issue of inadequate financing or lack of financing for HWEs can be attributed to three key barriers:

- **Borrower characteristics:** A significant gap between perceived risk and actual risk deters financiers.

- **Lender preferences:** A significant gap between the intent of financiers and policymakers and field-level execution limits financiers.

- **Mismatch between demand and product:** A significant gap between the financing needs of enterprises and available financial products leaves opportunities unaddressed.

4.4.1 Borrower Characteristics: How risk perception keeps financiers at bay

The persistence of the underfunding problem can largely be attributed to a mismatch between the perceived risks and actual risks associated with enterprises in the unincorporated sector.

Perception of High Risk and Limited Growth Potential:

The high-risk perception associated with HWEs, stems from their perceived vulnerability to failure, with nearly half expected to close within their initial years. For financiers, especially local rural branch managers, the fear of defaults outweighs recognition of entrepreneurial potential. This focus on minimizing defaults and maintaining a clean portfolio often leads financiers to avoid experimental or high-risk lending. As a result, collateral becomes a prerequisite for credit, leaving small businesses without security marginalized in favour of larger MSMEs with established credit histories.

Additionally, there is a pervasive belief that small businesses lack the capacity for significant growth, often stagnating or failing instead of scaling into more profitable ventures. Such assumptions reinforce the perception that these enterprises cannot generate competitive, risk-adjusted returns. This narrative unfairly dismisses the growth potential of HWEs, which, driven by entrepreneurial ambition, frequently exhibit strong potential for expansion and success.

Perception of Mixing of Household and Enterprise Cashflows:

As most of HWEs are proprietary enterprises, there is often a blending of business and personal expenses. Family emergencies, such as illness or marriage, can divert funds away from the enterprise to meet household needs. This mixing of cashflows creates a shadow of mistrust, promoting a perception of financial mismanagement, and lack of discipline. Traditional credit evaluation frameworks of institutional lenders, based on collateral and historical financial data, therefore exclude entrepreneurs operating in informal economies with mixed and irregular cash flows.[15] The high use of cash rather than bank accounts also discouraged many formal lenders to lend to HWEs.

Opacity of Cashflows:

Data from ASUSE 2023-24 reveals that only 5.7% of HWEs maintain audited accounts. Even among those with audited records, computerized accounting practices are rare. This raises questions and increases the perceived risk: are revenues being under-reported or multiple sets of books being maintained for different stakeholders. Such doubts erode the confidence of potential financiers.

4.4.2 Lender Preferences: Secured loan with fixed repayment schedule

Over the past 50 years, numerous committees, including the Tandon Committee (1975), Nayak Committee (1991), Raghuram Rajan Committee (2008), and RBI Expert Committee on MSMEs (2020), have highlighted the chronic underfunding of MSMEs. They have proposed need-based, cashflow-oriented, and scalable solutions. However, structural challenges—including rigid financial products, risk-averse behaviours, misaligned targeting, and operational inefficiencies—have hindered institutional lenders from effectively addressing the financing needs of MSMEs. As a result, despite well-intentioned reforms and schemes, the financing landscape continues to perpetuate a funding shortfall, limiting the ability of MSMEs to grow, innovate, and contribute to economic progress.

Current Lending Practices by Institutions

• **NBFC-MFIs:** Primarily focus on OAEs through JLG group financing.

• **Regular NBFCs:** Cater to HWEs with loan-against-property products.

• **Banks:** Primarily serve higher-order HWEs (with investments above ₹50 lakh). They only lend to lower-order HWEs and OAEs when obligated under government schemes like PMMY, PMEGP, or PMFME.

[15] "Credit Accessibility and Issues to Formal Credit: A Study on Informal Micro-Businesses," International Journal of Science and Research, 2020, highlights that traditional credit evaluation frameworks, reliant on collateral and historical financial data, often exclude micro-entrepreneurs due to their irregular cash flows.

4.4.3 Limitations of Lenders

1.) Microfinance is too small for HWEs: Studies indicate that 10-20%[16] of microfinance clients (mostly OAEs) have the potential to evolve into HWEs, but the MFIs do not have loan products to meet the specific requirements of such enterprises. Typically, OAEs require up to ₹1 lakh, with even the largest OAE rarely needing more than ₹2.5 lakh. In contrast, HWEs require between ₹10 lakh and ₹20 lakh, partly for fixed investments and partly for working capital.

2.) Rigid Loan Structures: Microfinance loan products are designed with EMI repayment structure for meeting household needs of the wage-employed and the limited capital needs of those self-employed in OAEs. This repayment structure fails to accommodate the cashflow variability, seasonality, and uncertain startup phases inherent in entrepreneurial ventures.

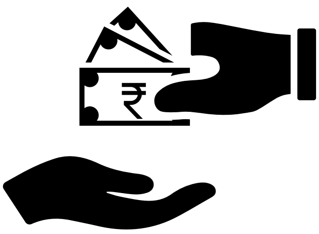
3.) Group-Centric Lending Model: Individual loans with joint liability of a group of individual borrowers for each other's loans is a core feature of microfinance. This reliance on collective accountability is suitable for OAEs only. This concept is not suitable for HWEs with higher growth potential and thus higher capital requirements.

4.) Regular NBFCs Focus Solely on Loan Against Property: Regular NBFCs primarily provide loans against property (LAP), with little consideration for entrepreneurial acumen or business growth potential. This approach means that only those HWE owners who have accumulated surpluses and invested in property can get this type of LAP financing.

5.) Government Schemes Focus on the Excluded and thus Do Not Select the Most Entrepreneurial: Government welfare schemes are focused on the excluded – women, SCs, STs, the disabled, etc. as they should be. However, when the scheme has a loan component, this focus on the excluded often leads to non-selection of the most entrepreneurial persons in a community, who are most suited to establish or grow enterprises.

6.) Complex, Lengthy, and Arbitrary Processes in Banks:[17] Bureaucratic hurdles, convoluted application procedures, arbitrary rejections, delays, and stringent documentation requirements deter achievement-driven entrepreneurs, who are often time-conscious and resource-constrained, from accessing these schemes.

7.) Refinancing and Credit Guarantees Focus on Lender Risk: Programs offering refinancing and credit guarantees were designed to mitigate risks for lenders rather than reduce risks for entrepreneurs. Despite guarantees, banks remain reluctant to offer collateral-free loans, citing operational risks, which exacerbates barriers to financing.



[16] CGAP, Financing Small Enterprises: What Role for Microfinance? Focus Note, July 2012

[17] Mund, Chandra Shekhar, IES (2020), Dy Director, Ministry of MSME, Government of India. "Problems of MSME Finance in India and Role of Credit Guarantee Fund Scheme," IOSR Journal of Economics and Finance (IOSR-JEF) e-ISSN: 2321-5933, p-ISSN: 2321-5925.Volume 11, Issue 4 Ser. III (Jul. – Aug. 2020), PP 01-06 www.iosrjournals.org

4.5 Consequences of current limitations

From the days of the Integrated Rural Development Program (IRDP) loans, bankers have learned that loans driven by government mandates or tied to government subsidies of principal or interest rate subventions, lead to poor portfolio performance. Thus, bankers tend to underfinance loans linked to government schemes, for fear of higher NPAs.

To minimise the extra risk and effort, bankers often resort to rebranding outdated loan products under new schemes[18] instead of pursuing innovative financing solutions. Rigid EMI-based loans fail to accommodate the unique challenges of entrepreneurial ventures, resulting in increased non-performing assets (NPAs) and low returns on investment.

4.5.1 Mismatch between demand and supply in terms of loan size

Between 2015 and 2024, under the PMMY, over 41.16 crore loans were disbursed, totalling ₹22.90 lakh crore. Of these, 68.6% were granted to women, accounting for 41.7% of the total loan amount. Most PMMY loans fall into the Shishu category (≤₹50,000) with an average loan size of ₹27,507 - sufficient only to support lower-end subsistence OAEs. While many individuals use these funds to purchase assets, a significant number fail to engage in productive activities, leading to considerable misallocation of resources.[19]

The PMMY recognised that there are larger enterprises than micro - the higher-growth and employment generating HWEs and they need larger loans. Indeed 14.8% of PMMY loans were given to the Kishore category of enterprises with loans between ₹50,001 and ₹5 lakh. Another 2.0% of all PMMY loans were given to the Tarun category with loan size from ₹5 to 15 lakh. This shows that the PMMY has reached the appropriate proportion of larger HWEs.

Yet the ASUSE data shows that the average loan outstanding per HWE was just ₹2.73 lakh and was inadequate to meet the HWE's needs. The average loan to HWEs was just 15.0% of their gross output value, indicating a mismatch between their financial needs and the credit support they receive.

Source: Image

[18] Vijay Mahajan, MUDRA: The Art of Taking Credit for Credit Given by Banks in the Normal Course of Their Business, RGICS Policy Watch, with PMMY data from https://mudra.org ,in Overall_Performance_2023-24.pdf

[19] Mund, Chandra Shekhar, IES (2020), op.cit.

4.5.2 Misalignment between repayment schedules and enterprise cashflows

The glaring disconnect between what entrepreneurs need and the financing products currently available leaves HWEs grappling with rigid, ill-suited financial solutions that fail to address their unique challenges and growth potential. Fixed EMI loans, while effective for businesses in the maturity stage, are ill-suited for enterprises with fluctuating cash flows or those undergoing transformative growth. Consider the following scenarios:

1.) **Seasonal Working Capital (X → X+):** Only enterprises in mature phase with predictable sales can comfortably manage fixed EMI loans; for such cases, existing financial instruments suffice.

2.) **Startups (0 → X):** Businesses at the inception stage often deal with uncertain revenue streams and require flexible, patient capital to establish operations and gain momentum.

3.) **High-Growth Enterprises (X → X++):** Rapid vertical expansion requires significant reinvestment and adaptability, which rigid repayment structures are poorly equipped to accommodate.

4.) **Stable Moderate Growth Enterprises facing a sudden shock (X → X-):** This has been a bane of small enterprises in India. In the past decade, for example, many suffered due to shocks caused by demonetization in 2016, implementation of GST from 2017 to 2019 and COVID-19 between 2020 and 2022. At such moments, even stable enterprises need flexible finance. Indeed, during COVID-19 pandemic, the Government and the RBI did encourage banks to offer flexibility in repayment to micro and small enterprises.

Instead, these businesses receive rigid EMI-based repayment structures that demand fixed repayments, irrespective of business fluctuations, seasonal variations, or unexpected contingencies. These rigid financial products place the full burden of risk on the entrepreneur, leaving them solely responsible for navigating economic uncertainties while lenders remain insulated.

Product-market mismatches lead to defaults or overdue payments caused by misaligned financing terms, resulting in **poor credit bureau ratings**. This, in turn, further restricts access to future financing.

HWEs need financing that sharesthe risk and offer flexibility - products that align repayment schedules with business cash flows, upswings and downswings in the business, or unforeseen challenges—repayment terms that adapt to actual performance through profit-sharing or revenue-sharing mechanisms.

4.6 Innovative Solution: Flexible Financing with Repayment based on Cashflows (FFRC)

This solution emphasizes loan repayment aligned with enterprise cash flows— based on revenue, expenses, and profitability of the business. One party, the financier, provides capital, while the other contributes entrepreneurship and management. The enterprise's cashflows are then shared in pre-agreed proportions, aligning the financier's risk and reward with that of the entrepreneur.

Characterized by adaptability to business performance, enterprise life cycle, and shared risk-and-reward mechanisms, this model features repayment structures tied to cash flows— determined by revenue, expenses and profitability.

4.6.1 Overcoming high-risk perceptions through borrower transparency and digitization

Digitization has unlocked opportunities that were unthinkable just a few years ago, providing tools to address long-standing issues like cashflow opacity. The widespread adoption of digital payment systems, particularly UPI, has transformed transaction visibility for small businesses.

According to NPCI data,[20] P2M (Person-to-Merchant) transactions through UPI have experienced an extraordinary CAGR of 105% over the past four years. A recent study[21] shows that 55% of SMEs have fully adopted digital payments, while 30% have partially adopted them.

For Hired Worker Enterprises (HWEs), promoting GST registration further enhances transparency by incentivizing enterprises to disclose their sales and cash inflows. This is because input GST credits are only available against reported sales, significantly reducing the incentive for cash transactions.

For example, HWEs with a turnover above ₹40 lakhs in a GST registered supply chain have minimal chances of bypassing GST compliance.

To build on these advancements, institutional lenders can focus on a subset of HWEs that are digitally linked, GST-registered, and listed on the MSME Udyam portal.

Lenders can mitigate risks of informality by targeting these fully digitally visible enterprises. Lenders can monitor key input-output ratios, digital payment data, and GST filings, and monitor the activity level closely and on a continuous basis.

Furthermore, digital lending, account monitoring and repayment via the UPI or the NEFT/RTGS should be promoted. Participation in data sharing with Credit Bureaus, the IndiaStack, Account Aggregators network, and the Open Credit Enablement Network (OCEN), along with the adoption of the Open Network for Digital Commerce (ONDC), should be encouraged so that lenders can accurately assess the financial health of these businesses.

[20] National Payments Corporation of India (NPCI). (n.d.). Growth of various modes of digital payment. Ministry of Finance, Government of India. Retrieved from https://financialservices.gov.in/beta/en/page/growth-various-modes-digital-payment

[21] Digital payment adoption among SMEs. Journal of Emerging Technologies and Innovative Research, 10(10), 533–538. Retrieved from https://www.jetir.org/papers/JETIR2410533.pdf

Additionally, there is a need to accelerate AI-based credit scoring and alternative data-based lending. AI models, trained with both structured and unstructured alternative data, can enhance creditworthiness assessments by reducing reliance on collateral and subjective judgment. This allows lenders to make more informed decisions and offer tailored financing solutions that align with the dynamic needs of digitally visible HWEs.

4.6.2 Aligning products with needs: Bridging the demand-product mismatch

Addressing the Product Market Mismatch requires a paradigm shift from rigid, one-size-fits-all loan structures to hybrid, blended and flexible models tailored to the dynamic needs of OAEs and HWEs. These new approaches must account for the diverse cashflow patterns and growth trajectories of unincorporated enterprises, particularly high-growth HWEs.

A hybrid approach should combine fixed EMI loans for working capital with flexible financing for fixed capital, where the repayment is based on cashflows. This innovative model has a strong potential to reduce the risk of defaults, enhance portfolio performance for lenders, and empower entrepreneurs to manage financial obligations without undue stress.

4.6.3 Key Features of Flexible Financing with Repayment based on Cashflows (FFRC)

Flexible Financing with Repayment based on Cashflows (FFRC), is an innovative mechanism to cater to the unique needs of hired worker enterprises:

a.) Tailored Financing Size: Capital ranging from ₹5, lakh to ₹25 lakh designed to address diverse enterprise needs, particularly of HWEs.

b.) Repayment Linked to Daily Cashflow: A pre-agreed percentage of daily net cashflow is automatically deducted and transferred to the lender. This ensures repayments are proportional to business performance, reducing financial pressure during lean periods. Use of POS systems can automate repayments daily and the use of NACH can do it weekly or monthly, thus seamlessly aligning with business cashflow cycles.

c.) Minimum positive cashflow requirement: Loan agreements require borrowers to maintain net positive cashflow for at least 150 days annually for early-stage enterprises and 300 days for mature businesses. This balance between flexibility and financial discipline ensures sustainability. No debits occur when cashflows are negative.

d.) Tenure Options: Financiers can structure loans either with flexible tenure and fixed returns (debt-like financing) or fixed tenure and flexible returns (equity-like financing).

- Flexible Tenure and Fixed Returns: Entrepreneurs gain flexibility to repay a fixed IRR over shorter or longer periods based on business outcomes, offering predictability without compromising adaptability. This mechanism aligns closely with the principles of cashflow-based financing.

- Fixed Tenure and Flexible Returns: Lenders bear more risk and share in the upside or downside, providing greater alignment with business performance. This mechanism closely aligns with the principles of participatory or equity financing. However, as that will require major regulatory changes, we are not proposing this alternative.

e.) No ownership by the financier: The lender does not take any kind of ownership stake in the business and does not depend on traditional exit routes like IPOs or strategic sales for repayment. Flexible Financing with Repayment based on Cashflows (FFRC) takes a partnership interest without ownership dilution and the HWEs deliver competitive returns directly tied to a percentage of enterprise revenue, bypassing reliance on complex exits.

4.7 Validation and Impact: Evidence supporting the proposed framework

This chapter highlights the successful establishment of a proof of concept through the IIMA Ventures (IIM Ahmedabad)-incubated micro-equity fund (MEF) pilot. The pilot serves as a groundbreaking demonstration of how flexible financing mechanisms can address the core barriers faced by unincorporated enterprises—demand-side perception, supply-side systematic barriers, and product market mismatch—while achieving consistent portfolio performance over three years. The pilot showcased how Flexible Financing with Repayment based on Cashflows (FFRC) could effectively align with the dynamic needs of HWEs. The MEF pilot not only validated the feasibility of revenue sharing and profit-sharing financing models but also provided practical insights into their scalability and adaptability for broader implementation.

4.7.1 Key Findings of the FFRC Pilot by the Micro Equity Fund (2021-2025)

1.) Addressing Demand-Side Perception Barriers:

The pilot demonstrated that achieving 100% visibility into the revenue streams of HWEs is possible through digital integration. By leveraging digital tools and transparent monitoring mechanisms, the likelihood of financial mismanagement was minimized. This 100% visibility addressed the perception of high risk, creating a stronger foundation for trust between the Micro Equity Fund and the entrepreneurs.

2.) Addressing Supply-Side Systematic Barriers:

Contrary to traditional assumptions, the pilot proved that HWEs are capable of managing larger loan sizes effectively. Entrepreneurs in these segments displayed the financial discipline and operational capacity required to handle substantial financing, dispelling concerns about their ability to manage larger credit exposures. This insight underscores the importance of rethinking loan size thresholds for these enterprises.

3.) Addressing Product Market Mismatch:
The pilot established that a hybrid financing approach—combining Flexible Financing with Repayment based on Cashflows (FFRC) for fixed capital and traditional loans for working capital—best serves the needs of HWEs. This blended structure aligns with their cashflow variability while ensuring adequate support for growth and scalability. Over three years, the Flexible Financing with Repayment based on Cashflows (FFRC) model yielded a consistent competitive net yield,[22] making it a compelling option for lenders seeking securitization and rating-worthy portfolios.

The success of the pilot demonstrates that tailored, blended financing solutions empower entrepreneurs, deliver consistent returns for lenders, and has potential to bridge the "missing middle" HWEs gap and add an important new component in the financial ecosystem.

4.8 A Call to Action

HWEs, given their higher growth potential, require larger and more flexible loans. Institutional lenders can address this by offering loans averaging ₹15 lakh per enterprise—₹5 lakh as a term loan for fixed assets and ₹10 lakh for working capital—resulting in a total credit requirement of ₹15 lakh crore for over 1 crore HWEs by 2025.

This level of financing can triple the output of these HWEs and generate 2 to 2.5 times the current 4.4 crore jobs, potentially creating as many as 10 crore new jobs in the non-farm sector. Nothing is more urgently needly by the Indian economy than this. The best part is that our suggestion does not require a single rupee from the government budget, as the entire financing can be mobilized through loans from the banking sector.

An initiative at this kind of scale will require concerted action from a broad range of stakeholders, adopting an eco-system approach with complementary roles for various actors. An eco-system thrives on diversity and symbiosis, incorporating feedback loops to trigger self-corrective actions. In thissense, an ecosystem based approach differs fundamentally from a top-down, command and control model of directed lending. Given below are points of action required by different stakeholders:

The Government of India: The Ministry of Finance, Department of Financial Services, the Office of Chief Economic Advisor, the Niti Ayog and the Ministry of MSME, must seriously consider this proposal and recognize that Flexible Financing with Repayment based on Cashflows (FFRC) effectively addresses the financing challenges at the HWE level in a responsible and sustainable manner – without any fiscal burden on the government. Most importantly that this has the potential to create 10 crore new jobs in the non-farm sector.

The Reserve Bank of India: The RBI may encourage banks to increase lending to HWEs, as these enterprises generate more output and employment compared to the subsistence-level microenterprise sector, which is already credit-saturated. However, simply increasing credit through traditional, rigid EMI-based loan products will not be effective.

To encourage banks to explore FFRC, the RBI must introduce new Income Recognition and Asset Classification (IRAC) norms. In particular, the definition of “default” must shift from non-repayment of a specific amount on a fixed date to non-repayment despite an adequate, pre-agreed level of positive cashflow.

[22] Longitudinal and cross-sectional portfolio performance is available at www.weecee.com

This transition will also necessitate new monitoring mechanisms for enterprise cashflows, leveraging account aggregation and digital watch of cashflows.

Additionally, the RBI may permit the use of its regulatory sandbox to test and formalize the FFRC product. This could be done by allowing a major bank, such as the State Bank of India (SBI) or the Bank of Baroda, to conduct this at a convincing scale – covering 6,000 HWEs (1,000 in each of RBI's six regions), each getting about between ₹10 lakh to ₹20 lakh, with a total exposure limit of ₹1000 crore.

Leading Banks and Institutional Lenders: Once the Government of India endorses this initiative and the RBI issues IRAC norms for FFRC, banks such as SBI and Bank of Baroda, along with financing institutions like SIDBI, NABARD-NABFIN and IREDA, may consider providing FFRC to HWEs.

To ensure that FFRC achieves Product-Market fit, banks will need to focus strategically on this product in the initial years and make incremental changes as learning sets in through experience. This would be similar to how banks had approached SHG lending and microfinance at the lower end and infrastructure financing at the higher end of financing over the past three decades.

Credit Bureaus and Credit Rating Agencies: Credit Bureaus must extend their reach to all HWEs, ensuring that no lending occurs without the lender having access to the HWE's prior indebtedness and repayment history. Similarly, SMERA should assess HWEs for creditworthiness, serving as India's equivalent of Dunn and Bradstreet.

SEBI for Listing and Trading of FFRC Portfolio Bonds: The securitization of FFRC revenue streams from banks and the issuance of FFRC Portfolio Bonds can attract institutional and retail investors into HWE financing. By pooling HWE cashflows into tradable assets, securitization would allow lenders to reduce risk, unlock capital, and offer more flexible financing models. FFRC bonds will create a structured investment instrument, where returns are pooled across thousands of HWEs, reducing risk of lending to individual HWEs. Listing these bonds would require SEBI approvals and proactive engagement in developing the FFRC bond market.

To further integrate FFRC bonds into mainstream financial markets, the RBI could classify FFRC Bonds as Priority Sector Lending (PSL) assets, allowing banks to invest in them as part of their mandated credit allocation. Additionally, the RBI could allow banks and NBFCs to use FFRC Bonds as collateral for repo operations, thereby improving liquidity. This market-driven approach would enable sustainable, scalable, and risk-adjusted financing for India's micro and small enterprises.

Impact Investors and Philanthropic Institutions: A subset of HWEs possesses extraordinary aspirations and is well suited for equity-like financing. According to ASUSE 2023-24 (Table 43), approximately 1.25% of HWEs in the unincorporated sector in India fall into the Small and Medium Enterprise category. However, the authors opine that this number could have been significantly higher if such a cadre of entrepreneurs had access to equity-like financing, which is currently non-existent in India. For these entrepreneurs, a SEBI-registered Alternative Investment Fund (preferably Category II) may be a more suitable vehicle for raising capital from accredited impact investors with a high-risk appetite.

Since impact investors typically invest only after seeing consistent returns—measured by IRR, MOIC, and DPI relative to risk-adjusted benchmarks—over two or three cycles of AIF funding, in this case, grants or soft investments from philanthropic or government institutions may be needed in the initial cycles to establish a large-scale proof of concept.

FFRC Financiers' Associations: The role of such associations is crucial in promoting responsible behaviour among its members through a code of conduct and mutual self-regulation. This will help prevent indiscriminate financing and other questionable practices.

HWE Associations in Different Geographies: The role of such association will be important in promoting the FFRC product and ensuring responsible behaviour among members who have availed of FFRC. Establishing these associations within specific geographical clusters or districts would allow financiers to gather valuable operational data and monitor industry fluctuations that impact all players simultaneously. This, in turn, would enable the implementation of flexible repayment responses as needed.

Researchers, Analysts and the Business Media: They will provide ongoing learning opportunities for various stakeholders, ensuring that, over time, FFRC becomes a reliable and profitable asset class in the financial sector. The knowledge base from these studies would also aid in policy formulation for both financial and enterprise promotion programs. The role of the business media is to inform stakeholders about this new financial product and its potential for driving growth and employment.

4.9 Conclusion

This proposal—to shift lending to HWEs toward flexible financing with repayments based on cash flows (FFRC)—marks a paradigm shift from traditional lending models such as bank-style secured term loans, NBFC-style loans against property, or MFI-style equated monthly installments.

This shift is as revolutionary as the transition in the 1990s, when lending to poor women through self-help groups (SHGs) replaced individual IRDP loans. As the first author was deeply involved in that transformative initiative and the subsequent dramatic growth of the microfinance sector, we are confident that flexible financing for small enterprises is an idea whose time has come.

Just as SHG lending has reached over 10 crore women, improving their lives and livelihoods, FFRC for HWEs can dramatically increase output and employment in India's non-farm small manufacturing and services sector. Ten crore new jobs can be created!

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