

Unorganized Manufacturing

Facilitating Entry to the Formal Sector by Removing Obstacles to Growth and Productivity

The unorganized manufacturing sector in India employs a vast majority of the manufacturing workforce, but it is characterized by low productivity and wages. A survey conducted for this study shows that there is considerable potential to improve both employment and productivity in this sector. Access to finance remains the major constraint to the operation of firms. As a result, enterprises are credit constrained and have difficulty investing in machinery and equipment. Analysis of the survey results shows that firms that are able to borrow from formal sources have 37 percent higher labor productivity than firms that cannot. Lack of a reliable power supply is the second-largest constraint. Firms get around this problem by employing more workers but pay a price in terms of profitability.

Importance of Unorganized Manufacturing

Unorganized manufacturing employs the vast majority of India's manufacturing workforce. In 2000/01, almost 99 percent of manufacturing enterprises and 74 percent of the manufacturing workers were in the unorganized sector (see box 4.1 for a definition of *unorganized sector* in India). Employment and wages in the unorganized sector grew over the 1990s, while they stagnated in the organized sector (Malhotra and others 2006).

Unorganized manufacturing is also more evenly distributed regionally than organized manufacturing. Large-scale organized manufacturing activity is highly agglomerated in a few areas and has become even more concentrated since the reforms of the 1990s. In 2005, 10 districts alone accounted for 49 percent of national investment in manufacturing (Chakravorty and Lall 2006). New investment has favored states with large manufacturing bases (Bhaumik, Gangopadhyay, and

Box 4.1 What Constitutes Unorganized Manufacturing in India?

The most commonly used definition of the *unorganized sector*—the definition used in this report—flows from the Indian Factories Act, 1948, which requires that an enterprise register with the state government if it employs 10 or more workers and uses power or employs 20 or more workers and does not use power. Units that do not come under the purview of this law constitute the unorganized sector.

Businesses that are organized are required to comply with health, safety, and welfare requirements. Firms are required to contribute toward insurance against sickness, disability, and maternity and to deposit linked provident funds or pension schemes. The state monitors compliance through a system of inspections. Unorganized firms largely fall outside this system, except for a few omnibus regulations pertaining to use of child labor, minimum wages, and workplace safety.

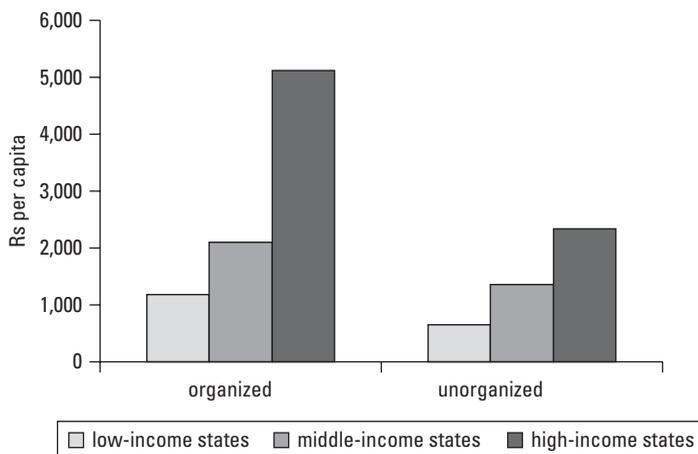
Krishnan 2006), existing industrial clusters, and locations with easy access to the coast (Chakravorty and Lall 2006).

Low Productivity, Low Wages, Weak Skill Levels, and Limited Integration with Large Supply Chains in Unorganized Manufacturing

Unorganized manufacturing performs worse than organized manufacturing in terms of productivity and, hence, jobs and wages. Differences in performance between organized and unorganized firms are to be expected, but the peculiarity of India is the large productivity differential between the largest and the smallest groups. These differentials are of the order of eight to one, compared with three to one in Japan before its post–World War II era growth or in the Republic of Korea during its early stage of development (World Bank 2007b). Productivity is often a good proxy for assessing how well enterprises use existing knowledge. Firms with higher productivity presumably have absorbed or developed superior production and management technology. Thus, absorption needs appear greatest among small enterprises. Productivity differentials are also reflected in wage differentials. Little, Mazumdar, and Page (1987) estimate that after controlling for human capital attributes, workers in larger enterprises earn wages three times higher than those of similar workers in the unorganized sector.

Per capita output across states varies more in organized manufacturing than in unorganized manufacturing (figure 4.1). This finding may be related in part to the fact that the relatively lower capital requirements for starting an unorganized enterprise allow a larger pool of entrepreneurs to start businesses. It also may be that agglomeration externalities (that is, the gains from concentration in a cluster) are less important for the smaller manufacturing firms. Nonetheless, interstate differences in the size of unorganized manufacturing are still quite large, suggesting

Figure 4.1 Per Capita Manufacturing Output, Organized and Unorganized Manufacturing, 2004



Sources: Central Statistical Office and World Bank estimates.

that state-level policies and the prevailing investment climate have an effect even on this sector.

To understand what hampers the productivity of the segment and whether firms avoid becoming organized and growing, an enterprise survey was conducted in 2006. The Unorganized Manufacturing Investment Climate Survey (ICS) covered 1,500 enterprises in five major industrial clusters in India: the Delhi–national capital region, Howrah, Hyderabad, Ludhiana, and Mumbai (see appendix A for a full description of the data and methodology). Enterprises have been divided into three subcategories: *household* (enterprises operating out of a home and employing hired workers), *tiny* (enterprises employing fewer than 6 workers), and *micro* (enterprises employing 6–10 workers). All the data presented in this chapter refer to data collected through this survey except when indicated otherwise.

The average age of firms in the sample was around 13 years, though there was some variation across industries. At the same time, more than 50 percent of firms in the sample were less than 10 years old, which suggests that a large number of firms tend to fail within the first 10 years. The data also show that a significant proportion of older, more established enterprises tend not to grow above the 10-worker threshold. More than 90 percent of the firms in the sample were single proprietorships, and the remaining 10 percent were partnerships. The incidence of female ownership was low in the sample group—only around 7 percent—and was highest among household enterprises.¹

Most enterprises were operated out of fixed premises, with unclear land titles being less of an issue. In India, a nationwide survey of unorganized manufacturing in 2001 conducted by the National Sample Survey Organisation (NSSO) found that almost 94.5 percent of urban unorganized manufacturing enterprises operated out of permanent structures and from fixed locations (NSSO 2001). The current ICS

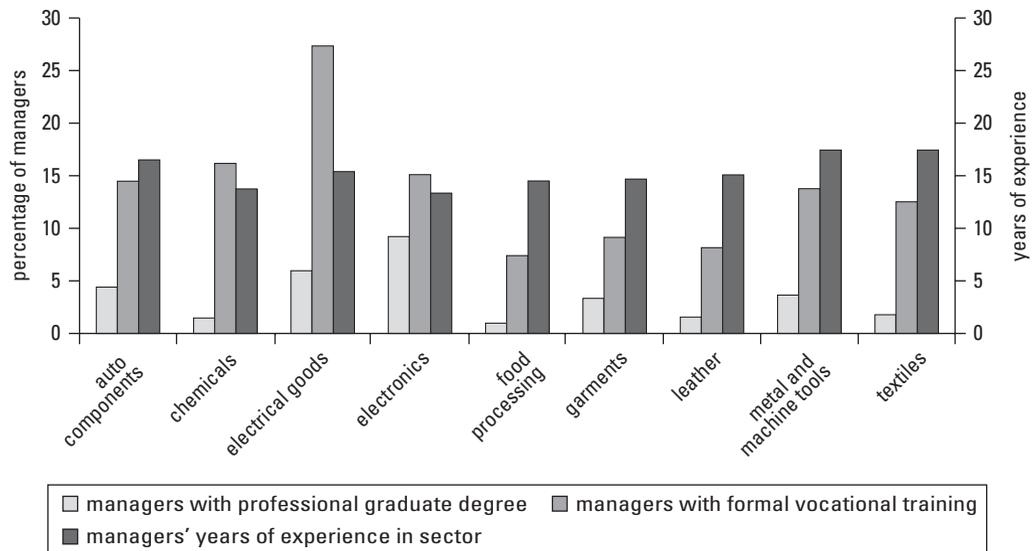
also found that most enterprise owners either owned (51.3 percent) or leased (47.5 percent) their premises. Out of the total sample of 1,500 enterprises, there were only six cases in which ownership of land was reported to be unclear.

Small enterprises catered mostly to other small firms and were not well connected with larger firms. Links between large and small enterprises can lead to productivity gains through technology transfer. Traditionally, however, the links between the organized and unorganized segments in India have been weak. Much of the manufacturing activity in the unorganized sector is geared toward producing final products for the consumer market rather than intermediate products and parts for the organized sector (Papola 1991). ICS results show that only 4.6 percent of firms reported that their main clients were larger firms. For 80 percent of firms, the main clients were either other small firms or individuals. This situation could also be explained in part by the small-scale reservation policy, which aimed to expand employment opportunities and production of consumer goods in the small sector. On the basis of this policy, the government restricted the entry of large players for as many as 873 items. The government has been phasing out this policy, and 35 items are still on the reserved list. Nevertheless, reversing the impact of the policy on links between firms will take some time.

With respect to education, most owners had not received formal training, the workforce in the enterprises was reasonably well educated, and part-time workers were used to deal with seasonality. In the ICS, 42 percent of owners were high school educated, and another 19 percent had general graduate or postgraduate degrees. Only 3 percent had professional graduate degrees. Formal vocational training was not common: only 12 percent of owners had received any formal training, mostly in technology-intensive industries, such as electrical goods and chemicals (figure 4.2). At the same time, the average manager reported around 16 years of experience, which did not vary much by industry. Years of managerial experience in the sector generally exceeded the age of the firm, suggesting that most owners had some experience before they set up their own enterprise. Half of the enterprises (50.3 percent) reported that their average worker had 7 to 12 years of education (that is, a secondary school-level education). On average, female, full-time employees constituted less than 5 percent of the total workforce, with the highest percentage in the garments and electronics industries. Family labor was important only in the garments and leather industries, and it was lowest in the chemicals industry (figure 4.3, panel a). Activity in many sectors varied over the year, and firms seemed to use part-time workers to deal with this seasonality.² There is a very close correlation between reported output variability and the use of part-time workers (figure 4.3, panel b).

Benefits of Becoming Organized and Why Some Firms Remain Unorganized

Being part of the organized sector, often referred to as the *formal sector*, has its benefits. However, international experience suggests that, despite the advantages,

Figure 4.2 Management Qualifications and Experience, by Industry, 2006

Source: Unorganized Manufacturing ICS 2006.

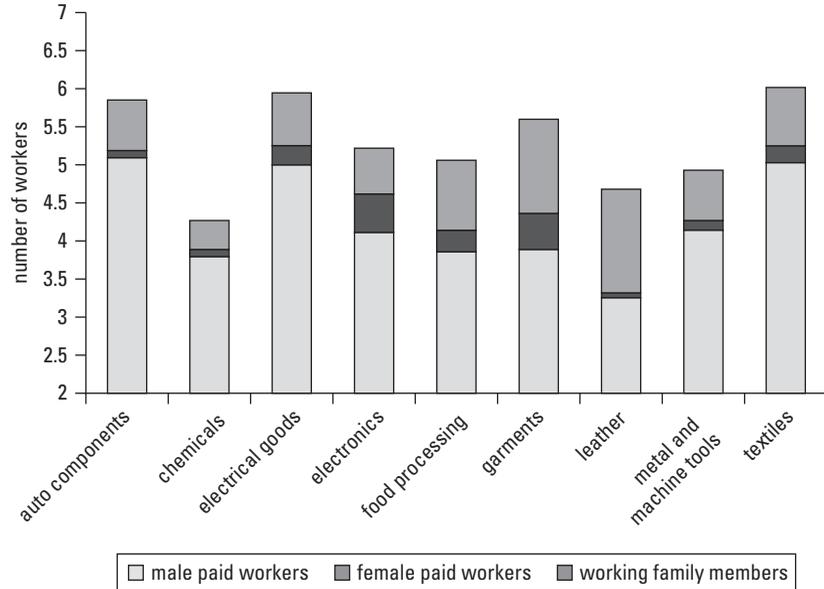
unorganized enterprises often wish to remain informal. Firms that are not registered with government authorities often suffer because of lack of legal status and bargaining power. Consequently, they may have less access to finance or can get it only at a high cost. They may also face difficulties in accessing business services, such as insurance or legal services. However, firms often prefer not to register or grow because they must then pay taxes and be subject to environmental and health and safety regulations. Sometimes larger firms are also more subject to bribes as they become more visible. In India, the 10-worker threshold is especially important because labor laws on wages and benefits are applied to units *above* this critical size. Enterprises graduating out of the unorganized sector thus face extra costs and lower flexibility, which encourage them to remain under the limit.

Firms can avoid being part of the organized sector in two ways: (a) by operating without detection by simply not registering or (b) by not growing. In India, firms with more than 10 employees must register with the state government if they are to comply with labor laws. In addition, all businesses need to register with the municipality to get industrial and electrical connections and to pay excise taxes.

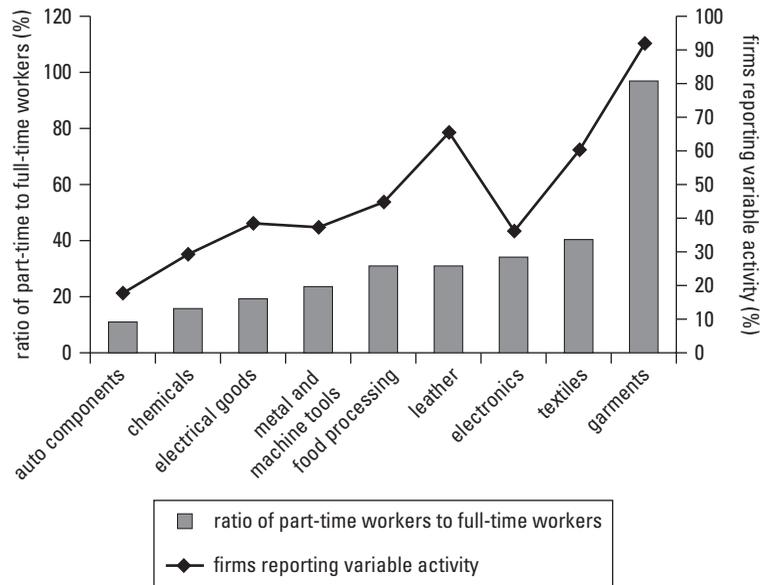
Nonetheless, a large number of firms were registered with some government authority and hence were not strictly beyond detection. Registration with tax or municipal authorities confers a measure of visibility to firms. About 41 percent of surveyed household enterprises reported being registered with a municipal agency, and 38 percent reported being registered with a tax authority. Almost three-fourths of microenterprises were registered with some municipal agency, with the relevant tax authorities, or with both (figure 4.4). This finding is at variance with the NSSO survey, which found overall that 80 percent of unorganized enterprises were

Figure 4.3 Full-Time and Part-Time Workforce, by Industry, 2006

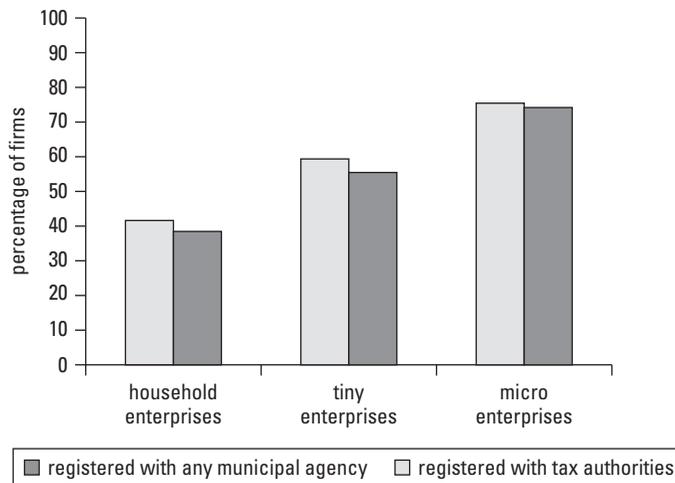
a. Full-time workforce



b. Ratio of part-time to full-time workers



Source: Unorganized Manufacturing ICS 2006.

Figure 4.4 Surveyed Firms Reporting Themselves as Registered, 2006

Source: Unorganized Manufacturing ICS 2006.

unregistered (NSSO 2001). The apparent difference between the two surveys may be because the ICS covered enterprises in major industrial clusters in urban locations, whereas the NSSO survey also covered rural enterprises. The chosen clusters were also often in states that did better even in the NSSO survey. Interestingly, most of the enterprises that reported themselves as not registered (83 percent) claimed that they did not think that they were required to do so. These two points suggest that a significant number of eligible enterprises are willing to be registered.

Moreover, the vast majority of unorganized establishments declare most workers and sales for tax purposes. Between 64 percent and 78 percent of unorganized firms in the ICS reported that a typical establishment declares 80 to 100 percent of sales, and between 77 percent and 89 percent of those firms reported that a typical establishment declares 80 to 100 percent of the workers. This result, which is somewhat at odds with the common perception of the unorganized sector, may reflect, in part, the fact that the sample was drawn from large industrial clusters. The surveyed firms may be more growth oriented and less survivalist than the average unorganized firm—and possibly more visible than enterprises located outside such clusters.

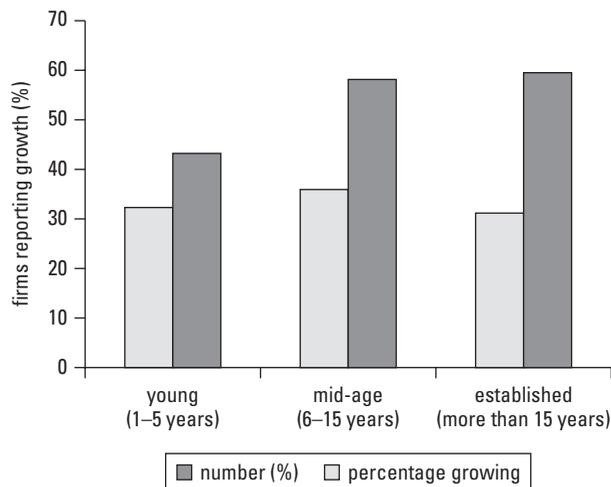
Firms that did not register failed to do so mainly because they lacked information or because the process took too long. Despite knowing that they were required to register, the largest percentage of firms attributed their unregistered status to lack of information about the process. Firms also did not register when it was costlier for them to do so, in terms of either resources or time (the average time to obtain an operating license varied from a low of five days in Ludhiana to about 67 days in Delhi). Registration rates were strongly negatively correlated with this timing (correlation of -0.58). Finally, a small proportion also reported that they failed to register because they wanted to avoid paying taxes.

A large number of enterprises started on a small scale and grew into organized manufacturing. The survey instrument for organized manufacturing firms asked respondents the workforce size when the enterprise began its operations, as well as the current workforce size. This information provides an opportunity to track firms' growth: a relatively large number of organized enterprises started life as small units, around 30 percent of organized enterprises started as microenterprises, 16 percent began as tiny enterprises, and 1 percent began as household enterprises.

Unorganized enterprises also stand to benefit from scaling up. An analysis of Indian firms' productivity and employment from the Unorganized Manufacturing ICS shows that a 1 percent increase in labor productivity, if the rest of the variables are kept constant, will generate a 0.91 percent increase in employment hours (see appendix B). The implication is that firms that become more productive tend to expand and employ more people. The survey shows that older, more established enterprises do tend to grow (figure 4.5). Around 58.5 percent of the interviewed firms reported having grown in terms of employment from the time they started operations.³ On average, growing enterprises added 2.6 full-time, paid workers to their payroll.

The investment climate is an important factor affecting the potential productivity growth of unorganized manufacturing. The productivity analysis shows that investment climate and control variables explain 19 percent of the variation in labor productivity. This relatively low contribution of investment climate variables reflects the fact that the explanatory power of the model is limited because unorganized manufacturing firms, thanks to their size, can operate outside of the investment climate and because unobservable factors, such as labor and managerial quality, play

Figure 4.5 Enterprises Reporting Employment Growth, by Age, 2006



Source: Unorganized Manufacturing ICS 2006.

a big role in the productivity of the sector. Although these factors are important for the sector, they are unobservable and are covered by other reports. Therefore, they are not discussed in the subsequent analysis, which instead focuses on the investment climate.

Access to Finance and Power Supply: Largest Constraints to Higher Productivity and Growth

By a wide margin, firms surveyed identified access to finance as the single biggest obstacle to their growth (box 4.2). More than a third of respondents identified this issue as their single, largest concern (figure 4.6). The availability of electricity was the

Box 4.2 Understanding the Problem of Access to Finance

The vast majority of the enterprises surveyed for the Unorganized Manufacturing ICS 2006 had a bank account, but very few had a loan and, of those that did, very few received it from a bank. Indeed, 89 percent of small enterprise owners had accounts in banks, and 58 percent of them used those accounts for business purposes. However, only 20 percent of unorganized enterprises borrow from either formal or informal sources. Of these enterprises, fewer than 10 percent had taken either a term loan or an overdraft from a bank (see the accompanying table).

Proportion of Enterprises with a Bank Account, by Enterprise Size, 2006

Type of enterprise	Enterprises with no loans from any source (%)	Borrowing enterprises (%)	Enterprises with informal loans (%)	Enterprises with loans from any financial institution (%)	Enterprises with loans from banks (%)
Household	79	21	15	8	6
Tiny	83	17	11	8	7
Micro	78	22	13	10	9

Source: Unorganized Manufacturing ICS 2006.

Getting a loan from a bank is a lengthy endeavor, and it requires large amounts of immovable collateral. On average, it took surveyed enterprises 25 days to get a loan from a bank after all the documents had been submitted. Usually, an immovable asset of the enterprise (60 percent of cases) or personal asset of the owner (25 percent of cases)—and likely immovable assets as well—was required as collateral. At the same time, immovable assets accounted for a relatively small percentage of total asset value of the unorganized firms. Moreover, in about half of these cases, the collateral was more than double the amount of the loan.

(continued)

Box 4.2 continued

Informal finance is preferred for its flexibility. Interviews with a focus group suggested that informal borrowing offers features that the formal banking sector in India does not offer. Informal loans do not require any sort of collateral, and even where it is required, the loan is usually made against accounts receivable and inventories. Most important is the flexibility that informal sources provide in determining the payment schedule (small fixed installments collected daily or weekly, rather than large monthly payments); in structuring or restructuring repayment schedules and amounts; and in taking account of past credit history with the informal lender. Flexibility is especially important for small enterprises with seasonal activities and cash flow.

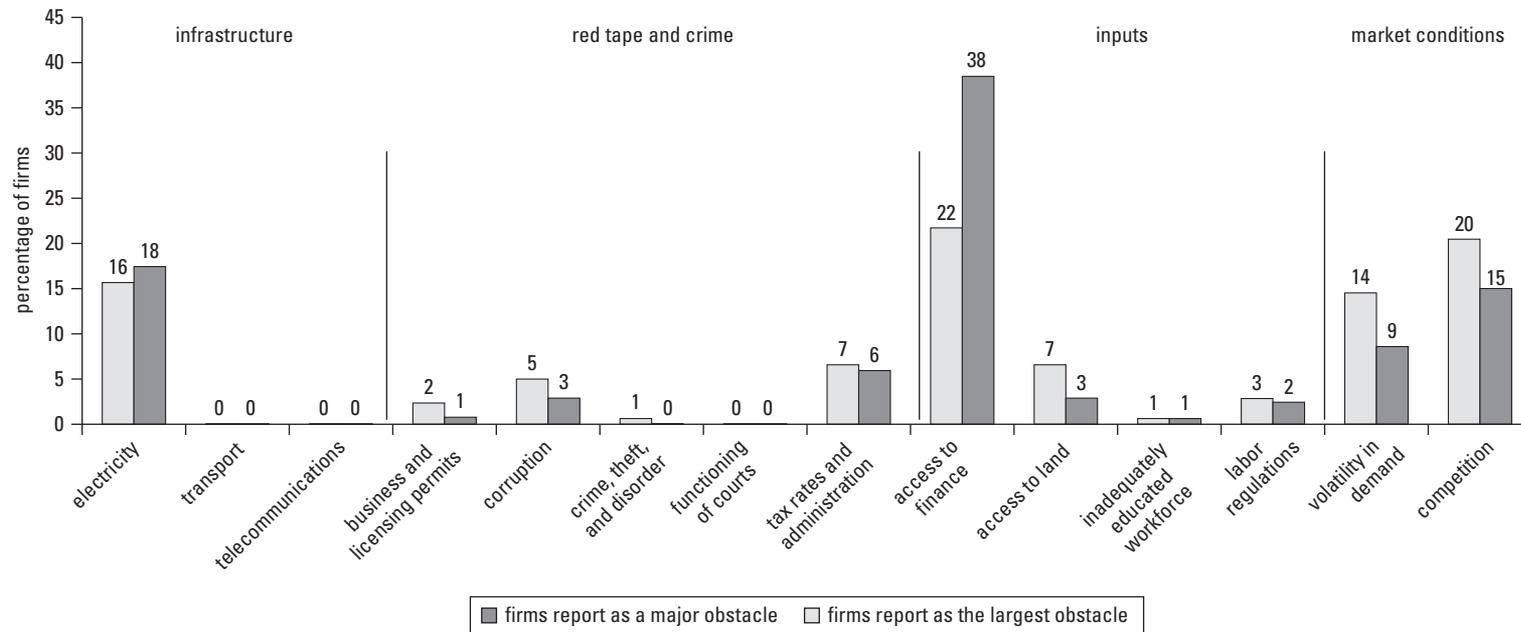
However, neither formal nor informal loans sufficiently meet the needs of the unorganized sector. Formal credit markets are difficult for small firms to access, while informal loans are based on personal relationships, are short term, and often attract high interest rates. Most enterprises surveyed preferred not to expand their activities until they had built up internal resources: 93 percent of enterprises said they usually used internal funds for making fixed investments, and 99 percent financed their working capital from the same source. Only 7 percent of enterprises had borrowed any amount from banks for working capital requirements, and just 9 percent had borrowed for a fixed investment.

The inability of the formal financial system to meet the needs of this sector has implications. First, it places a limit on firms' ability to invest in productive growth opportunities. Second, tax laws in India are such that the highest burden falls on investment financed out of own funds. Hence, inability to access debt from formal institutions places small enterprises at a significant disadvantage.

second, with 18 percent of enterprises saying that this was the most significant constraint. These findings contrast with the responses from larger firms in the manufacturing sector (as discussed in chapter 3), where availability of electricity is the largest issue. Among other constraints highlighted by the unorganized sector, market conditions, such as competition and volatility of demand, were considerable problems. Other factors appeared less important, though 7 percent of firms surveyed felt that tax rates and tax administration posed a major problem for them. The findings of the ICS echo those emerging from the NSSO (2001) survey.

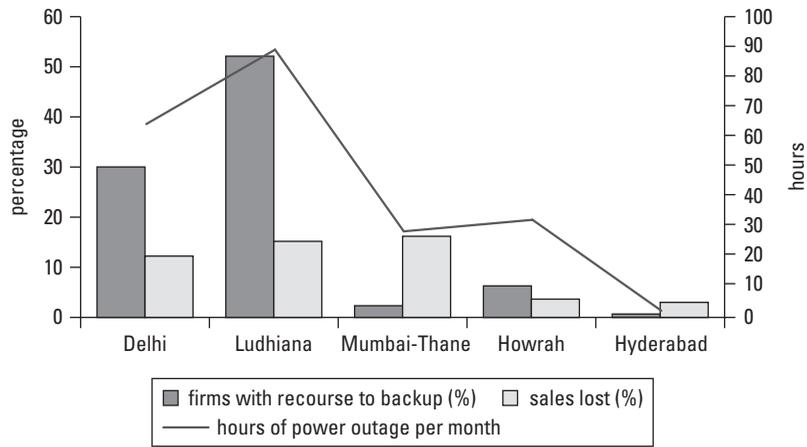
Access to formal finance is associated with significantly higher labor productivity, and informal finance is a poor substitute for productivity- and growth-enhancing investments. The econometric analysis of the effect of investment climate on unorganized firms also shows that firms that were able to borrow from financial institutions had 37 percent higher labor productivity than firms that could not, after controlling for other factors (see appendix B). This factor possibly reflects that cash-constrained unorganized enterprises use these short-term financial instruments to supplement their own resources for financing new productivity-enhancing fixed investments. Borrowing from informal sources is not strongly associated with any similar positive effects.⁴ The difference may be because the bulk of informal loans

Figure 4.6 Major Constraints to Normal Functioning Identified by Unorganized Enterprises



Source: Unorganized Manufacturing ICS 2006.

Figure 4.7 Effect of Power Outages on Unorganized Firms



Source: Unorganized Manufacturing ICS 2006.

(93 percent) are used for financing working capital and maintaining operations rather than for making fixed investments. A variety of reasons may limit their usefulness in financing the latter. Informal loans are likely to be of shorter duration, and they may not be available at the time they are needed or in the amount required. Consequently, their effect on labor productivity is lower. The result is in line with international evidence that suggests that informal lending can only partially substitute for formal lending in very poor countries.

Power availability is another major constraint for small enterprises, with arguably greater impact on growth and productivity. As with the larger manufacturing firms in the ICS, unorganized firms also had to contend with power outages. Power outages averaged as high as 89 hours (about nine working days) a month in Ludhiana. The relatively small scale of operation probably limited recourse to expensive backup options, such as generators and invertors, and few enterprises reported having them (figure 4.7). Outages were costly: on average, enterprises reported huge losses—11.3 percent of annual sales—because of outages. One must also keep in mind that unreliable power supply is likely to deter firms from growing and investing in new technology to the extent that such technology requires assured power supply. Hence, unreliable power sources might keep firms trapped in a lower-scale, low-productivity, and labor-intensive mode of production.

Nonetheless, power outages appear to have no effect on productivity, possibly because they push enterprises to adopt coping strategies based on employing more labor. Anecdotal evidence suggests that firms deal with outages by either employing more workers or enforcing longer shifts in order to finish orders. This hypothesis is borne out in the data to the extent that power outages are not negatively correlated with employment: more power outages lead enterprises to employ more labor, if other factors are held fixed. However, as discussed earlier, the loss of sales as a result of power outages is still quite significant at more than 11 percent.

Almost no enterprise identified transportation, telecommunications, law and order, the functioning of the courts, or labor force skills as a severe problem in the operation of their establishments. In some areas, such as telecommunications, this identification owes to the rapid progress India has made, especially in urban areas. In other areas, such as transportation or courts, it may reflect that these factors are not very important in the context of small firms. Unorganized firms probably do not supply across large distances and may rely only on local transport infrastructure. Similarly, very few firms ever use courts to settle disputes (only about 1 percent). Unlike larger firms, unorganized firms also do not rate labor regulations as a major problem. Again, this finding is to be expected because small enterprises are outside the purview of most labor laws. More than 54 percent of firms did not know or could not answer a question about which labor regulations they found most difficult to follow.

Although transport and corruption are not identified as a constraint by firm management, empirical analysis shows that both the short-term impact of transport problems and the long-term impact of corruption on productivity are considerable. Although only about 9 percent of firms reported difficulties in making timely deliveries to customers or receiving supplies because of transport-related issues, those that did report such difficulties had about 13 percent lower labor productivity. These firms also employed more workers, possibly to cope with these difficulties, but suffered nonetheless. Similarly, only 3 percent of firms ranked corruption as their foremost problem, and 5 percent ranked it as one of their three biggest problems; bribes were a small percentage of annual sales. This finding was expected because invisibility is one known advantage of small firms. However, corruption may also induce firms to remain small, which could have long-term impacts on their productivity. The amount of bribes a firm pays can be expected to be closely related to the number of inspections it faces, which, in turn, is closely related to its annual turnover, the number of workers it employs, and whether it is registered. This situation creates incentives for the firm to remain small, unregistered, and inconspicuous. The analysis also shows that when the reverse link between bribes and productivity is controlled for, paying bribes has a negative effect on firm productivity. A 0.1 percent increase in the amount of bribes paid (as a ratio to annual sales) is associated with a 3.4 percent decrease in the firm's labor productivity.

Conclusions

There is significant scope for improving productivity and employment in unorganized manufacturing. An analysis of survey results shows that firms in this sector face increasing returns from scaling up and that they thus have a strong incentive to grow. Consequently, many firms appear willing to grow but are held back by investment climate obstacles. Some successful firms, in fact, do grow—some even beyond the 10-worker limit that pushes them into the organized sector. At the same time, a very large number do not. The survey provides evidence of why they do not grow.

Access to finance is the biggest investment climate obstacle facing firms. This finding is apparent both from the firms' own perceptions and from the analysis of

their productivity and employment. Firms that are not able to access financing from formal financial institutions have almost 37 percent lower productivity than those that can access such financing. Interest rates are not the problem. Enterprises are deterred from seeking such loans because of stringent collateral requirements, necessary documentation, and the time it takes to process their application. Loans from informal sources are inadequate substitutes; they are more suited to meeting working capital requirements than to making fixed investments. Enterprises are thus forced to rely mostly on internal funds for such investments. Improving the situation does not require the government's direct intervention in the form of subsidies, but rather its facilitation of the development of an enabling financial infrastructure and its efforts to build good institutions.

Enterprises are also hampered by poor infrastructure and by their limited ability to invest in mitigating mechanisms. Expectedly, power is a problem, although a much smaller one than finance. In this respect, the unorganized sector differs markedly from organized manufacturing. Enterprises cope sometimes by investing in costly backup sources, but mostly by employing more workers and presumably enforcing longer working hours. The transport infrastructure is less problematic, and almost no firm in the survey identified it as a major constraint. However, econometric analysis shows that firms that reported being unable to make timely deliveries had significantly lower labor productivity. The high losses incurred because of poor infrastructure (more than one-tenth of annual sales because of power alone) reduce profitability and, consequently, firms' incentives to invest and to improve scale and productivity.

The various constraints discussed in this chapter may interact with each other, and action may need to be taken simultaneously on many fronts. For example, unless enterprises receive adequate financing, they will be limited in their ability to make productivity-enhancing investments. However, unless they also have access to a reliable power supply, the gains from investing in technology will also be lower. Improving access to finance thus will have only limited effect. If such investments make enterprises more vulnerable to rent-seeking, their incentive to grow will be reduced. A better understanding of these factors, the ways they interact with each other, and their impact on technology adoption and productivity is thus very necessary.

Notes

1. These results match the National Sample Survey 56th Round Survey, which found that 97 percent of urban, nonhousehold enterprises were proprietary, and of these only 5 percent had female owners. These results are also consistent with surveys in other developing countries, which found that firms operating out of the home were overwhelmingly female owned and that enterprises in commercial districts, industrial sites, and traditional marketplaces were mostly male owned (Ingram, Ramachandran, and Desai 2006).
2. *Part-time workers* are both those who work fewer than eight hours per day on all workdays and those who work for only a part of the year.
3. *Employment* refers to the number of paid, full-time employees.
4. The effect is positive but is not statistically significant at the 10 percent level.

Annex 4.A Obstacle Case Study—Access to Finance

The government of India's fiscal policies often crowd out lending to the private sector, hence limiting firms' access to finance. Although access to finance is an issue for all businesses, the problem is more acute for small businesses. High fiscal deficits have led the government to appropriate a large share of financial savings for itself, thus displacing credit to the private sector. As of 2006, total loans and advances for scheduled commercial banks amounted to 54.4 percent, with most of the other assets kept in liquid assets, including government securities. As a result, the ratio of private credit to gross domestic product is less than 40 percent (compared with more than 100 percent for such countries as the Republic of Korea and Malaysia), and much of this private credit takes the form of relatively safe lending to large corporations and consumer loans to high-income individuals. In fact, although banks are required to direct 40 percent of their lending to the "priority sector," which includes small firms, most get around this requirement by subscribing instead to other eligible instruments (for example, bonds issued by apex banks, such as the National Bank for Agriculture and Rural Development and the Small Industries Development Bank of India) (Reserve Bank of India 2005). Competition in the small business segment is still quite limited, and financial institutions have not yet developed appropriate products and procedures to serve the segment profitably, which requires large volumes, efficiency, and very high portfolio quality. In addition, the legal regulatory regime, although improving, still does not facilitate lending to the extent that it could, especially for small businesses.

Access to finance is also hampered by the high costs and lengthy enforcement procedures for immovable collaterals. Stamp duties for mortgage registration vary across states, ranging from 3 percent to 14 percent. At the same time, enforcement procedures for registered mortgages can take up to four years. As a result, the majority of the mortgages are unregistered (so-called equitable mortgages). Under an equitable mortgage, the debtor deposits the title deed with the creditor and this act creates the security. The mortgage might be a purely oral arrangement, and in most states no registration or stamp duty is required. However, because the title deeds are physically deposited with the creditor, the debtor can have only one mortgage on the entirety of the assets. Hence, businesses cannot fully leverage their collateral, leading de facto to a higher level of collateralization.

Despite improvements in the legal regulatory framework, it is still difficult for small businesses to use movable assets as collateral. The movable collateral regime for financial institutions is regulated by the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SRFAESI), which substantially improved the enforcement of securities over movables because it introduced out-of-court execution. SRFAESI also mandated the creation of a central registry for liens on movable assets, thereby making it easier, in theory, for the creditor to conduct searches. In practice, no central registry has been created. Hence, as in the past, liens on movable assets of incorporated businesses are registered in the company registry, except for liens on assets that must be registered in a particular registry (for example,

cars). SRFAESI has not improved the situation for small businesses, many of which are unincorporated and have mainly movable assets (as opposed to immovable assets). In fact, SRFAESI does not mandate any registration for assets pledged by unincorporated businesses (for example, partnerships and sole proprietorships), which make up the bulk of small businesses. This circumstance means that the registration is not a requirement for perfection of a security interest over a movable asset of an incorporated business. Hence, a lender has no means of conclusively determining whether the asset being offered as collateral has already been pledged. The effect of this ambiguity is to leave small businesses underleveraged because their assets cannot safely be offered as security.

The establishment of the Credit Information Bureau (India) Limited (CIBIL) and the approval of the Credit Information Companies Act have substantially improved the credit information system. However, much remains to be done to enhance the quality of the data collected and to facilitate a more extensive use of the bureau. A number of facts explain the limited reliability of the data collected by CIBIL. First, the data provided to CIBIL by financial institutions, especially state-owned organizations, are of variable quality and are often submitted a few months after the loan has been issued. Many state-owned banks, which account for the greater part of the retail financial sector, are not yet fully computerized. As a result, transcription errors occur often. Lack of computerization also affects the timeliness of the data reported by this segment of banks, which often report on only a quarterly basis. Second, some operating rules of the registry make it difficult to verify information. For example, there is a very high level of anonymity in the credit reports (for instance, the name of the reporting bank is not included in the report). Unlike other credit bureaus around the world, CIBIL does not verify information using third-party sources, such as courts, government registration departments, or company registries. Finally, in India, there is no unique identification number for customers. Although these issues affect the reliability of the data on all borrowers, the problem is particularly acute for small businesses, which are mainly served by state-owned banks.

Under the Credit Information Companies Act, credit bureaus can collect information only from financial institutions. This provision disadvantages small businesses, which often have limited credit histories with financial institutions. Unlike other bureaus, CIBIL can collect information only from financial institutions and not from utilities or mobile phone companies. This provision excludes important sources of credit history data, especially for small businesses, which often have limited credit history with financial institutions but are users of mobile phones and clients of utilities companies.

Source: World Bank 2004a.