Policy WATCH

Volume VIII, Issue 9
October 2019 New Delhi

RAJIV GANDHI INSTITUTE FOR CONTEMPORARY STUDIES

Growth with Employment

In this issue

Rajiv Gandhi
Institute for Contemporary Studies

Editorial

POLICY WATCH

Volume VIII, Issue 9
October 2019, New Delhi

Dear Reader,

Welcome to the latest issue of Policy Watch by the RGICS. Since the beginning of this year, we have rotated the Policy Watch issue focus over the five themes that the RGICS works on, namely

I. Constitutional Values and Democratic Institutions
II. Growth with Employment
III. Governance and Development
IV. Environment, Natural Resources and Sustainability
V. India's Place in the World

The sixth issue, in June and December, is a special multi-thematic issue. For earlier issues of the RGICS Policy Watch, please click on https://www.rgics.org/policy-watch/

In the month of October, we are focusing on the theme, Growth with Employment. We are publishing three articles in this issue.

The first article by Dr Amir Ullah Khan, Senior Visiting Fellow RGICS, gives and overview of the economy - the slowdown in growth and the rise in unemployment - and then argues in favour of investment in human capital, in the form of education as an urgent solution to the impasse. He cites estimates from NSSO's 'participation and expenditure in education' survey show that only 4.7 per cent of all population has completed post higher secondary education. There is large gap in the attainment levels in higher level education between rural and urban areas. Just above 2 per cent of the rural population is educated up to a level higher than secondary level as compared with 12 per cent in the urban part of India. He ends by offering simple solutions including   Better quality of primary education; Teaching at the right level instead of focusing on completing the syllabus; Cash incentives for attendance, especially in the poorest states;   Improving the quality and the number of teachers; Making schools and teachers locally accountable; Evaluate, monitor and publish performance results for schools; Increase mean years of schooling; Better quality of technical education; Improving health and nutrition status and Focus on the weak child.

The second article looks at agriculture - which employs the largest share of the workforce but generates a much lower share of the GDP. The need to stabilise and enhance farmers' income has been an important concern for policy makers for several years. One of the ways tried has to been to organise farmers to producers' companies and enable them to participate in the full value chain of an agricultural commodity, from input supply to crop cultivation to primary and secondary processing. The experience of hundreds of farmers' producer companies in several states - Maharashtra, Gujarat, Madhya Pradesh and Uttar Pradesh was discussed in a Consultation at the RGICS and this has been reported on in detail in this article by RGICS Fellow, Yuvraj Kalia.

The third article looks at financing for micro, small and medium enterprises (MSMEs). The article by Vijay Mahajan, Director RGICS and Jagmeet Singh, Senior Research Associate, RGICS, speaks of the large number of persons employed in the MSME sector - 111 million, second, only to employment in the agriculture sector. As the agriculture sector has a lot of under-employment, the growth of the MSME sector is essential to absorb the excess workforce from agriculture as well as the increments to the workforce every year. One critical factor for growth of the MSME sector is access to financing. The government had recognised this and launched the Pradhan Mantri Mudra Yojana (PMMY) in 2015 to provide additional bank loans to MSMEs. The article shows that the PMMY has been a limited success, if at all even in credit enhancement, and even less in incremental employment. The article traces the cause of this to a faulty design of the PMMY loan products and suggests design improvements including the provision for cash credit in place of term loans and micro-equity in place of loans for startup MSMEs.

We hope that the some of these recommendations will be heeded to help the economy bounce back in terms of growth and employment, particularly in agriculture and MSMEs.

We wish you a Happy Diwali.

Restoring Economic Growth in India

Investing in Human Capital

Amir Ulllah Khan*

The Indian economy and its challenges

India has gone through about six years of NDA government. The achievements of the NDA include the Insolvency Code that allows firms to declare bankruptcy. The next big goal was the setting up of a Monetary Policy Committee of the RBI to fix interest rates at the RBI. The government also succeeded in bringing in the GST, finally, after a decade of discussion and debate. The government also ensured that fiscal deficit remained under control for most of the time.

After these are counted, the legacy that the government is best known for now is its startling decision on demonetisation. The PM's unilateral decision to ban notes not only failed in flushing out hidden wealth but also caused significant damage to the economy[1]. The sudden decision had a two-fold impact on the Indian economy: an aggregate demand shock by reducing the supply of money, and, an aggregate supply shock by constraining availability of cash as a critical input for specified economic activities, such as purchase of inputs in the agriculture sector. Growth has slowed down to a historic low of 6% and unemployment climbed to an unprecedented high of 6.1%.

India is in a phase of economic development that poses difficult questions and seeks sophisticated solutions. It is the sheer size of the middle class that attracts investment even as other major economies namely China, Japan, the European Union and the United States slow down. The hope was that India with all its fault lines will achieve a high growth rate of over 9 per cent by 2020. This is despite that fact that nearly half the world's poor live in India, with high malnutrition amongst its children (nearing 40 per cent according to NFHS-4). One half of India's eligible population is either illiterate or barely educated.

The NDA government that came to power in India in 2014, clearly announced its social and economic intent. The economy picked up a little as oil prices went down, but then started a steady decline. This year too did not start well for the government at all. Private

1 The RBI annual report for 2017-18, shows that almost all the banned banknotes, or 99.3% of the notes withdrawn, were returned.

*Amir Ulllah Khan, Senior Visiting Fellow, Growth with Employment, RGICS

investment in India has gone to its lowest since 2004[2]. What is even more worrying is that public sector investments are also coming down[3]. All this explains the general gloom in the job market. With no new investment coming in, there are no jobs being created and as the year goes by, the gloom spreads across sectors as including auto, airlines and telecom.

The rupee is at an all-time low of Rs 71 to a dollar[4] and has added to the burden of the rising current account deficit[5]. Despite this weakening, exports have been declining and the trade deficit going up. The Indian stock market turned to be the riskiest in Asia last year. What hurt the capital markets most was the inexplicable introduction of a Capital Gains Tax and the collapse of ILFS, a major non-banking finance company. Foreign investment flows in India have been volatile for some time now[6]. Public spending on infrastructure went up, but not as expected. Global oil prices kept falling through the year in 2015 ending at 37 dollars to a barrel, last seen twelve years ago. However in 2017 and 2018, prices have again moved up and down. It is yet inexplicable and difficult to forecast how this trend will play out in the future[7].

---

2 Investments fell to a 14-year-low. Indian companies announced very few new projects, 53% lower than what was announced in September quarter, and 55% lower than the year-ago period. The trend of lower investments continues, with 2019 doing generally worse than 2018 that was already lower than the previous year

3 New public sector projects also declined. Fresh investment announcements in the public sector fell 37% on quarter and 41% on year to ₹50,604 crore—the lowest level since December 2004.

4 The rupee has depreciated by 10 per cent against the dollar since February 2018

5 http://www.livemint.com/Opinion/Yd6BOR2JYjMVA2zATmHyGM/India-needs-a-weaker-exchange-rate.html

6 Singh, S, and Sharda. "FDI in India." The International Journal of Business & Management 2.4 (2014): 82.

7 Hamilton, J. D. (2008). Understanding crude oil prices (No. w14492). National Bureau of Economic Research.

Unemployment: Where have the jobs gone?

The major problem that continues to haunt the government is the failure in creating jobs. Reducing unemployment was a major slogan given by the PM while campaigning in 2013-14. As per the Economic Survey (2015-16), the rate of unemployment has increased from 3.8% (2011-12) to 5% (2015-16). Additionally, in 2015 only 1.35 lakh jobs were added in eight labor intensive sectors, compared to 9.3 lakh jobs that were added in 2011-12. The latest data from the Periodic Labour Force Survey (PLFS) is even more dismal. Unemployment among urban youth in the age group of 15-29 years, has been consistently rising quarters and is at 23.7% in the last quarter. This is despite the urban youth getting better educated, as they are spending an average of 11 years in school, compared with 9.3 years spent by rural youth. The 1 million Indians, who enter the workforce every month are under stress.

The Telecom sector that has been a major creator of employment has also started reducing its numbers heavily. Campus placements also are under stress with Business schools and IT colleges reporting a remarkable fall in number of jobs. From July 2014 to December 2016, in the eight major sectors – manufacturing, trade, construction, education, health, information technology, transport, and accommodation and restaurant – only 641,000 jobs were created.

In comparison, these same sectors had added a total of 1.28 million jobs from July 2011 to December 2013. Specifically, jobs created by the Prime Minister's Employment Generation Program (PMEGP), which generates employment in rural and urban areas by initiating new micro enterprises and small projects, has fallen by 24.4% from 428,000 in 2012-13 to 323,362 in 2015-16. Joblessness has increased after the demonetization drive and gone up further after the introduction of GST.

In addition to the lack of jobs, poor wages also are a matter of concern. Marginalised sections of society, with poorly trained human capital, earn much less than the national average of Rs 113,222. SC and ST households earn 21% and 34%, respectively, less than the average. OBC households fare better but still earn 8% or Rs 9,123 less than the annual Indian average. Among upper caste groups, Brahmins earn 48% above the national average and non-Brahmin forward castes, 45%. India is one of the most unequal countries in the world with the top 10% controlling 55% of the total wealth, up from 31% in 1980, according to the 2018 World Inequality report[8]. Muslims have lower income than average and earn an annual household income 7% less than the national average.

However, the major concern we have now, is that the rising tide of economic growth seems to have bypassed the marginalised populations. The Scheduled castes, Scheduled Tribes and rural folk have fallen behind on most indicators. The last six budgets have seen significant cuts in outlays to minorities, to primary education, to nutrition and to rural infrastructure. India's future growth depends on an equitable growth across various sections and across the entire geographical map of the country. Inequitable growth will lead to social tensions and to regional conflict. This needs a big push towards harnessing human capital in the country, for solving both the supply and the demand side problems of labour markets.

8 The National Family Health Survey 2015-16 (NFHS-4) showed that 45.9% of ST population were in the lowest wealth bracket compared to 26.6% of SC population, 18.3% of OBCs, 9.7% of other castes and 25.3% of those whose caste is unknown

Why a focus on human capital

We discuss here a few of the top concerns that impact India's quality of human capital - namely education, urbanisation, jobs and poverty. Of course we have enormous challenges in other fields too, like the absolutely dismal lack of access to modern health systems for a majority of the population. The small scale sector, the export sector, energy, climate change, the environment and a host of other issues cry out for attention. In this paper we focus on the youth, job creation and the need for developing human capital.We have, according to the 2011 census 333 million youth, going up to 367 million in 2021 and 370 million by 2031.

The absence of jobs hurts the youth really hard and causes various kinds of socio economic problems. The controversy regarding the leakage of a government report on jobs comes from the realisation that unemployment has never been as high in the last four decades as it is today. On the rural front, incomes went down. Partially due to poor rains and also due to the government's inability to keep up to its commitment on social sector spending. Disbursements on account of programs like the MNREGA fell behind schedule[9]. Large cuts in the Ministries of women and child welfare and in the Ministry of Health and Family welfare meant further fall in demand.

As rural India spent less money, rural demand failed to pick up. Except for a small surge during the festival season again, cities and towns in India also remain unwilling customers. Cash is a critical input in the agricultural production process and its unexpected shortage had an impact at many levels, including a slowdown in employment of labour and a dip in

9 Shankar, S., &Gaiha, R. (2013). Battling corruption: has NREGA reached India's rural poor? OUP Catalogue.

overall farm incomes[10]. And when we look at the job numbers that some private-sector people estimate, nearly 12 million jobs were lost in that episode. And, of course, we haven't recovered them yet.

Education and Human capital

There are serious problems with respect to access to education itself and quality education is simply not available. 89% of kids of primary school going age of the richest 20 percent of the population attend school both in the rural and urban areas, while that proportion drops to 79% for kids in the poorest fifth of the population in rural areas and 78% in urban areas. But, attendance drops sharply when it comes to secondary school and becomes worse at the higher secondary level. Also, the difference between the richest and the poorest in enrolment widens sharply from the primary section to the secondary and higher educational levels.

The gulf between the poor and the rich widens as we go up the ladder. Only 6% of young people from the bottom 20 percent of the population attend educational levels above higher secondary in urban India, while 31% among the richest 20 percent of the population attend secondary school. The situation is substantially worse in rural India. Richer, urban children have better opportunities for higher education, essential for getting good jobs in the cities. The poorer children work in the informal sector at low wages and remain vulnerable[11].

What is indeed sad is that across the country, 29 percent of children drop out before completing five years of primary school, and 43 percent before finishing upper primary school. Only 42 per cent get to complete high school. This ensures that India stands among the top five nations for out-of-school children of primary school age, with 1.4 million children in the age group 6 to 11 year olds not attending school. What does not help at all is that a number of schools are not equipped to handle the complete population. There is a teacher shortage of 689,000 teachers in primary schools. Just about 53 percent of schools have functional girls' toilets and 74 percent have access to drinking water.

Some states have wide gender differences at the secondary levels. For instance, net attendance rates at the secondary level in Gujarat is 63% for boys and 43% for girls. Also the difference between scheduled castes and tribes and other categories widens at higher levels of education. It is particularly large for urban girls belonging to scheduled tribes at the secondary and higher secondary levels. Enrolment of Muslims is lower compared to those of other religions at every level, both for males and females. In urban India, while enrolment for Muslim boys in primary schools is only marginally lower, the proportion at the higher educational levels is substantially lower. Muslim girls enroll in comparable numbers in primary schools, but the drop-out rates at secondary levels are alarming,

Much of this can be attributed to the low levels of expenditure on education. According

10 The Economic Survey for 2016-17, authored by the former chief economic adviser Arvind Subramanian and released in January 2017, also echoed these concerns.

11 Muslims have the highest percentage of illiterates aged beyond 7 years at 42.72%, as compared to 36.40% among Hindus, 32.49% among Sikhs, 28.17% among Buddhists and 25.66% among Christians. Jains have the highest percentage of literates above 7 years of age among India's religious communities, with Census India 2011 finding 86.73% of them as literate and only 13.57% as illiterate. As compared to 63.60% of Hindus and 57.28% Muslims in the 'literate' category, the percentage of literates among Christians is 74.34%, among Buddhists 71.83% and among Sikhs 67.51%.

to the World Bank indicators, government expenditure on education as a percentage of gross domestic product was 3.8%. Compared to other poor countries it is abysmally low. The figure is 6.3% for Vietnam, 4.3% for Mali, 4.7% for Nepal and 5% for Rwanda. As a result, the state is unable to provide education infrastructure to a large number of the poor. It also results in primary schools rarely getting upgraded to secondary levels, forcing a number of our children to stop studying after primary levels as they are not able to travel long distances to continue their education.[12]

While there are various kinds of inequalities we see in modern India, nowhere is inequality higher than in access to higher education. This is despite Article 15 of the constitution that directs the governments to create equal opportunity and equity in access to all levels of education. Access to education, particularly to skills and to technical capabilities, is an essential element of escaping poverty and even in gaining access to health facilities and social security programs. Both market wages and human development indices depend on standards of higher education reached. Also stable high paced GDP growth requires skilled workers who can adapt to technology as it changes rapidly[13].

However, in India, the share of illiterate workforce was 30.7 per cent in 2016-17, and this is twice their 15.2 per cent contribution to the GDP. On the other hand, 9 per cent of graduates contribute over 29 per cent to the GDP. Labour productivity is critical for economic efficiency. East Asian economies developed at a fast pace primarily because of their factor productivity and capital per worker.

Estimates from NSSO's *'participation and expenditure in education'* survey show that only 4.7 per cent of all population has completed post higher secondary education. There is large gap in the attainment levels in higher level education between rural and urban areas. Just above 2 per cent of the rural population is educated up to a level higher than secondary level as compared with 12 per cent in the urban part of India. There clearly is an urban bias in access to higher level education, and also that the education linked jobs are concentrated in urban areas.

Another dimension where the achievement differentials are high is between genders; 6 per cent of the male population is educated up to post-higher secondary level in contrast with just 3.4 per cent of the female population. Socio-religious groups show extremely high variation in attainment, with a low of just about 2 per cent or less for the Muslims and H-SCs/STs, through to 12 per cent for Hindu-General or upper castes.[14]

Only 3.7 per cent of rural population in the age group 22 years and above has attained higher education. At the all India level, only 8.2 per cent of the population have attained any degree higher than the higher secondary. There is indeed a hugely unequal access to higher education in the country and this needs some urgent solutions.

---

12 The RTE mandates compulsory education for children in the 6 to 14 age groups. How then can it justify making schools only for the 6 to 10 year olds? What the RTE now implies is that there cannot be stand alone primary schools anywhere, and certainly not in areas where there are no other schools. All primary schools must immediately be converted to secondary schools

13 Education is indeed the driving force for economic and social development that is highly correlated with levels of education. The mean years of schooling, an indicator of educational achievement in a country is as high as 12 years in the USA and 5 years in India. http://www.nationmaster.com/graph/%20edu_ave_yea_of_sch_of_adu-education-average-years-schooling-adults

14 Shariff, A. (2009). Rural income and employment diversity in India during 1994 and 2005. Journal of Developing Societies, 25(2), 165-208.

Conclusion

It is not mere coincidence that Banerjee, Kremer and Duflo have won the Nobel this year. They have, in their extensive work with NGOs across the world noted that an educated, healthy, well-fed population affects the rate of return on investment, and is thus crucial to kick-starting the process of rapid development through rapid human capital development. Their work confirms the central role of schools for economic growth. Their evaluation of a program that hired tutors for underperforming students in India, and another that studied a computer-assisted learning program, concluded that both were effective interventions. They also found significant wage gains from public education spending in India.

The simple solutions come by way of

- Better quality of primary education
- Teaching at the right level instead of focusing on completing the syllabus
- Cash incentives for attendance, especially in the poorest states
- Improving the quality and the number of teachers
- Making schools and teachers locally accountable
- Evaluate, monitor and publish performance results for schools
- Increase mean years of schooling
- Better quality of technical education
- Improving health and nutrition status
- Focus on the weak child[15]

15 Banerjee has often pointed out that poor levels of learning are due to teachers' focus on somehow "completing" the syllabus rather than ensuring that every pupil has understood the parts already covered. "Teaching at the right level"— special teaching for those lagging behind — is what works. This also solves the problem of high level of drop outs, through offering corrective education to the weakest children.

India's economic policy continues to search for solutions towards ensuring inclusive equitable growth. The problems remain fearsome though several of them are being tackled. Health systems have ensured that infant mortality has reduced and life expectancy has gone up now to nearly 68 years. Infrastructure is not as poor as it was, at least in some urban locations. Education has improved in terms of enrolment at the primary school level, though the quality still suffers, and the problem becomes more acute at the higher levels. The core problem is that the quality of human capital remains poor, resulting in higher unemployment, poor productivity and low wages. The simple solutions mentioned above are worthy of examination, pilot testing, evaluation, if appropriate through RCTs and then large scale execution.

Bibliography

Government of India, Economic Survey, (Annual), Ministry of Finance, New Delhi.

Gupta, K., Arnold, F., & Lhungdim, H. (2009). Health and living conditions in eight Indian cities. National Family Health Survey (NFHS-3) India 2005-06.

http://164.100.47.5/newcommittee/reports/EnglishCommittees/Committee%20on%20Health%20and%20Family%20Welfare/82.pdf

http://economictimes.indiatimes.com/markets/stocks/news/with-a-25-year-history-as-proof-heres-why-sensex-can-end-2016-in-red-too/articleshow/50570115.cms

http://economictimes.indiatimes.com/news/economy/infrastructure/27-new-cities-selected-under-centres-smart-cities-mission/articleshow/54423653.cms

http://secc.gov.in/reportlistContent

http://www.livemint.com/Opinion/Yd6BOR2JYjMVA2zATmHyGM/India-needs-a-weaker-exchange-rate.html

Mitra, A., & Murayama, M. (2009). Rural to urban migration: a district-level analysis for India. *International Journal of Migration, Health and Social Care*, *5*(2), 35-52.

Reserve Bank of India, Report on Currency and Finance, (Annual).

Selvaraj, S., & Karan, A. K. (2009). Deepening health insecurity in India: evidence from national sample surveys since 1980s. *Economic and Political Weekly*, 55-60.

Sengupta, K. (2015). Determinants of Health Status in India. Springer

September 13, 2016 http://in.reuters.com/article/india-inflation-cpi-data-idINKCN11I1BH

Singh, Sanskriti, and Sophia Sharda. "FDI in India." *The International Journal of Business & Management* 2.4 (2014): 82.

Farmer Producer Companies in India

Does Aggregation lead to Prosperity?

Yuvraj Kalia*

A consultation was held on the above topic on September 13, 2019 at the RGICS. The following is a report on the Consultation:

Introduction

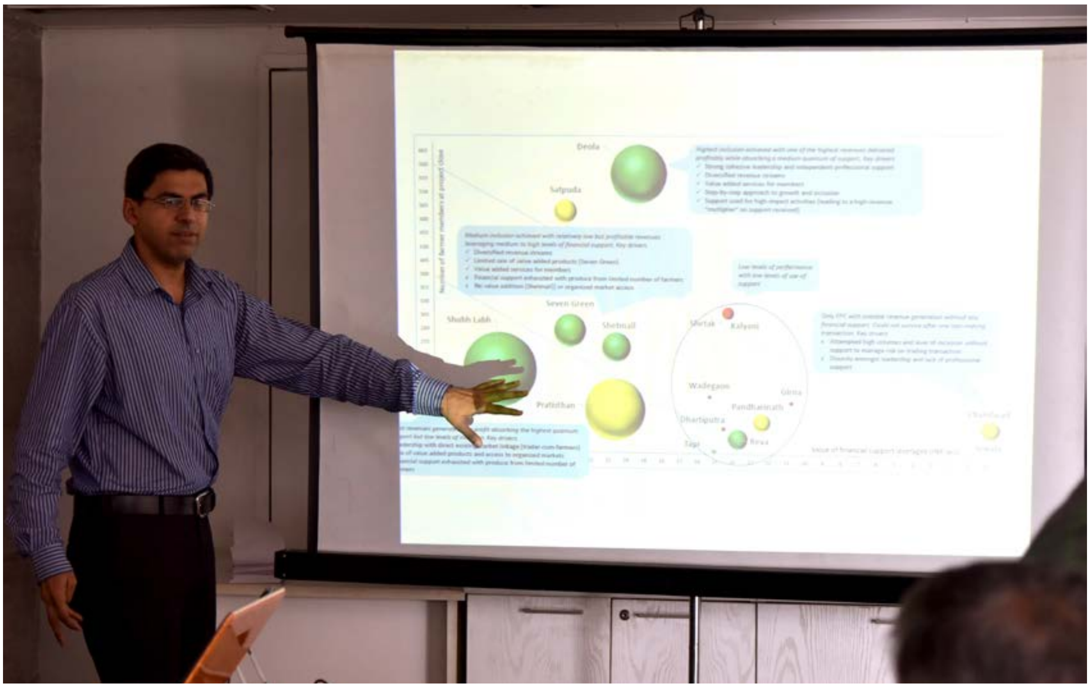
In India, the dependence of a high proportion of population on agriculture has remained even after almost three decades of economic reforms. In 2015-16, 42.5% of the total employed population of the country (in Primary sector, which is mainly agriculture) produced 12% of the value in the economy! This proportion has been in a consistent fall since the early 1980s.

Due to a number of reasons, Indian farm sector has been under distress from many years. "At least 270,940 Indian farmers have taken their lives since 1995, NCRB records show. This occurred at an annual average of 14,462 in six years, from 1995 to 2000. And at a yearly average of 16,743 in 11 years between 2001 and 2011. That is around 46 farmers' suicides each day, on average. Or nearly one every half-hour since 2001" (Sainath 2013).

A survey conducted by Centre for the Study of Developing Societies (CSDS), Lokniti, for Bharat Krishak Samaj in 2013-14 revealed that around 75% of farmers would prefer some other work than farming. It also pointed out that around 60% of farmers want their children to migrate and settle in a city. A huge proportion of these were landless, marginal and small landholders (Mukherjee 2014).

Under the current system, there seems to be a structural flaw. The producers of primary sector, especially farmers, have been divorced form the value addition that undergoes from farm gate to end consumer. In addition, the farm produce and remuneration for small and marginal landholders remains precarious given unpredictability of extreme climate variations, rising input costs, depressed prices, etc.

*Yuvraj Kalia, Fellow, Governance and Development, RGICS



Mr Aman Khanna, Consultant, Asian Development Bank sharing experience of FPCs in Maharashtra

In last four decades, India has become a food surplus country, and there are hardly any food commodities that are not exported from here. Given such circumstances, the current approaches to increase farmers' incomes through increasing productivity and using high yielding varieties, etc., may not be the best way possible. At best, there is a high risk of glut in the market that further depresses prices.

Background

There is a growing need to reposition farmers as owners of complete value chain rather than just producers of raw material for whole of food production system. Farmer Producer Companies or FPCs are one of the institutional solutions devised in India, to do just that. This brief report outlines learnings from a consultation held at Rajiv Gandhi Institute for Contemporary Studies, New Delhi in September 2019. After a brief background to the concept of farmer producer companies, the report is divided into two sections, one describing the experiences from four states viz. Maharashtra, Gujarat, Madhya Pradesh and Uttar Pradesh. The second section explores the feasibility of the concept and deliberates on potential solutions to address bottlenecks hindering the concept from realising its potential.

Cooperatives became the most popular form of institutional mechanism to generate collective action even before independence. A large number of cooperatives were formed oriented towards helping the neediest. After Independence, cooperatives became integral to planned development in India. The concept was widely used to increase agricultural production, and delivered good results during initial years. Over time, the nature of organisational structure and excessive state control led to appropriation of power by a few vested interests. In essence, apart from a few tremendous success stories, largely the cooperatives became den of evil that it was envisioned to counter.

Among small and marginal holdings, a relatively larger proportion of operational holdings are cultivated (92% and 91% respectively) as also relatively higher proportion on them is irrigated (52% and 47% respectively). These two inputs bring to fore that marginal holdings manage relatively superior quality of agricultural lands for higher productivity per acre. This is established through higher cropping intensity in the smaller group of operational holdings in relation to large size holdings.

Post liberalisation, need for a new institutional form was felt to reactivate collectivist idea in the agriculture sector specially to realise the value that small and marginal landholders can produce. As a result, a farmer producer company concept came into being with substantial improvements over cooperative form (Please refer Table 1)."A provision for setting up FPCs was made in the Companies Act, 1956 in 2003 by an amendment to the Act. Despite efforts by the government over the past 15 years or so, including major financial help, the country has just about 3,000 FPCs so far."(Bhosale 2018)

There have been many positive developments recently that believe in the promise of the concept of FPCs. In July, Union Budget made clear the intention of Central government to promote 10,000 FPOs in the country over next five years, perhaps in hopes of addressing the agrarian distress under the promise of doubling farmers' incomes. Nonetheless, it has certainly caught the attention of the stakeholders, and there is focused interest to explore and utilise the market potential of FPOs in general and farmer producer companies in particular.

Status and Experience of FPCs from 4 States

Maharashtra

Mr Aman Khanna, Consultant for Asian Development Bank (ADB), conducted an assessment study in Maharashtra. ADB created and supported 18 FPCs in the state by deploying funds from Japan Fund for Poverty Reduction (JFPR) grant from 2012 to 2018. The study aimed to compile experiences of FPCs supported for commercialisation under the grant; derive lessons learnt; and make recommendations for future support exercises by development partners/ aid agencies aimed at commercialisation of FPCs.

The experience form Maharashtra demonstrated that a number of factors impact performance of FPCs. Factors such as presence of experienced individuals on Board of Directors, external professional support deployed, extent of value addition or servicing of organised markets, were important. The diversification of income sources; incremental approach to planned growth; value of commodity produced; and amount of financial aid (by JFPR) absorbed; were other factors that were found to be correlated with performance of FPCs.

The following learnings from Maharashtra were shared by Mr Aman Khanna.

- It was found that cases where membership of FPCs increased steadily based on their performance after starting off with small number were more successful. In other words, the experience of business and catering to physical and logistical challenges, leads to sustainable capacity to absorb more members.
- Capacity building and financial support are required by an FPC simultaneously to sustainably enhance operations.
- Professional management and governance of FPCs is crucial. This required for two reasons. One, to plug the crucial capacity gap to carry out large transaction as a business. And two, to avoid the conflict of interest when ownership and management co-exist, which has often led to catastrophic results for the organisation.

- Since, FPCs operate in diversity of circumstances, location and market milieus; it is observed that blanket support schemes may not be the best bet to support FPCs. It is required that FPCs receive support catering to their unique requirement at ay give point in time.
- Absence of clear and consistent criteria for selection of Board of Directors often leads to inability to overcome disagreements and eventually closing of operation of the organisation.

Gujarat

Mr Kuldeep Solanki, Interim CEO, GUJPRO Agribusiness Consortium Producer Company Limited shared FPC experience from the state of Gujarat. GUJPRO is a consortium of 27 FPOs across 11 districts of Gujarat, and based in Ahmedabad. GUJPRO deals with farmers of mainly 5 commodities and offer different services for the same, like, procurement and processing of groundnut; procurement of oilseeds and pulses under MSP scheme; trading in cumin; and marketing support to mango growers. GUJPRO does high volume procurement for agencies like NAFED, SFAC, etc. They have also entered in an agreement with a private company for procurement, processing to supplying of final groundnut products. Farmers associated with GUJPRO earn a minimum of 3-4% premium over market price.

Key challenges faced by FPCs of GUJPRO are as listed below.

- Poor capacity of FPCs and low understanding of the business side of the FPC by members as well as Board members. Here, promoting institutions have also been seen lacking in having or transmitting requisite knowledge. Most FPCs have done well in agro-input production and doing business with farmers. However, there is lack of understanding or rooting in market business.
- Low level of initial equity becomes a bottleneck for expanding business in initial years. It is further exasperated by lack of access to formal capital. If capital is not available within initial 2-3 years of operation, most FPCs slip into inactivity.
- Professional human resource for management of affairs is unviable for small or medium level FPCs.
- Risk appetite of the members remains low, especially among new FPCs. It limits scope of activities under operation, usually FPCs remain stuck to input production.
- Limited cycles per year due to area being rain fed impacts turnover of the organisation directly. Commodities like milk or vegetables have higher flexibility of absorbing shocks.
- Development of good leadership is rare, and often impacts governance.

Way forward identified by GUJPRO experience:

- Capacity building of promoting institutions and FPCs, most importantly to generate capital for operations. Enhance patronage, maybe even by sharing produce with the company of not profits.
- Handholding support is required at ground level by experts post classroom type training.
- Design of FPC in terms of size, scope and scale must be catered to specific factors such as commodity, location, infrastructure and market distance, etc.
- Access to capital needs to be enhanced. In event of lack of it by scheduled banks

- Primary processing must be done locally to increase benefit to farmers. Higher level of value addition must be done at aggregated level by FPCs or federations.
- Village level scientific storage models are required that are strongly backed with technology. It would ensure better price discovery and sale, avoiding market uncertainties.
- FPCs must engage with members more vigorously and ensure higher patronage and higher holding in the FPC, which will enable solutions to a few challenges.

Madhya Pradesh

Mr Yogesh Dwivedi, CEO, Madhya Bharat Consortium of Farmer Producer Company Limited (MBCFPCL) shared experience from the state of Madhya Pradesh. MBCFPCL is a consortium of 108 FPC operational in Madhya Pradesh, having reach to over 174,000 small farmers in 43 districts. MBCFPCL is engaged primarily in commodity trading including aggregation, storage and primary processing; seed production and marketing with member FPCs; and backward integration for inputs to members. Additionally, the organisation is engaged in supporting members for credit linkages and infrastructure development; supporting in IT enabled management solutions and meeting statutory compliances; and support in capacity building of member FPCs.

MBCFPCL works with government agencies like NAFED, SFAC, State Agricultural Universities, etc. and also corporates like ITC, Britannia, Parle, etc. In last four years, the turnover has increased from around INR 71 Cr to 150 Cr, paid up capital has increased from INR 16 lakhs to 50 lakhs. However, such a glamorous increase has not been observed in total profits which increased from around 1 lakh to 6.5 lakhs only. It is also learned that farmers associated with 41 FPCs of the consortium earned additional income of INR 4,000 to 15,000 per season.

The state has 148 FPCs, of which around 60% are actively in operation having a total of INR 252 Cr annual turnover. Growth of FPCs business can be divided into three phases based on their average growth rate: 2006-2010 with >25% (total 15 FPCs); 2011-2016

Mr Yogesh Dwivedi, CEO, MBCFPCL shares journey of FPCs in Madhya Pradesh with ~15%; and post 2016 with <10% (±5% based on weather related uncertainties). A significant majority of first phase FPCs (13/15) are doing well without any external support since 2010. A considerable transformation has taken place among member farmers of FPCs, often earning 2-3 times more than they were earning in mid 2000s.

There were many peculiarities that led to high growth of FPCs in the first phase. Participatory varietal selection program (PVSP) done by ASA in association with MP District Poverty Initiative Program (DPIP) created awareness among farmers regarding agri-business model for seed production and prepared them for market oriented initiatives. A sustained financial support by SFAC proved crucial. A number of agencies facilitated timely capital availability. The state government's support in the form of allotment of land, construction of infrastructure using various schemes proved helpful. In addition, FPCs were authorised to supply seeds under government schemes which reduced the risk of new FPCs and allowed them to establish themselves. There was also a group of professionals at the helm of these FPCs who were well versed with local issues and linked with the community.

As per Mr Dwivedi, following challenges are faced by FPCs in Madhya Pradesh:

- High quality of appropriate (willing to work for FPCs in rural areas) and experienced human resource is not available to FPCs. Institutional ecosystem for creating such human resource is missing.
- High risk factor, especially in rain fed areas, restricts the horizon of operations and hinders investments in value additions.
- Support to invest in large scale processing and value addition plant and machinery is not available.
- Credit availability at competitive rates is a big challenge and FPCs have to rely on NBFCs for their capital needs.

Uttar Pradesh

Mr Rajnikant Prasad, AVP, Basix Uttar Pradesh, shared experience form state of Uttar Pradesh. Mr Prasad, along with his team, has promoted around 120 FPCs from 2011 onwards across 29 districts of the state with around 80% of associated farmers being small and marginal landholders. There 11 major commodity specific clusters

As outlined by Mr Prasad, following challenges were faced by FPCs promoted by Basix in Uttar Pradesh:

- The awareness towards and acceptance of the new institutional form took a long time, not only among farmers but also other stakeholders such banks, input marketing companies, etc.
- The working capital remained a challenge for almost all of the FPCs which hindered forward and backward linkages, meeting initial fixed costs, investments in infrastructure for value addition, etc.
- Skilled professionals for management of affairs of FPCs are not available.
- Lack of leadership in FPCs and within Board of Directors, coupled with low level of financial literacy and business orientation.

Way forward identified by Basix experience in Uttar Pradesh:

- Allowing two types of shares in FPCs – one with voting rights that are exclusive to

Mr Ashis Mondal, Director, Action for Social Advancement (ASA), making critical inputs at the event

the producer members, and second without voting rights to investors.

- Compliance requirements may be relaxed for FPCs and made different than private limited companies.
- Merging of FPCs or creating federations may additionally enhance economies of scales.
- Creating formal linkages with banks for making capital available at lower rates and decrease reliance on NBFCs.

Based on the experience of these states and the discussion held at the consultation, these functions/ services of the producer companies can be categorised into following core focus areas which need attention from policymakers and other stakeholders.

- Capacity building- Capacity building includes form the aforementioned list of functions - support on organisational services, technology services, education services, and management of resources.
- Capital/financial markets- It includes support on financial services i.e. various mechanisms of creating capital for long term sustainable growth.
- Connections- It includes the production services, and marketing services as mentioned in the above list, and some services in technology and education too.
- Miscellaneous- These areas cannot be appropriately fitted into above mentioned categories. Nonetheless, these are important to achieve the stated goals of an FPC.

These core focus areas are delved into some detail, exploring the major inhibitors and the way forward to address the same. These are based on discussion during the consultation, available literature on the subject and separate consultations with a few experts.

Capacity

The concern which echoes in most discussions around FPCs is their inability to understand business side of things, or lack of entrepreneurial culture, which often leads to unviable transactions in the initial phase with worst of downside risks playing out. It is often linked to the promoting institutions' lack of capacity beyond mobilising farmers to form an FPC, and also to tendency of resource institutions to not being able to transfer those skills creating a dependency. Lack of capacity also exists in understanding the institutional form of FPC by member producers and also the Board of Directors, often failing to meet statutory compliances.

It can be noted that the areas where FPCs require capacity building are independent of peculiarities that exist with regard to commodities that they deal with and building value chain. There exists an opportunity to easily aggregate such functions of capacity building geographically, may be at a regional level or state level. It will separate out functions which cannot be aggregated geographically and require particular support. Hence, specific verticals of capacity building can be addressed separately.

Mr Ashish Mondal, Director of Action for Social Advancement (ASA) shared their attempt to do something similar. ASA has created Centre for Incubation and Support for Smallholder Producers' Organisations (CISSPO) which has separate verticals within to address capacity needs of the FPCs. With over 40 professionals, CISSPO is engaged in FPCS in verticals ROC and governance; seed production value chain; organic cotton and pomegranate value chain; procurement and quality control; logistics and warehousing; credit linking; etc. in an integrated fashion. The Centre is financed from within ASA's grants.

From experience of various experts consulted, federations of FPCs at regional or state level have the potential to address capacity challenges. But the key to such federations at regional or state level is that they must commodity specific. This ensures greater cohesion within member producers and companies, better knowledge sharing, better price discovery, economies of scale throughout the value chain, etc. Some of the benefits of having commodity specific federations address concerns in other focus areas too. Please refer to section on Connections including production and marketing linkages, and also knowledge linkages.

Capital

Capital constraints have been the biggest bottleneck in an expected and take-off of the FPC concept. Since, it is aimed at small and medium landholder farmers, the initial paid up capital in almost all cases remains small. Plus, for FPCs engaged in commodities that have once a year cycle, absorbing even one season of losses becomes impossible as opposed to commodities such as milk, and vegetables, which have continuous production cycles. Low capacity of member producers to pool adequate funds not only limits the risk taking capacity of the FPC, but also the scale of operation due to low working capital, investments in capacity building and value addition. Most of the few examples of "good" FPCs that we come across had an advantage at the onset. For example, Sahyadri Farms started with around 10 farmers who contributed around 15 lakhs each to the company.

To address the capital constraints, especially at incubation or early stage, a provision for preference shareholding can be made for non-producers as well, may be NBFCs or agribusiness firms. These shares may entail no or limited voting rights."In case a Producer Company makes losses for two (or more) consecutive years, the preference shareholders shall have the right to move a resolution in the AGM/EGM of the company, seeking to elect other members in place of an existing member(s) of the Board of Directors and also another person in place of existing CEO. The voting on this resolution, however, would still be confined to the farmer members." (Mahajan 2014)

There have been a slew of steps taken by the government and governmental agencies to provide FPCs with access to capital. There is a credit guarantee scheme; funds from NABARD under producer organisations development, food processing categories, etc.; and equity grant fund of SFAC; and others. These funds have been described as inadequate by the experts; however, this is not the only challenge with it. The compliance levels and eligibility criteria to obtain these funds are unrealistically stringent for new FPCs. It has led to underutilisation of such funds. The credit guarantee scheme, too, has not succeeded in facilitating fund flow from commercial banks into the FPC system. Even as there have been MoUs and agreements, the challenge remains at the level of the decision makers, which is often a branch manager. In such a scenario, FPCs have been found availing loans from NBFCs at a higher rate of interest. This engagement with NBFCs dents into their margins, however, facilitates the business nonetheless.

As to facilitating cheaper credit from scheduled banks, the credit instruments needs orientation at the decision maker level. The current credit guarantee scheme may have to be notified by the RBI, as part of the priority sector lending. Also, unnecessary compliances for eligibility for credit need to be removed. According to Mr Emmanuel Murray, Senior Advisor at Caspian Investment, the current market size for debt to FPOs is estimated at around 600 Cr. The same report highlights that demand being met is around half of it around 300 Cr and rest is an opportunity that new NBFCs are attempting to fill. Large number of NBFCs entering the credit market in FPO space is a good signal to scheduled banks pointing to the promise of FPCs. The scheduled banks can target FPCs at emerging/ growing stage or matured ones looking to expand operations across the value chain.

A novel model which has emerged to address the most crucial need of capital is a Special Purpose Vehicle (SPV) model. This model recognises the limitations of FPCs operation and forms partnerships to perform an SPV a mutually beneficial manner. It essentially takes the functions of value addition and accessing capital to stakeholders and partners with specialisation to that end, by forming a different institution, usually a private limited company, with FPCs as shareholders along with corporate partners and/or NGOs.

Yuva Mitra, an NGO in Nashik area of Maharashtra, has promoted FPCs, which are also supported by NABARD. They have setup an SPV called Kisan Mitra Agro Services Pvt. Ltd., which is a joint venture of eight FPCs, Yuva Mitra, and Aditya Birla group as the corporate partner. Aditya Birla group is a majority shareholder in the SPV. This new institution takes care of infrastructure creation, capacity building, quality assurance and human resources. It has established three cluster level procurement and value addition centres. These centres are populated with capable human resources form local area doing grading, packaging, and supply to retail stores (which the SPV has entered into agreement with). At present the turnover of this SPV has touched 10 Cr. Since these FPCs are in rain fed area, it is difficult for them to access debt market. To address this challenge, Yuva Mitra has promoted another company in partnership with corporates.

Conclusion

FPCs offer a viable platform to create a space for small and marginal landholding farmers to retain the value of their produce, dignity of their labour, and avoid becoming a victim of captive or hierarchical value chains in face of the capacity and capital of large corporates. It has been more than a decade and there are unaddressed issues that require action from concerned stakeholders. A significant number of FPCs seem to have provided benefit to their member producers in real terms by facilitating better than market prices for commodities, inputs at reduced costs, and reducing transaction costs, etc. However, this is not enough given the greater challenge in food systems that is not favourable to the vast majority of small and marginal landholding farmers.Hence, there is a need for fine-tuning of the idea to make FPCs able to do what they are designed to do.

To that end, an FPC may not be considered successful unless it has end-to-end control over value chain of at least one food product, either directly or through some other mechanism. Today, there are very few which can be assessed as successful with this benchmark. To create a conducive milieu for majority of FPCs to attain the same benchmark, serious efforts to ease capacity, capital and other constraints of an FPC are required from policymakers. It may be best to use a multi-pronged approach, using suggestions described in this report,to design new generation of solutions required to make FPCs work.

Works Cited

Bhosale, Jayashree. *How farmer producer company model can transform Indian agriculture.* 29 September 2018. https://economictimes.indiatimes.com/news/economy/agriculture/how-farmer-producer-company-model-can-transform-indian-agriculture/articleshow/66000269.cms (accessed September 25, 2019).

Datta, S K. "Co-operatives in agriculture: philosophical and theoretical foundations of co-operatives." In *State of the Indian Farmer: Millennium Study*, by Government of India

Ministry of Agriculture. New Delhi: Academic Foundation, 2004.

Financial Express. *Maharashtra govt extends deadline to farmers for registrations of moong, urad, soyabean procurement.* 18 October 2019. https://www.financialexpress.com/economy/maharashtra-govt-extends-deadline-to-farmers-for-registrations-of-moong-urad-soyabean-procurement/1738875/ (accessed October 18, 2019).

Hellin, J, M Lundy, and M Meijer. "Farmer organization, collective action and market access in Meso-America." *Food Policy*, 2009: 16-22.

Mahajan, Vijay. "Farmers' Producer Companies: Need for Capital and Capability to Capture the Value Added." *State of India's Livelihoods (SOIL) Report.* New Delhi: Basix Social Enterprise Group, 2014.

Markelova, H, R Meinzen-Dick, J Hellin, and S Dohrn. "Collective action for smallholder market access." *Food Policy*, 2009: 1-7.

Ministry of Agriculture & Farmers Welfare, GoI. *Agriculture Census 2015-16.* Census, New Delhi: Agriculture Census Division, 2019.

Mukherjee, Sanjeeb. *More than 75% farmers want to leave their occupation.* 11 March 2014. https://www.business-standard.com/article/economy-policy/more-than-75-farmers-want-to-leave-their-occupation-114031100966_1.html (accessed October 15, 2019).

Narrod, C, D Roy, J Okello, B Avendano, K Rich, and A Thorat. "The role of public private partnerships and collective action in ensuring smallholder participation in high value fruit and vegetable supply chains." *CAPRi working paper.* Washington, DC: International Food Policy Research Institute, 2007.

Sainath, P. *Farmers' suicide rates soar above the rest.* 18 May 2013. https://psainath.org/farmers-suicide-rates-soar-above-the-rest/ (accessed October 12, 2019).

The Tribune. *Small farmers join hands to earn remunerative prices.* 20 September 2019. https://www.tribuneindia.com/news/business/small-farmers-join-hands-to-earn-remunerative-prices/835409.html) (accessed October 12, 2019).

Financing MSMEs for Growth and Employment

Vijay Mahajan^ and Jagmeet Singh^^

Introduction

Micro, Small and Medium enterprises have played a critical role in India's economic transition away from agriculture and allied activities towards growth in the non-farm sector. As stated in the report of the UK Sinha Committee[1]

"The Micro, Small and Medium Enterprises (MSMEs)... sector contributes in a significant way to the growth of the Indian economy with a vast network of about 63.38 million enterprises. The sector contributes about 45 per cent to manufacturing output, more than 40 per cent of exports, over 28 per cent of the GDP while creating employment for about 111 million people, which in terms of volume stands next to agricultural sector."

An overwhelming majority of MSMEs are tiny and informal - 96 per cent of them were sole proprietorships - usually located within or just outside the owner's household premises. Own-account enterprises (comprising 84 per cent of all enterprises) are those run by a single household member without paid workers and are often only one of multiple income sources for low-income households. The mean Gross Value Added of own-account enterprises was Rs. 7,980 per month while the mean GVA of firms classified as establishments was Rs. 53,425 per month. Only 31 per cent are registered with any industry and trade association or development board, indicating the in- formal and unorganized nature of their operations.

About 20 per cent of the MSMEs are based out of rural areas, which indicate the deployment of significant rural workforce in the MSME sector and is a testimony to the importance of these enterprises in promoting sustainable and inclusive development as well as generating large-scale employment, especially in the rural areas. At the level of individual households, the expansion in non-farm employment opportunities is believed to have increased the average income of rural households and helped to mitigate the income risk of farm-based households through diversification.[2]

^Vijay Mahajan, Director, RGICS

^^Jagmeet Singh, Sr Research Associate, RGICS

The Indian MSME sector, however, faces several constraints to growth. These include a lack of access to markets and value chains, the unmet demand for better infrastructure, difficulties in managing both skilled and unskilled workforce, technology or environmental constraints and finally, barriers to accessing regulatory facilitation.[3]

A critical factor limiting the performance potential of the MSMEs is access to finance. Credit gaps result from both demand and supply side factors. On the demand side, many MSMEs cannot access credit because of the financial documentation and collateral requirements for obtaining a loan; high interest rates; and long loan approval procedures, among others.

On the supply side, banks often consider MSMEs to be high-risk and high-cost clients to acquire, underwrite, and serve. Revenues per MSME client are lower than those of large firms. Documented information on MSMEs is also often limited. These factors deter banks from lending to small MSMEs and focus their attention on bigger MSMEs or larger firms.

The Pradhan Mantri Mudra Yojana (PMMY) – features and overview

To enhance the flow of credit to Micro, Small and Medium enterprises (MSMEs), in April 2015, the Government launched the Pradhan Mantri Mudra Yojana (PMMY) scheme for giving non-farm income-generating loans up to Rs10 lakh by existing government and private sector banks, and other financial institutions. PMMY offers unsecured loans for MSMEs requiring credit for investments in existing businesses, as well as for new start-ups.

Loans upto Rs. 50,000 are categorized as Shishu, from Rs. 50,000 upto Rs. 5 lakhs as Kishor and further up to Rs. 10 lakhs as Tarun loans. Further, by direction from the RBI since 2015, all lending to MSMEs lower than Rs. 10 lakhs by SCBs is required to be uncollateralized. The overall performance of PMMY in terms of number of loans as well as amount disbursed is given below.

As can be seen, nearly 17.8 crore loans have been given, worth Rs 8.95 lakh crore in 2015-19. A vast majority, nearly seven out of eight loans were of the smallest Shishu category with average loan size of only Rs 27143, due to which additional income is limited and additional employment is negligible.

Table 1: PPMY Loan for the period Apr 2015 to Mar 2019

Loan Type	No. of Accounts	No. of Accounts (per cent of total)	Disbursed Amount (Rs. Cr)	Disbursed Amount (per cent of total)	Average loan size (Rs)
Shishu	154,012,989 15,40,12,989	86.48%	418,042 4,18,042	46.72%	27,143
Kishore	19,212,879 1.92,12,879	10.79%	281,970 2,81,970	31.51%	1,46,761
Tarun	4,857,528 48,57,528	2.73%	194,765 1,94,764	21.77%	4,00,954
Total	**178,083,396 17,80,83,396**	**100.00%**	**894,777 8,94,776**	**100.00%**	**50,245**

This can further be seen from the analysis of in terms of type of borrowers in the table below. It indicates that loans to new enterprises were less than one in twelve and women accounted for only one out of five borrowers. Thus, additional employment effects of PMMY loans are likely to very limited.

Table 2: By various types of borrowers					
Borrower Type	**No. of Accounts**	**No. of Accounts (per cent of total)**	**Disbursed Amount (Rs. Cr)**	**Disbursed Amount (per cent of total)**	**Average loan size (Rs)**
Women	37,062,562 3,70,62,562	20.81%	1,29,153	14.43%	34,847
Minority	6,251,640 62,51,640	3.51%	29,029	3.24%	46,435
New Enterprises	13,393,802 1,33,93,802	7.52%	1,00,925	11.28%	75,352
PMJDY overdraft a/cs (poor households)	671,691	0.38%	63	0.01%	924
Source: https://www.mudra.org.in/Home/ShowPDF Tab: Overall Performance					

Note: Computation for per cent distribution of loan size, amount and average loan size by authors

Trends in MSME Lending over the years

In this section, we look at the aggregate lending trends available from the RBI data to understand whether PMMY represents a substantial expansion of credit to MSMEs. The trend for number of loans definitely shows an upwards rise since 2015, particularly for the smallest two categories. This seems to indicate some additionality of PMMY.

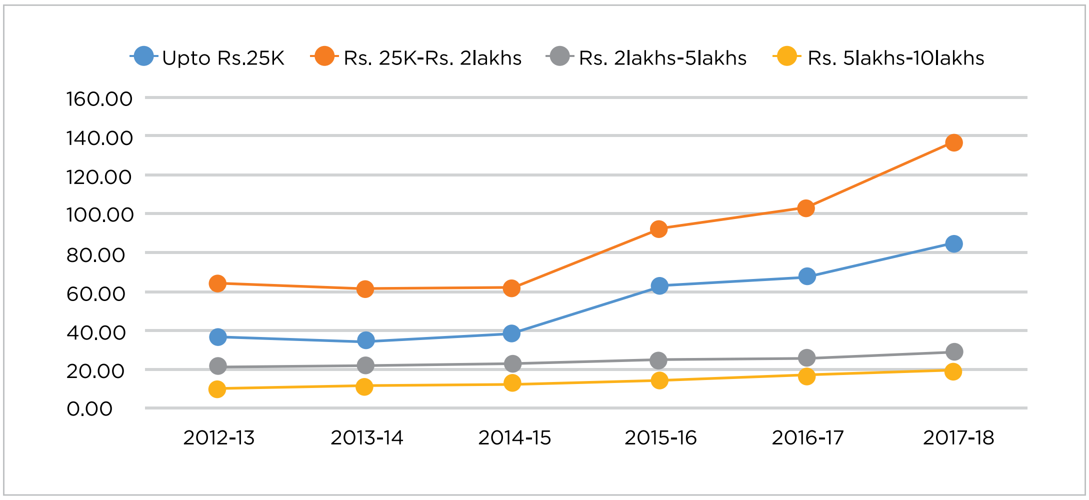


Figure 1: Number of MSME loans in crore upto Rs 10 lakhs by SCBs

But if we study the RBI data on the outstanding credit of SCBs, for loans lower than Rs 10 lakh and made to individuals or firms engaged in Industry, Trading, Transport or Professional Service occupations, the picture is different. This shows that compounded average credit growth was 7.9 per cent in the post-MUDRA 2016-18 three-year period as against 6.6 per cent pa in the pre-Mudra three-year 2013-15 period. That is a very marginal increase, and barely keeps up with inflation. Further it is only slightly above the growth rate of the overall net bank credit of 5.2 per cent in the period 2016-18.

Table 3: Small Loans (PMMY as well as others) given by Commercial Banks: RBI Data[4]					
Year ending 31st Mar	For loans of Rs 25,000 and Less	For loans above Rs 25,000 and up to Rs 2 Lakh	For loans above Rs 2 Lakh and up to Rs 5 Lakh	For loans above Rs 5 Lakh and up to Rs 10 Lakh	Total loan amount in Rs Crore
Amount outstanding in Rs Crore					
2013	73,683	4,41,150	4,29,956	2,40,701	11,85,489
2014	37,166	4,89,525	4,75,832	2,82,642	12,85,166
2015	35,995	5,31,504	5,32,215	3,36,272	14,35,986
2013-15				Pre-PMMY	39,06,641
2016	45,884	5,74,849	5,79,623	3,98,791	15,99,146
2017	41,294	6,17,332	6,31,800	4,71,241	17,61,667
2018	43,984	6,86,322	6,98,796	5,78,719	20,078,21
2016-18				Post-PMMY	53,68,634

The Problems with PMMY Loans

Out of the 17.8 crore loans disbursed till March 2019, 36.3 lakh accounts were in default as on 31 March 2019, which was about two per cent of the loans disbursed under PMMY. This looks fairly healthy. But non-performing PMMY loans saw a jump of 126 per cent in just one year - the NPAs of loans issued under PMMY rose from Rs 7,277 crore in March 2018 to Rs 16,481 crore in March 2019.[5] PMMY loans have raised concerns about becoming the potential source for the next bad loan crisis, along with some other schemes for MSMEs and farmers.

By their very nature, PMMY loans are flawed as financial products as these are structured as term loans with a tenor of three years, with periodic repayments of principal and interest, whereas 90 per cent or more of the amount is used for working capital, which is needed as long as the microenterprise runs. If the loan is repaid, the unit will not have working capital. These loans should have been offered as cash credit overdraft limits. That would also have reduced the interest burden on the borrowers.

To understand this better, let us take a typical Shishu loan, where the average loan size has been Rs 28,000. The microenterprise is likely to be in trading (such as a Kirana shop, or a street vendor), or in repairs (two-wheeler, mobile phones, consumer durables) or in services like tea-shops, ready-to-eat snack shops, tailors, barbers, cobblers, etc. Of the Rs 28,000 loan, the micro- entrepreneur will normally invest a large part, at least Rs 20,000 in working capital to buy supplies of raw material or goods to be sold, paying wages and paying for rent and electricity. Investment in fixed assets, if any, may go into wooden shelves and weighing scale for a Kirana shop; a gas cylinder, cook stove and utensils in case of a tea and snacks shop; and basic equipment and tools in case of a repair shop.

Now, with a PMMY loan, this micro enterprise has to make a periodic (monthly or quarterly) payment of a principal instalment and interest. For a loan of Rs 28,000 repayable monthly over 36 months, that could be as much as Rs 1000 per month. As we know, a vast majority of loans go into trading activities, and if we assume that the sales turnover was four times of the loan amount, it would be Rs 1.12 lakh. Even if assume 15 per cent

margin, on the higher side, the gross income will be Rs 16,800 in the year. The net income from the microenterprise is unlikely to be more than Rs 1400 per month, which means the monthly instalment is 70 per cent of the incremental income, leaving behind a mere Rs 400 per month.

This is bound to be drawn out by the micro-entrepreneur to meet household needs. If in some months due to contingencies such as illness in the family, if the micro-entrepreneur draws out more money, she will end up skipping an instalment. As happens in many cases, there is an adverse event like illness in the family, or a theft in the shop, or a client does not repay goods/services rendered on credit, there is no cushion to maintain the instalment repayment and this leads to the loan becoming a non-performing asset. Catching up on older instalments becomes tougher.

Even if assume that the micro-entrepreneur has other cashflow to meet their personal needs, they will still be able to save only about Rs 400 per month, which in 36 months will add up to Rs 14,400, and is just about half of the loan taken. In the meanwhile, three years have passed and if anything, the working capital requirement would only have increased beyond Rs 28,000. Thus micro-analysis shows why PMMY loans will not work to improve things for most of the micro-entrepreneurs, except temporary relief for the first one or two years.

The Way Forward

Yet, we cannot afford to merely critique the PMMY scheme. A viable alternative is needed. The inevitable conclusion from the above analysis is that PMMY needs to be revamped.

As explained earlier, PMMY loans are prone to default because debt for new enterprises is the wrong financial product. In debt financing, the entrepreneur has to maintain the fixed instalment repayment and this leads to the loan becoming an NPA. Catching up on older instalments becomes tougher. Had the Mudra financing been done using the micro-equity framework, the build-up of NPAs would have been avoided. Currently this is tried to be obviated through credit guarantees from the Credit Guarantee Trust for MSMEs (CGT-MSME).

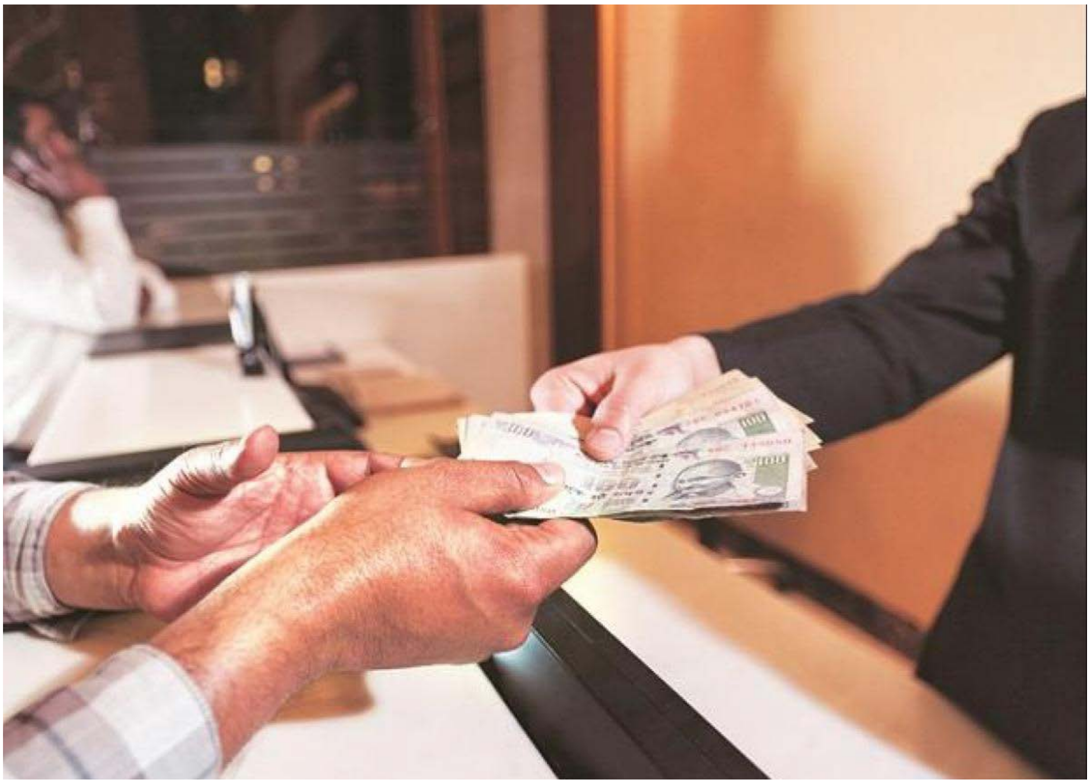
But no guarantee mechanism can sustainably deal with failure rates as high as a 70-80 per cent among new enterprises. Only a micro-equity fund mechanism can handle this. While many enterprises would go under, or would be marginally profitable, returns from the surviving and thriving enterprises would have been enough to offset the investment losses. If necessary, till the instrument gets fully established, a risk cushion may be provided by an entity like the CGT-MSME to the early small investors in micro-equity funds, so that they are assured of at least principal protection. Perhaps the MUDRA Agency can be redesigned and given this role.

An expert committee was established by the Reserve Bank of India early this year under the Chairmanship Shri U.K. Sinha. The RBI announcement said:[6]

> "*Considering the importance of the MSMEs in the Indian economy, it is essential to understand the structural bottlenecks and factors affecting the performance of the MSMEs. It has, therefore, been considered necessary that a comprehensive review is undertaken to identify causes and propose long term solutions, for the economic and financial sustainability of the MSME sector.*"

The expert committee was established soon after the RBI allowed a one- time restructuring of existing debt up to Rs 25 crore for the micro, small and medium enterprises (MSMEs) which have defaulted on payment but the loans given to them have continued to be classified as standard assets. This includes all the PMMY loans. The report of the Committee came out in Jun 2019 and it made several recommendations on financing, which are excerpted below:

> 10. Ministry of MSME may consider setting up of a Non-Profit Special Purpose Vehicle (SPV) to support crowd sourcing of investments by various agencies particularly to pave the way for conducive business ecosystem for MSMEs...
>
> 11. The Committee has made wide ranging recommendations for expanding the role of SIDBI. The Government should deploy the PSL shortfall to SIDBI on the lines of RIDF fund of NABARD, for lending to State Governments as soft loans for infrastructural and cluster development. SIDBI should deepen credit markets for MSMEs in underserved districts and regions by handholding private lenders such as Non-Banking Finance Companies (NBFCs) and Micro Finance Institutions (MFIs). Further, they must develop additional instruments for debt and equity which would help crystallise new sources of funding for MSMEs and MSME lenders such as first loss guarantees, Pass Through Certificates (PTCs), etc. SIDBI should gradually take on the role of a market maker for SME debt on select platforms.
>
> 12. SIDBI, as a nodal agency, should ideally play the role of a facilitator to create platforms wherein various Venture Capital Funds can participate and in turn create multiplier effect for providing equity support to MSMEs. A Government sponsored Fund of Funds (FoF) to support VC/PE firms investing in the MSME sector should be set up to encourage them to invest in the MSME segment...
>
> 14. The Committee recommends for the creation of a Distressed Asset Fund, with a corpus of ₹5000 crore, structured to assist units in clusters where a change in the external environment... has led to a large number of MSMEs becoming NPA...



18. With the increased availability of data from several sources, including GSTN, Income Tax, Credit Bureaus, Fraud Registry, etc., it is now possible to do most of the due diligence online and appraise the MSME loan proposals expeditiously. It is recommended that banks should have access to such surrogate data for speedier and robust credit underwriting standards.

While it will require several years to implement the recommendations of the UK Sinha Committee, here are some recommendations about changes in the design of existing loan products which can be implemented in the short run.

- Below Rs 1.25 lakh (the new RBI limit for microfinance loans), we may continue the present MFI system of giving a composite loan with an equated monthly instalment, following the maxim "don't fix what ain't broke". We can go more digital as suggested in recommendation 18 of the UK Sinha Committee report to undertake due diligence, help build borrower cashflow history, to look for winners who can graduate.
- From Rs 1,25 lakh to Rs 5 lakh, we may continue with loans, but make those into two parts, first a term loan (which NBFCs or banks/SFBs could give) and a second component can be added – a Cash Credit limit which should be given by a co-financing SFB/RRB/UCB/ any other commercial bank. All cashflows must be routed through the cash credit account to keep good track of the business.
- From Rs 5 lakh upwards, we should offer micro-equity for start-ups which are GST registered and are willing to share their input/output data to ensure digital tracking of business input purchases and output sales, plus utility bills, statutory payments etc. The return on the micro-equity can be linked to the revenue share (which can slowly decline as a per cent and eventually taper off once the hurdle IRR of 60-70 per cent pa is achieved. So, there will be no need to monitor profits, which are hard to determine.

Micro-Equity financing is based on the principle that in case of a start-up enterprise, the financier must share the risk if he wants to share the profits. The proportion of risk and return sharing can be negotiated in advance but unlike in a debt instrument, there is no promise of a fixed return to the financier nor are the dates and amount of repayment (interest and principal) instalments pre-fixed. The product should ideally be offered by entities registered with SEBI as Alternative Investment Funds, AIF Category I, with some tweaking on extant provisions. Those details can be worked out by a technical working group.

In the meanwhile, the RBI can guide MFI-NBFCs, NBFCs, SFBs and commercial banks to offer the first two types of loan products. The task is urgent. Millions of MSMEs are waiting for this to happen and if it happens, it will generate a large number of employment.

Endnotes

1 Expert Committee on Micro, Small and Medium Enterprises, Chair Mr UK Sinha, Reserve Bank of India, 2019https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=924

2 Morduch 1995

3 Planning Commission 2013

4 Basic Statistical Returns for Scheduled Commercial banks, RBI for last 6 years

5 Business Today June 25,2019

6 RBI policy Statement December 5, 2018

Published by Rajiv Gandhi Institute for Contemporary Studies, New Delhi.

Design: Ishtihaar.com

Rajiv Gandhi Institute for Contemporary Studies
Jawahar Bhavan
Dr. Rajendra Prasad Road
New Delhi 110 001
India

rgics.org

RAJIV GANDHI
INSTITUTE FOR CONTEMPORARY STUDIES