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# **Financial Inclusion Challenges Faced by Rural Micro Businesses in Cuddalore District of India**

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## **Abstract and rationale**

Small and Micro Enterprises (SMEs) in India are facing many problems such as unable to access to low cost credit from the formal financial institutions, specifically banking and extend their product to the remote markets. Some factors restrict the access to the finance on the input side while others restrict the products and its market outreach on the others side blocks the micro enterprises growth and lead to the rural population to be interlocked in chronic underemployment underdevelopment. With regard to this there are a very few research attempts are only available to test and verify the implication and operations of the Economic theories that highlights these two side issues rationalize how they contribute for the long run credit gap in the rural economy. Particularly the literature on the credit rationing theory on the input side of the financial inclusion policies and the pecking order theory on the demand side of the finance and their inter relationship with other theories like theory of moral hazard, agency theory, and the theory of adverse selection etc. are not documented and tested at the gross root level for which this paper attempted fill this gap.

**Key words:** Challenges of Micro Businesses, Issues of Rural Micro Enterprises, Test of theoretical impact on micro businesses, challenges of rural business Management, Financial inclusion challenges in rural areas.

**JEL Classification:** D21, E32, G53, L22, L98, M30

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## **1. Introduction and the Research Gap**

Financial accessibility is one of the important problems among the business households particularly Small and Micro Enterprises (SMEs) in India. SMEs are not only find difficulty to get financial resources for growing their business and also they are facing various problems to get it from the formal source like banking products for supporting their business. Research found that the lack of knowledge about banking product and services such as credit services made them made them unbendable. (Faiza Hikmah & Tatik Suryani, 2014, Rajasekaran 2018).

The literature and comprehensive study about the cause of difficulties accessing banking institutions in micro-enterprises are also very limited at the regional and sub-regional level makes the issues to survive. The policy importance to these issues has been increase word wide resulting to the existing studies focused on access to financial institution and financial inclusion which mostly cover the community perspective. For example, a study conducted by Fungacova & Well (2015) about financial inclusion in China, a study from Demiguc-Kunt & Kappar (2012) in Africa, and Sinclair (2013) in England on the context of European countries. Therefore, it is important to carry specific research to the community, especially SMEs which play an important role to the economic growth of nation. In this line the government of India has also been implementing various initiatives to increase the extent of financial inclusion in mission mode and nearly achieved by attaining the banking coverage of about 80 percent on an average throughout the country (RBI 2019).

But the output of the financial inclusion initiatives of the government of India is not satisfactory in terms of the micro enterprises performances and their outreach in the market. Most of the micro enterprises surviving in the rural areas are failed to increase their output and meet the vast amount outside market with high potential for profit and grow their business on the one hand and the insights on the quality of financial services delivered to various target groups needed to be documented to at the gross root level the impact of financial inclusion policies on overall financial wellbeing (Reserve Bank of India- Reports, n.d 2024).

This calls for an inquiry into theoretical implications and causes that contribute the existence of the exclusion and the poor out reach of the micro enterprises. There are number of academic and policy documents and literature on the rural micro enterprises and the rural financial inclusion which are aimed to provide a provide comprehensive outlook of these issues and suggest the appropriate polices and the same time a very few research attempts are only available to test and verify the implication and operations of the Economic theories that highlights these two side issues rationalize how they contribute for the long run credit gap in the rural economy. Particularly the literature on the credit rationing theory on the input side of the financial inclusion policies and the pecking order theory on the demand side of the finance and their inter relationship with other theories like theory of moral hazard, agency theory, and the theory of adverse selection etc. are not documented and tested at the gross root level. An attempt is made in this paper to fill this gap in research.

The study will focuses on the causes of difficulty which related to micro-enterprises in accessing financial institutions and explore the economics theories that are operating in the issues of financial inclusion and micro emperies performances. Theoretical Review of Financial Inclusion

## **2. Reviews of literature**

Financial inclusion becomes an important policy in many countries for increasing formal financial services access for low class in developing countries. Financial inclusion is defined as the timely delivery of financial services to disadvantage section in society (Ramdji, 2009). In the simple way, financial inclusion defined as the use of formal account (Allen *et al*, 2012). In the wider context people got difficulty to access from the simplest formal institution product and service such as saving and credit until the complex one such as pensions and insurance. Bruhn & Love (2014) found that some of societies can't access formal financial services. They have many barriers to get access of financing access from formal financial institution.

A comprehensive study that focus on financial inclusion which is

conducted in 148 countries have resulted World Bank Global Index (WBGI) become a reference in many studies about financial inclusion (Deminiguc-Kunt & Klapper, 2012). This research also investigated how people behavior in saving, borrowing, making payment and managing risk. This research should be explored further to investigate why this situation occurred in that country.

In developing countries, a crucial problem for small and medium enterprises is not sufficiency of finance to develop their business. The problem will be overcome by facilitating access for micro enterprises to formal financial institution. By providing technology, opening financial such as banking branch in many areas, and educating about financial institutions and their products and services will reduce the problems.

Study about financial inclusion in Africa revealed that insufficient legal documentation, cost, and the distance from bank influence people to use bank (Deminiguc-Kunt & Klapper, 2012). As the formal financial institution legal documents requirement is very important to open account and use many kinds of product such as credit. Banks have prudential principle for delivering credit for SMEs. The other obstacle is location. Location has correlation with accessibility. In location which is far from urban, the further location the higher cost to access. From marketing perspective, it's about the distribution. Distribution strategy as marketing mix will influence people for buying decision making (Kotler and Armstrong, 2013). Beside legal documentation, location cost also one of barrier factor to open bank account.

Sinclair (2013) conducted research to review the comments of stakeholders on the condition of people in England that had not been in touch with good financial inclusion. In getting loan, people preferred to get from the door-to-door creditor instead of getting one from banks. There are six aspects of getting in a financial inclusion, namely accesses to the banks, credits, insurance, savings, and financial consultancy and of course the understanding of financial literacy. The result of the research was that the minimum level of the credit range determined by the banks was still too much for the customer, while the credit term was very

short. This result led to an implication that there should be credits design for that group of customers. The success of the program due to the main policy of government which were basic bank account offering simple bank transactions such to ATM, debit facility, salary transfer., and the second policy was post office card account (POCA) which was the payment of wealth allowance for people through post office.

Among the various theories documented in the review of literature like the institutional theory, transaction cost theory, adverse selection, moral hazards, agency theory etc, there are two theories that can be interpreted as the pillars of the rural financial sector. First Myers (1984) and Myers & Majluf (1984) built up the packing order theory (POT) in view of the reason that 'inside' the executives are better educated regarding the genuine estimation of the firm than the 'outside' speculators. These data asymmetries bring about shifting expenses of extra outer money, as potential financial specialists see value to be less secure than obligation. They recommend that organizations try to conquer issues of undervaluation emerging from data asymmetries, liking to back venture ventures with inward assets in the primary occurrence. At the point when inner value is depleted, firms use obligation financing before coming about to outside value. Creators express that the POT is significantly progressively pertinent for the SME part in light of the fact that the moderately more prominent data asymmetries and the greater expense of outside value for SMEs (Ibbotson, Sindelar and Ritter, 2001). Also, a typical marvel in the area is the craving of the firm proprietors to hold control of the firm and keep up administrative freedom (Jordan, Lowe & Taylor, 1998).

These components recommend that MSE proprietors source their capital from a hierarchy of, first, their "own" cash (individual reserve funds and held profit); second, momentary borrowings; third, longer term obligation; and, least favored of all, from the presentation of new value financial specialists, which speaks to the greatest interruption. Observational proof backings materialness of the POT in clarifying the money of MSEs ( Haynes, 2006). These examinations accentuate that little firms depend on inner wellsprings of account and outside

obtaining to back activities and development, and just an extremely modest number of firms utilize outer value. Various investigations report that organizations work under an obliged hierarchy, and don't think about rising outside value (Howorth, 2001).

Adherence to the POT is reliant on request side inclinations, yet in addition on the accessibility of the favored wellspring of financing. The inventory of money relies upon numerous variables, especially the phase of improvement of the firm. The most significant wellspring of subsidizing for fire up and incipient firms are the individual assets of the firm proprietor, and financing from loved ones. Howorth (2001) examined the hierarchy, in spite of the fact that the hypothesis rose in other writing: business visionaries will in general look for money first from their own assets, and afterward loved ones, and afterward from different sources, for example, banks. Without a doubt, the cash from loved ones is frequently basic (and regularly viewed as semi value by the banks) to open help from business organizations.

Second the one of the most significant hypotheses that concentrated on the financial gap of the rural enterprises is the Credit Rationing Theory by Stiglitz & Weiss (1981). In their detailing, Stiglitz and Weiss (1981) contended that agency problem (as an irreconcilable situation of conflict between the executives (agents) and the investors (owners) of the association) and data asymmetries are the significant motivation behind why SMEs have compelled access to fund. They contended that just SMEs know their genuine money related structure, the genuine quality of the speculation venture and the compelling goal to reimburse the obligation, that is, firms have unrivaled private data ( Consequently, the bank supervisor settles on choices under wrong data, and works under towards the moral hazard.

Stiglitz and Weiss (1981) clarified the decision among various financing sources under states of unbalanced data and credit rationing. Uneven data can prompt credit apportioning conditions by altering the hazard return appropriation; this reality urges banks to decline capital for speculations and

produces dissimilarity between capital interest and supply (Alfo & Trovato, 2006). Compelled access to fund got from budgetary foundations' credit proportioning conduct probably won't be productive in light of the fact that administrators work under states of lopsided data. This may bring about less productive speculations getting financed while increasingly beneficial ventures are as a rule forgot about and subsequently bringing about unfavorable determination and good danger dangers. Consequently, lopsided data can clarify unbalanced of acknowledge among firms for indistinguishable qualities, the loan specialists not monitoring the specific chapter 11 probability for the organizations, know just that this probability is sure and thusly decide to expand obligations' expense.

The above discussion on the theoretical review of literature clarifies and demands an attempt to validate the theoretical implications and improve the validity of the economics theories at the gross root level. This research is an attempt to fill this gap in research.

### **Small and Micro Enterprises (SMEs) in India**

SMEs have been showing very crucial roles in supporting the economic development of India. They have been strengthening India employment that help increase the rate of national unemployment, improve productivity, and improve economy of informal sectors.

According the ministry of MSMEs the enterprises were classified into three categories. On the basis of the turnover of the micro enterprises it is classified as micro enterprises when their annual turnover limited up to 5 cores. In the same way the enterprises with the 5 cores to 75 cores are classifies as the medium enterprises while the same can be classified as large enterprises when its turn over accounted between the 75 cores to 250 cores of rupee which covers all the investment on machines and equipments.

Most of India's SMEs are those of small ones with low competence and less developed due to the limited access to financial institutions especially banks. The second level of the middle level enterprise take about 1.12% only, but have aver strong potential and are able to support the economic development as long as



they are well developed.

The Reserve Bank of India in 2015 carried a study showing that the most difficult problem faced by SMEs was that they found difficulties in accessing banking service of getting loans and operating at the sub optimal level production which only meet the local demand while there is a vast scope for the market at the national and international levels. This is due to the lack of knowledge on banking funding and credit services of the banks including the requirements of credits, lack of competence in managing business especially the financial aspect which is considered less professional. In order to trace the causes of such gap in financing the rural micro enterprises the following hypotheses are derived from the theories

According to the reserve bank of India report titled on national strategy on financial inclusions ( NSFI-2019-2024), and the various DFS annual reports of the ministry of financial services, journey map report of the India prepared by the USAID 2019,the critical appraisal of the financial inclusion and digital India by EPW research foundation Engage there are various theories are shortlisted to identify the theoretical impact on the process of financial inclusion. These includes, the theory of limited liability, theory of contract, principal agent theory, transaction cost theory, theories on marginal utility of money, decision making theories under risk and uncertainties and the theories of credit rations and their relationship with the moral hazards and adverse selections.

### **3. Hypothesis**

On the basis of the theories highlighted in the above section the following testable hypothesis are framed to guide the research.

**H1:** Micro enterprises in rural areas invest their money in the order of a package such that from their own personnel saving as first option to the long term debt preference as the last preferences which make them to interlock them to target meeting the local market alone.

**H 2:** The prime cause of financing gap in the rural areas for the tiny businesses is due to credit rationing raised by adverse selection and moral hazard.

## 4. Research Methodology

### 4.1. Sampling Method: Multistage Sampling.

In the first stage of the survey block wise rural areas are identified. Based on the secondary data collected from the commissionaire of the District Industrial Centre, Cuddalore and the data downloaded from the website of the National Rural livelihood Mission, State level Bankers Committee of the Tamilnadu the village Panchayath with highest number of SHGs are identified. At the second stage, on the basis of equal proportionate random sampling principle 10 percentage of the sample SHGs in each panchayath selected to a total 96 SHGs. In order to cover all types of the micro enterprises in functioning in the rural areas of the Cuddalore district the researchers has used the convenient sampling as the third stage. At the rate of two rural entrepreneurs per SHGs about **192** micro entrepreneurs (**96 SHGs X 2 =192**) were selected and interviewed.

### 4.2. Statistical Method:

Common statistical methods such as average and percentages were employed to highlight the socio economics characteristics while the multiple liner regression is used for the analysis and testing the hypothesis.

## 5. Major Findings: Socio Economics Characteristics

**Table 5.1. Socio Economics Characteristics: Gender**

#	Micro Enterprise Activity	Male	Female	Total
1.	Agarbathi Making	9	5	14
2.	Appalam Making	5	7	12
3.	Basket	19	1	20
4.	Blacksmith	0	2	2
5.	Biscuit/Cakes	1	8	9
6.	Candle	2	5	7
7.	Cashunut process	3	7	10
8.	Confectionary	7	6	13
9.	Country brick	11	4	15
10.	Hand Made Murukku	5	3	8
11.	Jaggary Making	3	0	3
12.	Laundry/Cleaning	5	7	12
13.	Nursery	9	3	12
14.	Pickle Mixer	7	4	11

<b>15.</b>	Pottery/Mud	5	6	11
<b>16.</b>	Tailoring	15	6	21
<b>17.</b>	Woodturning	10	2	12
<b>18.</b>	<b>Total</b>	<b>116</b>	<b>76</b>	<b>192</b>

**Source: Computed from primary data**

The above table shows that the interview respondents gender wise classification. It reveals that the overall male female participation in the taking up a micro enterprise activity is relatively higher among the male respondents over the female. The activities such as basket making and marketing it, country brick making, tailoring, and wood turning, nursery and agarbathi making are the most familiar activities that the male respondents are engaging in the district. In the same way Appalam making, pottery, loundary, cashunut processing and confectionary, biscuit and cake production are the familiar rural micro enterprises are functioning.

**Table 5.2. Socio Economics Characteristics: Family Type**

#	Micro Enterprise Activity	Nuclear	Joint	Total
<b>1.</b>	Agarbathi Making	3	11	14
<b>2.</b>	Appalam Making	5	7	12
<b>3.</b>	Basket	15	5	20
<b>4.</b>	Blacksmith	1	1	2
<b>5.</b>	Biscuit/Cakes	6	3	9
<b>6.</b>	Candle	2	5	7
<b>7.</b>	Cashunut process	7	3	10
<b>8.</b>	Confectionary	6	7	13
<b>9.</b>	Country brick	2	13	15
<b>10.</b>	Hand Made Murukku	3	5	8
<b>11.</b>	Jaggary Making	1	2	3
<b>12.</b>	Laundry/Cleaning	9	3	12
<b>13.</b>	Nursery	5	7	12
<b>14.</b>	Pickle Mixer	9	2	11
<b>15.</b>	Pottery/Mud	6	5	11
<b>16.</b>	Tailoring	12	9	21
<b>17.</b>	Woodturning	3	9	12
<b>18.</b>	<b>Total</b>	<b>95</b>	<b>97</b>	<b>192</b>

**Source: Computed from primary data**

The above table represents about the family type distribution of the surveyed respondents. It can be concluded from the table above that the number of (49

percent) of joint family is just near to the equivalents of the number (51 percent) of nuclear family which highlights that the traditional joint family systems is losing its importance among the recent modern families due to the financial issues of managing the large family with one or two earning members in the households.

**Table 5.3. Socio Economics Characteristics: Caste**

#	Micro Enterprise Activity	SC	OBC	Others	Total
1.	Agarbathi Making	8	6	0	14
2.	Appalam Making	8	4	0	12
3.	Basket	6	12	2	20
4.	Blacksmith	2	0	0	2
5.	Biscuit/Cakes	7	2	0	9
6.	Candle	6	1	0	7
7.	Cashnut process	1	9	0	10
8.	Confectionary	8	5	0	13
9.	Country brick	6	9	0	15
10.	Hand Made Murukku	5	3	0	8
11.	Jaggery Making	2	1	0	3
12.	Laundry/Cleaning	8	4	0	12
13.	Nursery	6	6	0	12
14.	Pickle Mixer	8	3	0	11
15.	Pottery/Mud	7	4	0	11
16.	Tailoring	12	9	0	21
17.	Woodturning	10	2	0	12
18.	<b>Total</b>	<b>110</b>	<b>80</b>	<b>2</b>	<b>192</b>

**Source: Computed from primary data**

This table titled Socio Economics Characteristics of the surveyed respondents with respect to the caste reveals that the about 110(57 percent) of the respondents belongs to the SC category while the 80(41 percent) of the respondents belongs to the OBC category and the remaining the 2 percent of the respondents belongs to the others caste category. This proves the NNSO data that the Cuddalore district is predominantly occupied by SC community.

## **6. Test of the Hypothesis:**

For the purpose of the analysis the hypothesis were redefined from the earlier theoretical form to the testable variable form as follows.

### **Hypothesis 1:**

The Regression Model for the modified testable hypothesis is the rural micro entrepreneur's decision to go outside the local areas to cover the market is determined by the choice of the investment and the source of initial investment.

Regression Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.727 <sup>a</sup>	.528	.526	.360
2	.765 <sup>b</sup>	.585	.580	.339
a. Predictors: (Constant), Initial Investment				
b. Predictors: (Constant), Initial Investment, Choice to the Emergency Investment Needs				

The above table shows that how far the model fit the data. It can be understood by comparing the value of R Square and adjusted R square values. Since both these values are higher than 0.05 the regression model gives a good prediction of the dependent variable by the predictor variables. The model used for this regression is as follows.

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2$$

Y= Dependent variable (Decision to expand and cover the external market)

X=Predictors are choice of the investment such as from personal saving at first and looking for the informal sources as the second and searching the formal source only for long term financial needs.

ANOVA						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	27.422	1	27.422	211.779	.000 <sup>b</sup>
	Residual	24.473	189	.129		
	Total	51.895	190			
2	Regression	30.349	2	15.175	132.404	.000 <sup>c</sup>
	Residual	21.546	188	.115		
	Total	51.895	190			
a. Dependent Variable: Ready go for covering the outside market						
b. Predictors: (Constant), Initial Investment						

c. Predictors: (Constant), Initial Investment, Choice to the emergency Investment Needs

### Model Co Efficient

Model		Unstandardized Coefficients		Standardized Coefficients	t
		B	Std. Error	Beta	
1	(Constant)	.883	.032		27.848
	Initial Investment	9.062E-6	.000	.727	14.553
2	(Constant)	.710	.045		15.626
	Initial Investment	6.862E-6	.000	.550	9.401
	Choice to the Emergency Investments Needs	.225	.045	.296	5.053

### Decision rule and the result of the test of hypothesis H1

The regression result shows that the calculated p value is 0.883 which lesser than the table value 27.84 at 1 percent significant level. Since the calculated value is lesser than the table value the hypothesis is accepted and indicated that all the independent variables have strong influence on dependent variables at 1 percent significance. It means that the rural micro entrepreneur's decision to go outside the local areas to cover the market is determined by the choice of the investment and the source of initial investment can be accepted.

### Test of hypothesis H2

The Modified testable hypothesis is the prime reason for the credit gap lending to micro enterprises of the in the rural area is credit rationing due to the adverse

selection and moral hazards. To test this researcher has divided **it into two parts**. In the first part of the test the relationship among the peer cooperation and the whether the loan was used for the same purpose or not and their impact on the credit rationing variable highlighted by the question Bank ever refused to offer a credit?

#### **Test: 1. Test of Hypothesis-H2- Using Correlation Analysis:**

Correlations are the relationship between two or more variables which can be used as a method to identify the linkage of one variable over the others. It also explains the nature of relationship. The complete positive relationship can be said to be exist if the value is positive and vise versa.

<b>Correlations</b>				
		Banks ever refused	Peer co Operation	Used for same Purpose
Banks ever refused	Pearson Correlation	1	-1.000**	-1.000**
	Sig. (2-tailed)		.000	.000
	N	192	192	192
Peer co operation	Pearson Correlation	-1.000**	1	1.000**
	Sig. (2-tailed)	.000		.000
	N	192	192	192
Used for same Purpose	Pearson Correlation	<b>-1.000**</b>	1.000**	1
	Sig. (2-tailed)	.000	.000	
	N	192	192	192
**. Correlation is significant at the 0.01 level (2-tailed).				

It is noted in the above multiple correlation analysis that the inverse relationship between the loans used for the same purpose and that of the bank refuse to offer a new credit. It means that banks will limit and stop to issue the credit if they found that it is not utilised in any other unproductive manner. So the second hypothesis can be accepted that the prime reason for the credit gap lending to micro enterprises of the in the rural area is credit rationing due to the adverse selection and moral hazards.

#### **Test of Hypothesis-H2- Using Analysis Simple Linear Regression**

The analysis of relationship between the entrepreneur's readiness to go to international markets and the banks refuse it to finance.

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.079 <sup>a</sup>	.006	.001	.521
a. Predictors: (Constant), banks ever refused				

ANOVA						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.321	1	.321	1.183	.278 <sup>b</sup>
	Residual	51.596	190	.272		
	Total	51.917	191			
a. Dependent Variable: are you Ready to go for outside Marketing						
b. Predictors: (Constant), Banks ever refused						

Coefficients								
The Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95.0% Confidence Interval for B	
		B	Std. Error	Beta			Lower Bound	Upper Bound
1	(Constant)	1.157	.039		29.630	.000	1.080	1.234
	Banks ever refused	-.157	.145	-.079	-1.088	.278	-.443	.128
a. Dependent Variable: are you ready to go for outside Marketing								

### Result of the test 2 of H2:

The regression result shows that the calculated p value is 1.157 which is lesser than the table value 29.630 at 1 percent significant level. Since the calculated value is lesser than the table value the hypothesis can be accepted. It means that the financing gap in the rural areas for the tiny businesses is due to credit rationing raised by adverse selection and moral hazard.



## **Conclusions and Policy Suggestions**

By taking both of this hypothesis above it can reached and concluded that the influence of the decision making theories such as the packing order theory on the demand side of the credit and the credit rationing theories on the supply side determines the credit gap of providing the financial inclusion among the rural areas of the Cuddalore district. Even in the presence of group lending practices inbuilt with the micro credit programmers the financial secrecy and independency followed by the rural micro enterprises stop the users to reap the benefit of group lending and peer monitoring practices adopted. On the other hand the credit culture of the micro enterprises in the rural areas of the district is determined fully by the pecking order theory which becomes a strong institution among the poor. These institutions barriers also have to rectify to clear the financing gap to the poor.

Keeping this impact the government should restructure the policies in such a way that can bypass the influence of these theories and support the rural micro enterprises and their market outreach to the vast areas of the demand where ever it is available. Provisions of the awareness programmers and skill empowerment programs at the door steps without sacrificing the micro entrepreneurs revenue and creating the cultural shift among the rural enterprises towards the scope of their business in future and is sustainability, providing full-fledged, subsidized marketing assistance to the micro enterprises to market their products in the national and international market can only be the best plan of action that can work to rectify these invisible theoretical impacts in the rural Economy. For these regional specific, micro enterprises specific innovative policies are too identified and implemented after testing the effectiveness on pilot basis and the existing policies are to be revised accordingly.

The global market potentials of the micro enterprises are to be identified and the necessary support marketing subsidies to be offered so that the micro enterprises can meet the demands of global markets and can grow as the multinational and profitable, sustainable businesses and can boost the economic growth.

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