

The Landscape of MSME Finance in India: A Study of Funding Sources and Existing Barriers



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Abstract

Access to finance for Micro, Small and Medium Enterprises (MSMEs) continues to be an obstacle in India, impacting their growth and sustainability. This study examines the landscape of MSME financing, focusing on the various funding sources available and the key barriers entrepreneurs face at different stages of their business life cycle. The findings reveal that MSMEs predominantly rely on informal sources, such as personal and family wealth, rather than formal institutions like banks. The major obstacles to accessing formal finance include inadequate collateral and limited financial literacy among entrepreneurs. The study aims to fill a gap in existing literature by analyzing the financial needs of MSMEs at various stages of their life cycle, specifically investigating the sources of finance utilized and the challenges encountered in accessing these funds.

1. Introduction

Micro, Small, and Medium Enterprises (MSMEs) play a vital role in economic development especially in emerging economies. These enterprises have recently attracted significant focus in India, considering their strategic importance to the economy and the nation. MSMEs are often considered as the nucleus of national economies, significantly contributing to employment generation, innovation and GDP growth. MSMEs play a crucial role in employment generation- 4.68 crore Udyam registered MSMEs provide employment to a total of 20.19 crore people. According to a report by the Press Information Bureau (PIB), "The MSME sector in India has consistently demonstrated remarkable resilience and adaptability, significantly contributing to the nation's GDP over the years. The Gross Value Added (GVA) by MSMEs in India's GDP was 29.7% in 2017-18, rising to 30.1% in both 2022-23. Even amid the unprecedented challenges posed by the COVID-19 pandemic, the sector sustained a contribution of 27.3% in 2020-21, rebounding to 29.6% in 2021-22. These figures highlight the sector's pivotal role in driving economic growth and stability, reflecting its enduring strength and importance to the Indian economy".

Micro, Small and Medium Enterprises Development (MSMED) Act, 2006

1.1 In terms of Gazette Notification S.O. 1364 (E) dated March 21, 2025 w.e.f. April 01, 2025, an enterprise shall be classified as a micro, small or medium enterprise on the basis of the following criteria viz.,

a micro enterprise	where the investment in plant and machinery or equipment does not exceed ₹2.5 crore and turnover does not exceed ₹10 crore.
a small enterprise	where the investment in plant and machinery or equipment does not exceed ₹25 crore and turnover does not exceed ₹100 crore.
a medium enterprise	where the investment in plant and machinery or equipment does not exceed ₹125 crore and turnover does not exceed ₹500 crore.

2.2 All the above enterprises are required to register online on the Udyam Registration portal and obtain 'Udyam Registration Certificate'.

Despite their contribution, MSMEs in India face numerous challenges. In addition to dealing with high borrowing costs, they often struggle to keep pace with the rapidly evolving technologies and are at the risk of becoming technologically obsolete. Furthermore, studies on MSMEs have highlighted that the ease of access to financial resources and their availability are among the most critical factors for fostering the growth of MSMEs in developing nations. A key issue is the lack of awareness among MSME entrepreneurs regarding available funding schemes. Additionally, the role of alternative financial resources available to MSMEs, such as Venture Capitalists, Angel Investors, Initial Public Offering (IPOs) non-banking financial companies (NBFCs), foreign banks, remains limited in supporting MSME financing. These factors collectively contribute to financial constraints faced by MSMEs, obstructing their growth and development.

The Reserve Bank of India (RBI) has designated micro, small and medium enterprises in the list of priority lending sectors. The Reserve Bank of India has, from time to time, issued a number of instructions / guidelines to banks relating to lending to the Micro, Small and Medium Enterprises Sector. In terms of the recommendations of Prime Minister's Task Force on MSMEs, "banks are advised to achieve (i) 20 per cent year-on-year growth in credit to micro and small enterprises, (ii) 10 per cent annual growth in the number of micro enterprise accounts and (iii) 60 per cent of total lending to MSE sector as of the corresponding quarter of the previous year to micro enterprises".

The research objectives are two-fold: (i) to determine the various sources of finance and their intended uses at various phases of the MSME life cycle and (ii) to determine the obstacles MSMEs encounter while accessing finance from various sources at different stages of their life cycle.

2. Literature Review

The literature on Micro, Small and Medium Enterprises (MSMEs) shows how important they are in shaping the economy, especially in developing countries like India. Many studies point out that MSMEs are not only a source of employment but also play a big role in supporting local industries and encouraging entrepreneurship. At the same time, the literature also reflects the common struggles these enterprises face, such as lack of access to credit, difficulties in adopting new technology, and the burden of regulatory requirements. By looking at different research works, one can clearly see both the strengths and the vulnerabilities of this sector. A review of existing studies helps in connecting these insights, showing what has already been explored and where more attention is still needed to understand the real challenges and opportunities for MSMEs.

Press Information Bureau (2024), the report titled "Transforming India's Economic Landscape" highlights the central role of MSMEs in shaping India's industrial base. It notes that MSMEs contribute nearly 30 percent to the national GDP and employ more than 20 crore individuals. Despite these achievements, the report stresses

persistent barriers in accessing affordable finance, with entrepreneurs continuing to depend heavily on personal and family resources.

Reserve Bank of India (2024), "Master Directions on Lending to Micro, Small & Medium Enterprises", updated guidelines mandate banks to expand credit to MSMEs through priority sector lending. While the policy framework is robust, the RBI acknowledges the challenges of low awareness, documentation barriers, and collateral requirements that limit actual disbursements. The document highlights the gap between policy intent and effective implementation.

Singh (2022), the work explores enterprises in the sustenance stage. The study reveals that even mature MSMEs encounter persistent difficulties such as high interest rates, lack of awareness of schemes, and bureaucratic hurdles. Singh in his doctoral thesis titled "Financing Challenges of Sustenance-Stage MSMEs" concludes that financing challenges are systemic and extend across all stages of the business cycle.

Sharma (2021), examines institutional rigidities affecting MSMEs' access to finance. The findings suggest that financial exclusion is not caused by scarcity of funds but by rigid documentation processes, lengthy procedures, and risk-averse lending practices. The thesis titled "Institutional Barriers in MSME Financing in India". Sharma calls for simplifying loan systems to enhance accessibility.

Reddy (2021), Reddy's work investigates the limited role of venture capital and angel investors in India. The thesis "Venture Capital and MSME Financing in India" finds that cultural dependence on family funds and regulatory constraints prevent MSMEs from accessing alternative financing. The study emphasizes the need to diversify credit channels beyond traditional banking.

Das and Chatterjee (2020), the empirical paper titled "Role of NBFCs in Strengthening MSME Financing in India" highlights the growing importance of Non-Banking Financial Companies (NBFCs) in bridging credit gaps. The authors find NBFCs more flexible in lending terms compared to banks, but argue that their outreach and integration into MSME financing remain insufficient.

Chaudhary (2020), studies the impact of crises, particularly COVID-19, on MSMEs. The dissertation reveals that MSMEs showed remarkable resilience, sustaining GDP contributions above 27 percent during the downturn. Nevertheless, the dissertation titled "Resilience of MSMEs During Economic Shocks". Chaudhary concluded access to finance remained restricted due to strict collateral requirements and lack of awareness of relief schemes.

Patel (2018), applies the financial growth cycle model to the Indian context, finding that MSMEs in Gujarat rely heavily on personal savings and family resources, even at advanced growth stages in his doctoral thesis titled "Life Cycle Financing Patterns of MSMEs in Gujarat". This dependence is attributed to low trust in financial institutions and procedural inefficiencies in banks.

Khan (2017), evaluates the implementation of RBI's priority sector lending norms. The study titled "Effectiveness of Priority Sector Lending for MSMEs in India" concludes that while banks formally comply with regulatory targets, many MSMEs remain unaware of available schemes, resulting in underutilization of credit facilities.

Verma and Goyal (2019), "Policy Gaps in MSME Financing," Journal of Rural Development. The authors analyze MSME financing policies and highlight weak dissemination at the grassroots level. They argue that lack of awareness campaigns and bureaucratic barriers prevent many small businesses from benefiting from existing schemes.

Kumar (2019), Doctoral Thesis, Jawaharlal Nehru University – "Role of MSMEs in India's Economic Development". Kumar's thesis demonstrates that MSMEs contribute 30 percent to India's GDP and nearly 40 percent to exports. However, he concludes that financial exclusion remains the most serious barrier to growth, with entrepreneurs depending largely on informal sources of funding.

Berger and Udell (1998), "The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle". This seminal paper introduces the financial growth cycle model, showing how small firms transition from reliance on internal and informal sources at the start-up stage to formal credit as they grow. The framework remains highly relevant to Indian MSMEs, which often remain locked in early-cycle financing patterns.

Stiglitz and Weiss (1981), "Credit Rationing in Markets with Imperfect Information". This classical paper provides the theoretical foundation for understanding financing constraints. The authors argue that asymmetric information compels banks to ration credit by demanding collateral or denying loans to smaller enterprises. This theory is directly applicable to the MSME sector in India, where entrepreneurs lack collateral and adequate financial histories.

3. Scientific Background and Insights

The financing of Micro, Small and Medium Enterprises (MSMEs) has been a central concern in development economics and financial research for decades. The significance of MSMEs lies not only in their ability to contribute to GDP but also in their role as engines of inclusive growth, employment generation, and technological innovation in emerging economies. In the Indian context, MSMEs account for nearly one-third of national output and employ more than 20 crore individuals, which situates them as both economic stabilizers and

social equalizers. Despite this, the persistent financing gap underscores a structural disconnect between policy initiatives and the financial realities faced by entrepreneurs at the grassroots level.

From a theoretical standpoint, the financing challenges of MSMEs can be linked to asymmetric information theory and credit rationing models (Stiglitz & Weiss, 1981). Banks and formal institutions are often reluctant to extend loans to smaller firms due to limited credit histories, absence of collateral, and perceived higher risk. This forces enterprises to depend on informal financing sources, despite their inefficiency and high interest costs. In India, this phenomenon is exacerbated by low levels of financial literacy, a fragmented credit infrastructure, and the dominance of family-based entrepreneurial ecosystems.

The life cycle approach employed in this study provides a structured lens through which financing patterns can be analyzed. Enterprises at different stages—start-up, survival, growth, and sustenance—display distinct financial behaviors and vulnerabilities. For instance, early-stage firms typically rely on personal savings and family networks, whereas growth-stage firms attempt to integrate into formal banking systems, only to encounter obstacles such as stringent collateral requirements and high borrowing costs. This transition reflects not just the financial evolution of firms, but also the institutional inadequacies in catering to their dynamic needs.

Insights from this study reveal that while policy frameworks such as the MSMED Act, 2006 and RBI's priority sector lending directives are theoretically robust, their practical effectiveness remains limited. Entrepreneurs either lack awareness of these schemes or find procedural complexities insurmountable. The gap between policy design and policy uptake emerges as a central theme in the study, pointing to the need for enhanced financial literacy, simplified compliance processes, and greater outreach mechanisms.

Another key insight is the underutilization of alternative financing channels in the MSME sector. Globally, mechanisms such as venture capital, angel investing, crowdfunding, and non-banking financial companies (NBFCs) have significantly contributed to entrepreneurial ecosystems. In India, however, their penetration into the MSME sector remains marginal. This indicates both a market failure in diversifying credit supply and a research gap in understanding the scalability of such alternatives for smaller enterprises.

Finally, the findings also resonate with broader debates in development finance regarding the balance between credit expansion and financial sustainability. While indiscriminate lending can endanger financial stability, excessive risk aversion leads to credit exclusion, particularly for MSMEs. The challenge, therefore, lies in creating a financially inclusive ecosystem that simultaneously safeguards institutional stability and promotes entrepreneurial dynamism.

In conclusion, this study advances the scientific understanding of MSME finance by highlighting the intersection of enterprise life cycle, financing behavior, and institutional barriers. The insights underscore the urgency of shifting from policy announcements to practical, accessible financial instruments that can empower MSMEs to realize their full economic and social potential.

4. Research Methodology

4.1 Techniques and Methods Used

The present study adopts a qualitative and descriptive research design to investigate the financial landscape of Micro, Small, and Medium Enterprises (MSMEs) in India. Since the focus is on understanding funding sources and barriers rather than testing a hypothesis through primary data, the methodology is rooted in secondary data analysis and documentary review.

4.2 Sources of Data: Secondary Data

Official reports and press releases from the Press Information Bureau (PIB) highlighting the contribution of MSMEs to India's GDP.

Regulatory guidelines from the Reserve Bank of India (RBI) regarding MSME lending norms and priority sector lending requirements.

Policy frameworks and schemes introduced by the Ministry of MSME, particularly the Udyam registration framework and strategic action plans.

Academic and policy-oriented literature examining challenges of MSME financing in emerging economies.

4.3 Thematic and Stage-Wise Analysis

The study systematically classifies MSME financing needs and challenges according to their life cycle stages—start-up, survival, growth, and sustenance. This stage-wise analysis enables the identification of distinct financial patterns and barriers encountered at each phase.

4.4 Regulatory and Policy Analysis

Special emphasis is placed on the MSMED Act, 2006 and subsequent amendments, which define MSMEs by investment and turnover criteria. The study also reviews RBI's Master Directions on lending to MSMEs, which guide banks in terms of credit expansion targets and support mechanisms.

Thus, the methods combine policy review, secondary data interpretation, and comparative analysis, ensuring a comprehensive understanding of both financing sources and barriers.

5. Sources of Finance and Challenges in Accessibility

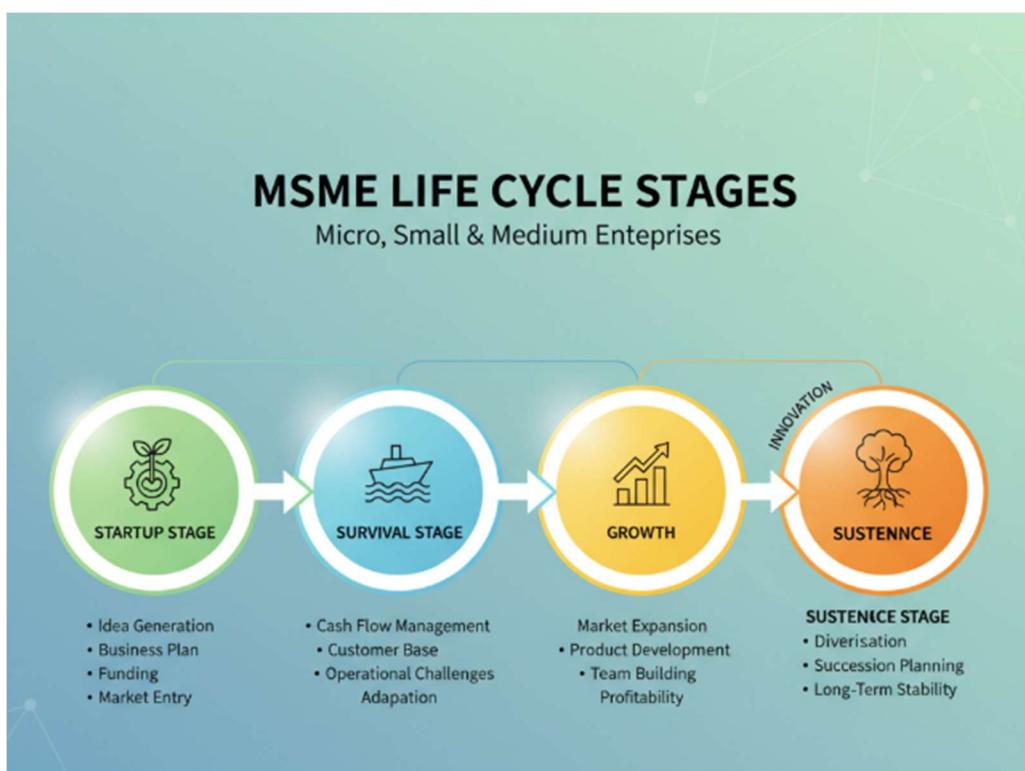


Fig.1 Stages of MSME Life-Cycle Source: Compiled by Author

5.1 Finance Used by MSMEs in Different Stages of the Life Cycle

Start-Up Stage: Enterprises at this stage usually obtain finances from their personal and familial sources, friends, acquaintances and public (i.e., government-owned) banks majorly for working capital requirements. Another widely utilized institutional source of financing is public sector banks, specifically for collateral financing.

Survival Stage: Enterprises seek financial assistance in the survival stage primarily for the purpose of working capital requirements, overdrafts, short-term loans. Funding for working capital was primarily obtained from public banks and reputable money-lenders, complemented by personal investments and distinguished private banks. These private banks are also utilized to secure short-term loans and overdraft facilities. Enterprises also obtain financing through moneylenders, albeit to a more limited extent. Enterprises at this stage seek to pay off their debts, necessitating seamless daily operations with adequate availability of working capital to achieve the same.

Growth Stage: Enterprises at this stage require working capital, short-term loans and finance for collateral. Short term finance for working capital is primarily sourced from esteemed public banks, personal and familial sources and to a lesser degree from private and cooperative banking institutions. Collateral financing is usually secured from public banks with additional support from select cooperative banks. Private and cooperative banks were utilized for securing short-term loans, indicating that enterprises prioritized their specific financial needs and sought appropriate funding sources. The prevalent use of public banks for collateral financing, along with reliance on the banking system and family wealth for working capital, highlights the role of trust in financial decision-making.

Sustenance Stage: At this stage enterprises secure finance from personal sources, cooperative financial institutions, public banks and private banks primarily to meet their working capital requirements. Cooperative Banks also serve as a source for collateral financing and short-term loans. The demand for working capital, collateral financing, and short-term loans remains predominant among enterprises at this stage.

5.2 Challenges in Accessing MSME Finance

Despite the sector's considerable importance, MSME financing in the nation remains a substantial concern. The industry has stumbling blocks such as a lack of funding history, unsatisfactory collateral, a lack of expertise regarding government programs, and outrageous interest rates. These issues have made it difficult for MSMEs to

obtain financial circles, limiting the sector's growth and development. MSME has obstructions at various junctures, which are addressed in the sections that follow.

Start-up Stage: Major obstacles in obtaining finance at this stage includes challenges in offering collateral or a guarantee, lengthy processing periods for loan applications, insufficient awareness of available programs, and complexities in procedures. Enterprises also face high service fees for loan requests and difficulty in completing required documentation were challenges. Enterprises in the start-up stage may not be able to offer collateral for a loan and MSMEs often do not have access to information about these schemes, which may hinder them from selecting the most effective option for financial assistance.

Survival Stage: The major challenges encountered by enterprises at this stage are corresponding to those experienced by enterprises in the start-up phase, albeit in a different sequence. The challenges associated with offering collateral or a guarantee, together with administrative complexities, received the highest ratings. The four issues of prolonged processing time, insufficient awareness of available programs, high service fee for processing loan requests, complications in fulfilling the necessary documentation were seen as equally problematic.

Growth Stage: Enterprises in this stage learn significant adversity, ranging from barely enough knowledge of available schemes, higher service fees for loan processing, difficulty in provision of collateral or guarantee, high interest rates, and complications in completing necessary documentation. A lack of knowledge regarding specific schemes could hinder owners from making the most appropriate choice of financing for their enterprise. Enterprises in the growth stage are also in a state of rapid transition and therefore the need to provide documentation for securing financial assistance would be a barrier to accessing funds.

Sustenance stage: Common challenges to access finance reported by enterprises in this stage included difficulty in provision of collateral or a guarantee, procedural complications, lack of knowledge about available schemes, lengthy processing time for loan applications, high service fees for processing loan requests, and difficulty in completing required documentation. High interest rates is also a significant barrier, which often deterred MSMEs from pursuing necessary funding.

In its entirety, MSMEs confront multiple obstructions at each stage of their life cycle.

6. Conclusion

Micro, Small and Medium Enterprises (MSMEs) play crucial role in economic growth, employment generation, particularly in developing nations like India. In spite of their significant contribution MSMEs continue to face considerable challenges, especially when it comes to securing financial resources. Throughout their life cycle—from start-up to sustenance—these enterprises depend on an array of financial sources, including personal savings, banks, and moneylenders. Nevertheless, challenges such as elevated borrowing expenses, insufficient collateral, protracted loan processing times, and a lack of awareness regarding funding opportunities impede their growth and long-term viability.

While initiatives by the Reserve Bank of India (RBI) and other financial institutions aim to enhance MSME financing, there remains a gap in accessibility and awareness of available financial resources. Enhancing financial literacy, streamlining loan application procedures, and broadening access to alternative funding avenues like venture capital and non-banking financial companies (NBFCs) could greatly elevate MSME financing. Addressing these challenges will be crucial in unlocking the full potential of MSMEs, ensuring their continued contribution to economic advancement and national prosperity.

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Conflict of Interest

The author declares that there is no conflict of interest regarding the publication of this research work and that there are no known financial or non-financial conflicts of interest that could have appeared to influence the work reported in this manuscript.

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