Inclusive Finance and Small and Medium-Sized Enterprises Financing Constraints-Practical Challenges, Structural Causes, and Policy Optimization in Developing Economies

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Abstract. Small and medium-sized enterprises (SMEs) play a crucial role in promoting employment, driving technological innovation, and enhancing economic resilience. However, for a long time, SMEs have generally faced limited financing channels and high financing costs. Financing constraints have become an important factor restricting their sustainable development and structural upgrading. This paper adopts a research method combining literature analysis and comprehensive induction. From three levels - the conditions of SMEs themselves, the supply of inclusive financial services, and the external institutional environment - it systematically analyzes the practical difficulties and causes faced by inclusive finance in empowering SMEs in financing. The research finds that although inclusive finance and digital finance have developed rapidly, problems such as high financing costs, single financing structure, and insufficient long-term funding supply still remain prominent. The root causes lie in the insufficient transparency of enterprise information, the limited risk pricing ability of financial institutions, and the incomplete credit system and policy support mechanism. Following the analysis, this article recommends enterprise capacity building, financial institution service optimization, and institutional environment improvement to lead policy and practice.

Keywords: Inclusive Finance, SME Financing, Financing Constraints, Developing Countries, Financial Support.

1 Introduction

Emerging countries' most active economic unit, SMEs, create jobs, diversify industries, and build economic resilience. SMEs have long been underrepresented in financial resource allocation and have faced funding issues and high costs, despite their relevance to economic development. Financing constraints hinder SMEs' firm operations growth. Companies' ability to expand output, convert technology, and embrace long-term development is limited by financial capacity. SME credit contraction occurs earlier and more directly than large business contraction, especially amid macroeconomic shocks

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or stricter financial environments [1]. Also, their operational stability is poorer. Therefore, the financing problem of SMEs is not only a practical difficulty at the enterprise level but also relates to employment stability and economic structure optimization.

Against this backdrop, inclusive finance has gradually been regarded as an important policy tool to alleviate the financing difficulties of SMEs. Compared with traditional financial models, inclusive finance pays more attention to the accessibility and sustainability of financial services, aiming to include SMEs in the formal financial system by reducing entry barriers and service costs [2]. With the development of fintech, digital technologies have been widely applied in credit assessment and risk management processes, to a certain extent enhancing the potential of inclusive finance to alleviate information asymmetry and reduce transaction costs [3].

Regarding the actual effects of inclusive finance, the existing research conclusions are not entirely consistent. On the one hand, some studies suggest that inclusive finance has significantly improved the opportunities for SMEs to obtain financial services, especially having a positive impact on small and micro enterprises; on the other hand, some studies indicate that inclusive finance has not fundamentally changed the financing structure of SMEs in practice, its support still mainly relies on short-term credit, and problems such as financing costs and insufficient long-term funds still exist [2,4].

Based on the existing research, it can be found that inclusive finance is not an "all-purpose tool" that can automatically alleviate the financing constraints of SMEs. In the context of developing countries, the financing difficulties of SMEs are often the result of the interaction of enterprise conditions, the behavior of financial institutions, and the institutional environment. Based on this, this paper systematically reviews the relevant research results over the past five years, from the three aspects of actual difficulties, cause mechanisms, and optimization paths, to analyze the issue of inclusive finance empowering SMEs' financing, aiming to provide more targeted theoretical references for policy improvement and practical enhancement.

2 The Realistic Challenges of Financial Inclusion: Empowering SMEs in Financing

2.1 Financing Challenges at the SME Level

From the perspective of SME financing practices, the high financing cost remains the most direct and constraining issue they face. Compared to large enterprises, SMEs generally hold a disadvantaged position in the financial market in terms of information and bargaining power, and their loan interest rates are usually higher. At the same time, during the actual financing process, SMEs also need to bear implicit costs such as guarantee fees, asset evaluation fees, information disclosure costs, and various compliance expenditures. These hidden costs, together with the nominal interest rate, considerably raise enterprises' complete financing burden, making it impossible for some SMEs to qualify for long-term external borrowing [1].

In 2023, an enterprise applied for credit support from the bank in order to upgrade its equipment and expand production capacity. Although the enterprise's orders remained stable and its production and operation conditions were generally normal, during the loan assessment process, the bank still required the enterprise to provide additional guarantees and charge multiple additional fees. As the overall financing costs continued to rise, it made it difficult for such enterprises to provide sufficient collateral assets, and ultimately the enterprise failed to obtain medium- and long-term financing and had to rely on short-term working capital loans to maintain operations. This case indicates that even though the basic operating conditions of small and medium-sized enterprises are relatively stable, the high explicit and implicit financing costs may directly limit their ability to obtain long-term external funds.

Capital pricing and tight financing circumstances reflect financing cost pressure. SME loans have stricter repayment terms and fewer grace periods. Debt repayment pressure develops quickly when business conditions and cash flow change. Such scenarios force SMEs to curtail investment or delay technical upgrades, reducing their long-term competitiveness.

Mismatched financing terms and expenses are a great difficulty. The inclusive finance system favors short-term working capital loans, while SMEs need medium-term funds for R&D, equipment renewal, digital transformation, and market expansion. Financial institutions are hesitant in long-term SME lending due to medium-term loans' longer risk exposure duration and higher capital occupation [5]. Short-term loan renewals are common for SMEs, increasing funding uncertainty and liquidity risk.

SMEs' single financial channels remain problematic. Bank credit dominates SME external finance, with direct and diversified financing sources rare. Firm size, information disclosure capabilities, and institutional thresholds make capital market, bond, and equity funding difficult for SMEs [6]. A single financing structure makes SMEs more vulnerable to economic downturns and credit tightening due to bank lending and macro financial regulations.

2.2 Supply Dilemma in the Field of Inclusive Finance

The ongoing financial demands of SMEs have put structural restrictions on the supply side of inclusive finance. Financial institutions are expanding inclusive finance services under government regulation, but precision, risk management, and operational sustainability remain issues. The existing evidence also indicates that inclusive finance faces significant cost pressures on the supply side. For instance, data provided by China's banking industry in 2023 shows that, according to the data of the China Banking Association in 2023, the average loan amount for small and medium-sized enterprises in inclusive finance business is only 1/15 of that for large enterprises, while the unit operating cost is 3.2 times that of large enterprises. This relatively low return rate and the imbalance between relatively high service costs and relatively low returns have put pressure on financial institutions and helps explain their cautious attitude towards expanding and deepening inclusive financial services.

Firstly, the homogeneity of inclusive finance products and services is relatively high. To control operating costs and improve business processing efficiency, financial

institutions generally adopt standardized and batch-oriented product design models, mainly providing general-purpose financial products such as short-term credit. However, SMEs have significant differences in industry attributes, development stages, and risk characteristics, and a single product is unable to effectively match their diverse financing needs [4]. In the absence of differentiated pricing and customized services, inclusive finance support often remains at the stage of "expanding coverage" rather than achieving "precise support".

Secondly, the difficulty in risk management restricts the further deepening of inclusive financial services. SMEs generally have incomplete credit information, strong business volatility, and unstable financial data quality, making financial institutions face high uncertainty in risk identification and credit assessment. Even in the context of digital inclusive finance, financial institutions can obtain more information through big data and algorithm models, but fragmented data, insufficient authenticity, and limited model applicability still affect the reliability of risk assessment results [7]. Under the pressure of risks, financial institutions often compensate for risks by raising interest rates, shortening terms, or strengthening guarantee requirements, thereby objectively raising the financing threshold for SMEs.

Thirdly, the operational costs of inclusive finance businesses are relatively high, which also weakens the enthusiasm of financial institutions for continuous investment. SMEs' financing usually has the characteristics of small single amounts, high business frequency, and high management costs, making it difficult to form a scale effect, and the unit business cost is difficult to be effectively amortized [2]. At the same time, the internal assessment of some financial institutions still focuses on profit indicators and non-performing rate control, with a low tolerance for risks in inclusive finance business, further limiting the depth of services.

2.3 Complications at the External Environment Level

Apart from the conditions of the enterprises themselves and the supply behavior of financial institutions, the imperfect external institutional environment has significantly amplified the practical difficulties in providing financial support to SMEs through inclusive finance. Firstly, the relatively lagging development of the credit system remains a crucial institutional factor restricting the effective operation of inclusive finance. The credit information of SMEs is scattered across multiple departments such as industry and commerce, taxation, judiciary, and finance, with limited cross-departmental sharing, inconsistent data standards, and insufficient data updates, making it difficult for financial institutions to form a complete risk assessment for these enterprises [5].

In an informationally insufficient institutional environment, financial institutions often adopt more conservative credit strategies, such as raising interest rates, shortening loan terms, or reducing credit lines to cope with uncertain risks. This choice has certain rationality at the institutional level, but in practice, it weakens the inclusiveness of inclusive finance and excludes some SMEs from the formal financial system.

Secondly, there is still a gap between the design and implementation of policy support measures. Although the government has launched a number of policy tools to

alleviate the financing difficulties of SMEs, some policy processes are complex and the information transparency is insufficient, resulting in the inability of policy resources to precisely reach the SMEs that truly have financing needs [8]. Some SMEs, due to a limited understanding of the system, fail to fully utilize the policy support.

The external institutional context greatly impacts inclusive finance's ability to fund SMEs by affecting information structure, risk expectations, and incentive mechanisms.

3 Analysis of the Causes of the Financing Difficulties Faced by SMEs Enabled by Inclusive Finance

3.1 Causes at the SME level

SME funding challenges originate from their size and business nature. A lack of asset scale and operational consistency makes SMEs exposed to market volatility and macro shocks. Risk-control-focused financial institution assessment systems automatically consider such enterprises high risk. Even if some enterprises have good operating conditions, they still find it difficult to completely escape this preconceived judgment. This structural disadvantage keeps SMEs in an unfavorable position in the financing game for a long time.

On this basis, the non-standardization of financial systems and insufficient information transparency further amplify the financing difficulty. In reality, many SMEs have not established a complete financial management system, with insufficient standardization and continuity of financial statements, and the verifiability of enterprise operating information is relatively low. This not only increases the difficulty for financial institutions to identify risks but also weakens their confidence in the long-term solvency of enterprises. In fact, the limited transparency of information makes it difficult for financial institutions to accurately verify the operational conditions of small and medium-sized enterprises. When financial records are incomplete, banks will face greater uncertainty when assessing the stability of cash flow and repayment ability. To address this uncertainty, financial institutions tend to adopt more cautious lending strategies, such as raising interest rates, increasing collateral requirements, or shortening loan terms. This ultimately leads to higher financing costs and entry barriers for small and medium-sized enterprises. Even in the context of digital inclusive finance, algorithm models and big data analysis still highly rely on the quality of basic data, and the problem of weak information foundation of SMEs will not disappear automatically due to the introduction of technology.

Furthermore, insufficient collateral and guarantee capabilities constitute another important source of financing constraints for SMEs. Most SMEs lack traditional collateral assets such as land and real estate, while their intangible assets such as technology, brand, and data are difficult to be effectively valued and widely accepted in the existing financial system. The development of guaranteed systems and credit enhancement mechanisms is relatively lagging, making it difficult for SMEs to compensate for the credit gap through external means. The combination of these factors

forms a self-reinforcing constraint mechanism, making the financing difficulties of SMEs have strong persistence and path dependence characteristics [1].

3.2 Causes at the Level of Inclusive Financial Institutions

If the conditions of SMEs constitute the intrinsic foundation of the financing difficulties, then the behavioral logic of inclusive financial institutions largely determines whether these difficulties can be alleviated. When financial institutions carry out inclusive financial business, they always face the realistic tension between profit goals and social responsibility. Although the policy level continuously emphasizes providing more financial support to SMEs, in commercial banks and other institutions oriented towards profit, risk controllability and income stability remain the most core decision-making basis.

The financing business of SMEs generally has the characteristics of small single amounts, high risk uncertainty, and relatively high management costs, which are in a natural conflict with the business logic of financial institutions to pursue scale effects and cost efficiency. In the absence of sufficient risk compensation and long-term incentive mechanisms, financial institutions often respond to inclusive financial policies at the institutional level but remain cautious in business practice. Inclusive finance often remains at the level of "expanding coverage" rather than "enhancing support depth" [4].

Insufficient risk pricing ability further exacerbates this problem. The high heterogeneity of SMEs in terms of industry distribution, life cycle, and business model makes refined risk pricing highly difficult. Some financial institutions still adopt relatively loose risk assessment methods, making it difficult to effectively distinguish the actual risk levels of different types of SMEs. In such circumstances, institutions often use overall interest rate increases, shortening of terms, or strengthening of guaranteed requirements to hedge against uncertain risks, thereby implicitly excluding some enterprises with growth potential but high short-term risks.

Although the development of fintech provides new tools for inclusive finance, technological empowerment has not fundamentally changed the risk preference structure of financial institutions. On one hand, the fragmentation of data and model applicability limits the actual effect of technology; on the other hand, some institutions, during their digital transformation, focus more on business expansion efficiency rather than the construction of long-term risk control capabilities. Furthermore, there is a shortage of comprehensive talents who are both familiar with financial business and understand the actual operations of SMEs, which also restricts the continuous innovation of inclusive financial products and service models [2,4].

3.3 Causes at the Policy and Institutional Level (Expanded and Optimized)

At a more macro level, the financing difficulties of SMEs are also deeply influenced by the policy and institutional environment. Firstly, the incentive mechanism for inclusive finance is not yet perfect, weakening the internal motivation of financial institutions to participate in the financing of SMEs for the long term. The existing policy tools still have deficiencies in risk sharing, cost compensation, and incentive intensity, and are

unable to fully cover the additional risks and operational costs that financial institutions bear in the financing process of SMEs [8]. Without stable institutional arrangements, financial institutions may consider inclusive finance as a short-term policy duty rather than a long-term ambition.

Second, trailing credit has exacerbated institutional knowledge asymmetry. Industry and commerce, taxation, justice, and finance share SMEs' credit information, but data standards and sharing routes are inconsistent, limiting integration and use. Financial firms must pay more for data gathering and verification, weakening digital inclusive finance models. Insufficient credit infrastructure makes banks cautious and limits SME financing.

Furthermore, deviations in policy implementation have to some extent weakened the actual effectiveness of inclusive finance policies. Some policies supporting the financing of SMEs have clear goals in design, but in the implementation at the grassroots level, there are problems such as complex procedures, lack of transparency in information, or insufficient local implementation efforts, resulting in significant differences in policy effects among different regions and enterprises. This implementation gap makes some SMEs unable to have stable expectations and also reduces the confidence of financial institutions in the sustainability of the policies.

Finally, the imperfection of the legal system further strengthens the risk concerns of financial institutions. In terms of contract execution, bankruptcy liquidation, and creditor protection, the insufficient efficiency of the system increases the uncertainty costs for financial institutions in the post-event disposal stage. In the absence of clear and stable legal expectations, financial institutions tend to reduce the scale of medium- and long-term financing for SMEs to lower potential risk exposure. Thus, the policy and institutional environment is not merely an exogenous background but rather profoundly shapes the actual operation mode of inclusive finance in supporting the financing of SMEs through influencing the incentive structure and risk expectations.

4 Optimization Countermeasures for Enhancing SME Financing through Inclusive Finance

4.1 Enhancing the Self-Financing Capacity of SMEs

In the long run, enhancing the self-funding capacity of SMEs is the most fundamental step to alleviating financing constraints. Although the disadvantages of SMEs in terms of scale and resources are difficult to change in the short term, their business models and information quality can be adjusted. In practice, when financial institutions assess SMEs, they often pay more attention to the stability of the business operation and the coherence of information rather than just the short-term profit level. Thus, standardised corporate records constitute a "hidden asset" [1].

Standardized management is essential during this operation. Stable and trustworthy financial information helps financial institutions understand enterprises' real operational realities, reducing uncertainty-related risk judgment aberrations.

Improvement is small but cumulatively affects funding greatly. SMEs may become more active in funding conversations as information improves.

SMEs should consider credit building as a long-term investment, not merely capital. Working with financial institutions and paying obligations on time helps firms develop a stable credit record and predictable funding relationship. Credit accumulation may not cut financing costs immediately, but it often improves business financing over time [9].

Additionally, corporate financial literacy must be improved. Many SMEs are inactive about funding because they don't grasp financing options, cost structures, and inclusive financial legislation. Studies suggest that financial literacy strongly affects SMEs' financial resource use [6]. Training and advisory support help businesses understand financial products and risks and use inclusive financial resources more effectively.

4.2 Strengthening the Service Supply Capacity of Inclusive Financial Institutions

Inclusive financial institutions' service methods and conduct affect long-term SME funding. Financial services should meet SMEs' needs more than financing. SMEs have distinct industry distribution, development stage, and firm models, so overly standardized financial products cannot suit their financing needs [10].

Thus, financial institutions must gradually improve product and service model flexibility under controllable risks. Financial institutions can aid SMEs without increasing risks by being flexible with credit lines, terms, and payback. This enterprise-specific service reduces funding term mismatch and promotes inclusive finance.

Digital transformation helps. Financial institutions can spot dangers and improve service with big data and AI. Technology cannot automatically change financial institutions' risk choices. Digital tools can only support SME financing when properly integrated into company processes and risk management systems and used for decision-making [3].

Thus, risk pricing system optimization must be gradual. Understanding small and medium-sized enterprise risk can help financial institutions avoid uniformly raising interest rates or overusing collateral guarantees. This helps inclusive finance companies survive and minimizes some SMBs' funding needs [11].

4.3 Improving Policy and Institutional Guarantee System

Policy and institutions support inclusive finance at a macro level. Even if financial institutions want to finance SMEs, they may struggle to invest without solid and clear institutional expectations [8]. Thus, policy design should prioritize long-term coordination over rapid alterations that disrupt market behavior.

Policy incentive mechanism improvement is crucial. Fiscal subsidies, tax incentives, and risk compensation policies only motivate small and medium-sized firms when they fit their financing risk and cost structure. Financial institutions' enthusiasm for financing small and medium-sized firms will increase when governmental incentives can properly share the increased risks carried in inclusive finance operations [5].

Credit system construction matters too. Promoting the integration and sharing of credit information of SMEs, reduces the cost for financial institutions to obtain and verify information, providing a more reliable institutional basis for risk assessment and pricing [3]. More comprehensive sharing of credit information enables financial institutions to establish more complete and consistent credit files for small and medium-sized enterprises. When lenders can obtain cross-sector credit data, the phenomenon of information asymmetry will decrease, thereby enabling risk assessment to rely less on conservative assumptions. This improves the accuracy of risk pricing, which in turn helps to reduce financing costs and expand the opportunities for small and medium-sized enterprises to obtain credit. In addition, improving the legal and regulatory system plays an irreplaceable role in enhancing the stability of inclusive finance. The efficiency of contract execution, bankruptcy liquidation procedures, and the level of creditor protection directly affect financial institutions' judgment of medium- and long-term risks. When legal expectations are clearer and the institutional environment is more stable, financial institutions are more motivated to provide medium- and long-term financing support to SMEs.

5 Conclusion

This paper, based on the actual context of developing countries, systematically analyzed the actual role of inclusive finance in alleviating the financing constraints of SMEs. By sorting out and integrating the relevant research results in recent years, the article comprehensively discussed the issue of inclusive finance empowering the financing of SMEs from three aspects: the current predicament, the cause mechanism, and the optimization path.

The study found that although inclusive finance and digital finance have developed rapidly in recent years and achieved certain results in expanding the coverage of financial services, the financing constraints of SMEs have not fundamentally changed. Problems such as high financing costs, a mismatch between financing terms and the development needs of enterprises, and relatively single financing channels still exist and continue to affect the long-term investment decisions of SMEs. These problems are not caused by a single factor but are the result of the interaction of the enterprise's own conditions, the behavior logic of financial institutions, and the external institutional environment. From this perspective, inclusive finance has improved the problem of "whether enterprises can enter the financial system" in practice, but the improvement of financing quality and stability is still limited.

Based on the above analysis, this paper believes that alleviating the financing constraints of SMEs should not rely on a single reform path but should be advanced simultaneously at multiple levels. SMEs need to improve their recognizability in the financial system through standardized operations and continuous credit accumulation; financial institutions should enhance the professionalism and flexibility of their services for SMEs under the premise of risk control; at the policy level, it is necessary to further improve the incentive mechanism, credit infrastructure, and legal system to provide a stable expectation for the long-term operation of inclusive finance.

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