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Research Report

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Microenterprises in Developing Countries: Is there Growth Potential?

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Microenterprises account for a large fraction of employment in developing countries and they are likely to increase in importance in the future. In Sub-Saharan Africa, for example, around 8 million additional jobs need to be created annually in order to cope with the increasing number of new entrants into the labour market (The World Bank, 2013). As microenterprises typically only provide subsistence income to few individuals the question remains whether they have the potential to grow and to contribute to the creation of jobs.

Studies suggest that many businesses do indeed have the potential to grow. However, they often lack the necessary funds due to imperfect credit markets, insufficient household savings or behavioral reasons and missing information to exploit their potential. Policy interventions to overcome these issues show some promising results.

Background

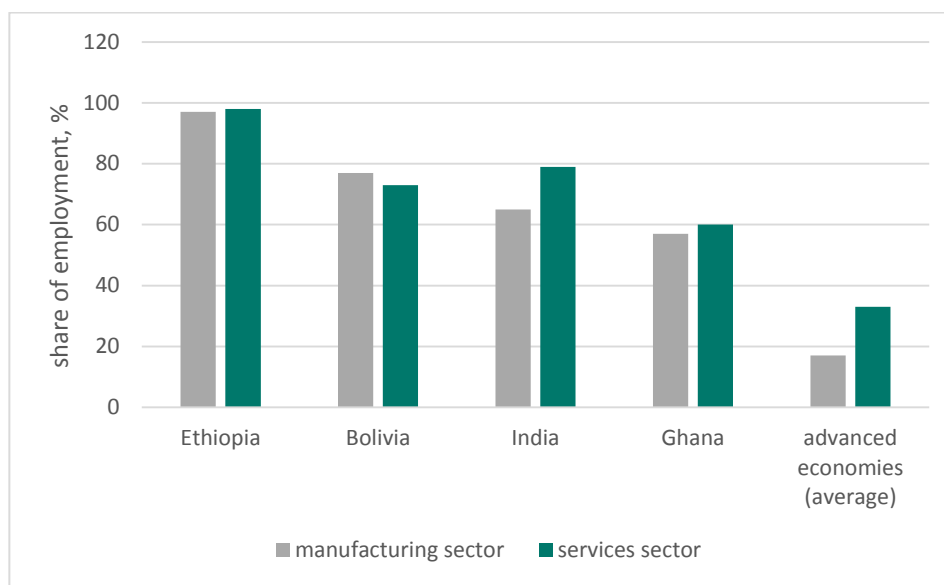
The stereotypical picture of economic activity in many developing countries can be characterized by numerous small shops at the side of the road – many of them selling seemingly identical or similar items. Each of these small shop owners or vendors is a microentrepreneur, operating her business either alone or with only a few employees.

In fact, that impression is not deceiving. According to the World Development Report on Jobs (The World Bank, 2013) the number of microenterprises or household businesses is much higher in developing countries compared to industrial countries. Taking Ghana for example, micro- and household enterprises account for around 57% (60%) of employment in the manufacturing (services) sector (see Figure 1). The average for advanced economies, however, is much lower with around 17% for the manufacturing and 33% for the services sector.

Many countries, predominantly in Sub-Saharan Africa and Southeast Asia, will experience a steep increase in their labor force in the next years (The World Bank, 2013). The reasons are manifold: increased population growth and increasing life expectancy. To keep the ratio of “employment to working-age population” constant, many additional jobs will be needed in the future. In Sub-Saharan Africa, for example, the number of jobs would have to increase by approx. 8 million annually (The World Bank, 2013). The need of “job-rich economic growth” due to new entrants into the labor force has also been identified as an important challenge by the G20 initiative “Compact with Africa”, endorsed in early 2017 (G-20 Finance Ministers and Central Bank Governors Meeting, 2017). Based on these future challenges and the fact that microenterprises presently contribute a large fraction of

employment in developing countries, one should be concerned about how well these businesses actually perform. Do microenterprises in developing countries only provide subsistence income for few or do they have the potential to develop and grow, to create jobs for many and thus contribute to economic development?

Figure 1: The employment share of microenterprises is greater in developing countries



Source: Illustration based on: *The World Bank* (2013).

Do Microenterprises Have the Potential to Grow?

In a profit maximizing business, marginal returns to capital should equal the market interest rate (Dodlova et al., 2015). High marginal returns to capital are typically seen as an indication for business growth potential (Hussam et al., 2016). Hence, increasing the physical capital in those businesses by making additional investments yields high returns (Grimm et al., 2012). The existing literature provides ample evidence of high marginal returns to capital in developing countries. This evidence is derived from different sources: firstly, by the observation that some firms are willing to pay extremely high interest rates. This suggests that the borrowed capital is used for productive purposes which suggests that return to capital must be high – at least for some firms (Banerjee and Duflo, 2005). Secondly, empirical evidence stems from studies that estimate marginal returns to capital within firms. These estimates are achieved either by experimentally changing the business environment (De Mel et al. 2008; McKenzie and Woodruff, 2008) or by estimating production functions (Grimm et al., 2011).

To summarize the experimental evidence, De Mel et al. (2008) and McKenzie and Woodruff (2008) both apply the same design by providing random grants of either cash or equipment to businesses. This leads to an exogenous shock to the business capital. De Mel et al. (2008) use the random assignment to treatment as instruments for changes in the capital stock. The grants lead to an increase in business profits by 5% per month (around 60% per year) in Sri Lanka. The estimated monthly returns by McKenzie and Woodruff (2008) for male-owned Mexican firms range between 20-100%.

Grimm et al. (2011) provide estimates of return to capital by estimating production functions. They use survey data on micro- and small enterprises of seven economic capital cities in West Africa. They estimate returns to capital for different levels of capital stock, and find returns exceeding 70% per month for levels of capital stocks below <150 Dollars. This finding suggests that even small businesses with low capital stocks do have the potential to grow.

To summarize these findings: estimated returns to capital appear to be high, exceeding the level of market interest rates charged on a typical loan product by formal or informal lenders. Based on this empirical evidence the typical business should have the potential to grow by making more investments. But where could the additional capital needed to fund these productive investments come from? Capital could stem from outside the existing business by borrowing money from formal institutions (i.e. banks), semi-formal institutions (i.e. microfinance agencies) or informal sources of credit (e.g. family and peers or informal services provider). Alternatively, investment funds could stem from own (household) resources (i.e. accumulated savings, or business cash-holdings).

What Keeps Businesses from Investing?

Lack of access to capital is known to be a common problem in developing countries. In many business surveys, entrepreneurs state limited or lacking access to capital as a major obstacle for business growth and development (De Mel and McKenzie, 2011).

The literature indeed provides empirical evidence which underpins that businesses are capital constrained:

- Bigsten et al. (2003) model loan demand and supply for firms operating in the manufacturing sector in six African countries. They find that, out of those who apply for credit, only a quarter does obtain a credit. Especially micro and small firms are less likely than large firms to receive a credit.
- Banerjee and Duflo (2014) enrich the literature by showing that even larger formally registered firms in India are credit constrained by exploiting a policy change that affected the credit eligibility. They show that certain firms are credit constrained as they expand their production instead of substituting for other borrowing as non-constrained firms would do.
- McKenzie and Woodruff (2008) estimate returns to capital based on grants provided to microentrepreneurs in Mexico. They can show that those businesses reporting to be credit constrained have higher increases in profits due to the additional capital compared to firms reporting not to be credit constrained.

There are several arguments why credit markets are imperfect in developing countries. Insufficiently developed information systems make it hard to enforce contracts (Banerjee and Duflo 2005). Further, borrowers are mostly poor and often under strong economic pressure. These circumstances are tempting to cheat the lender (Banerjee and Duflo 2005). In addition, unmet criteria set by financial institutions or the inability to find personal guarantors are other possible reasons for a lack of sufficient supply of capital (De Mel and McKenzie 2011). Apart from this, the entrepreneur himself might have reasons that prevent him from borrowing such as interest rates charged are too high, religious reasons or behavioral factors (e.g. risk aversion). Entrepreneurs might also simply be uninformed about how to apply for a credit (De Mel and McKenzie 2011).

To conclude, many entrepreneurs in developing countries are affected by pervasive credit constraints. Back in the 1980s, the first microfinance institution (the Grameen Bank) started to operate in Bangladesh and provided small loans ("microcredit") to

address this concern. Microfinance might seem as *the solution* to solve the problem of insufficient supply of capital in developing countries.

A recent series of randomized controlled trials implemented by Banerjee et al. (2015a) and Banerjee et al. (2015b) analyze the effectiveness of microcredits in Bosnia, Ethiopia, India, Mexico, Morocco and Mongolia. Their findings are relatively disappointing: take-up rates of microcredits are generally low, those who do receive microcredits do neither show an increase in consumption or income. However, Banerjee et al. (2015a) do find the intended additional investments in existing businesses to take place. It seems that providing microcredit alone does not spur growth of microbusinesses considerably. While for some businesses access to microcredits has negligible effects, others might indeed benefit. Based on survey data from West Africa, Grimm et al. (2012) seek to identify microentrepreneurs with growth potential (“constrained gazelles”). Microbusinesses identified as constrained gazelles are characterized by low capital stock, lack of access to capital, high productivity and high returns to capital. Targeting microcredit specifically to those with potential might be a way to ensure that businesses benefit, and additionally provides increased repayment safety to the lender.

Undersaving as a Potential Problem?

Own (household) savings could be an alternative to the reliance on credit in overcoming capital constraints. By accumulating savings, the capital that is needed to make business investments can be built up. However, it is widely assumed, that people in developing countries have difficulties saving sufficient amounts of money. What are possible reasons for undersaving?

One simple explanation could be that people in developing countries are just too poor to save more without giving up money for subsistence consumption. This argument is refuted by Banerjee and Duflo (2007) as they show that people could easily save more by spending less on temptation goods such as alcohol or tobacco. Hence, some would be able to save (more), but what prevents them from doing so?

There are several aspects that might keep microentrepreneurs from saving sufficiently large amounts. Karlan et al. (2014) provide an excellent review and summarize important obstacles to save money such as behavioral bias and lack of information.

The field of behavioral economics has elaborated on several biases in preferences, expectations or perceptions that may cause people to undersave. There is an observed lack of *self-control*, meaning that people “live for today” and “when tomorrow arrives it is today again” (Karlan et al., 2014, p.54). The consequence of lack of self-control is that intended behavior changes such as intentions to start saving or to cut back expenses and to save more are (constantly) delayed. Another argument is that people tend to be *over-optimistic*. This leads to the overestimation of future incomes and generates under-saving. Further, there is a *bias in price perceptions*, meaning that people underestimate the effect of compound interest.

To overcome this issue of undersavings, several saving promotion interventions have been implemented. In a meta-analysis, Steinert et al. (2017) analyze whether saving programs can reduce poverty and economic hardship in Sub-Saharan Africa. They exclusively include randomized controlled studies that contain a saving promotion component and report effects on saving or poverty related outcomes. Their findings suggest that saving promotion strategies do indeed have a positive impact on saving amounts and investments.

Low levels of financial literacy are summarized by Karlan et al. (2014) under the aspect of lack of information as another reason that might cause undersaving.

Similar to interventions that aim at promoting savings, there are by now many interventions that try to improve financial literacy. Meta-analyses on this issue unanimously find that financial literacy interventions can significantly influence saving outcomes (see for example Kaiser and Menkhoff (2017)). It should be mentioned, however, that the literature on financial education interventions is quite heterogeneous in terms of the type and scope of the design of the interventions and also regarding the magnitude of the effects.

Policy Lessons and further Scope for Research

The presented empirical evidence suggests that microenterprises often have high returns to capital. Hence, there is reason to believe that microbusinesses do not only provide subsistence income but possess the potential to grow. From a policy perspective, this seems promising in tackling the challenges associated with the numerous entrants into the African labor market in the next decades.

However, “growth potential” does not imply a guarantee for business growth. Therefore researchers and organizations explore different possibilities on how to spur business growth. These possible interventions range from overcoming financial difficulties (provision of credits and cash grants, saving promoting interventions), tackling behavioral aspects (e.g. self-control) to improving knowledge (e.g. financial literacy).

While some of these interventions do show results in the intended directions, none seems to be the perfect solution to generally foster business growth. Probably one needs combinations of interventions or very targeted interventions to increase effectiveness. Moreover, this leaves scope for future research in several aspects. Future work should focus on how to increase the effectiveness of existing forms of interventions and on the creation of new innovation forms.

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