Microfinance, entrepreneurship and institutional quality

Malavika Nair and Martha Njolomole
Troy University, Troy, Alabama, USA

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Abstract

Purpose – The purpose of this paper is to consider the success and failure of microfinance institutions in generating economic growth over the past 30 years and propose a dual criterion of evaluation.

Design/methodology/approach – It surveys the empirical literature on microfinance and finds that while there has been small and localized success in various countries in improving access to credit, at the same time there has been a broader failure to generate economic growth. The authors argue that this broader failure should be viewed from the viewpoint of institutional failure or the lack of supporting institutions such as private property rights and stable rule of law within developing countries.

Findings – Using Baumol's (1968) theory of entrepreneurship, the authors argue that the broader failure of microfinance is a case of poor institutional quality leading to unproductive or even destructive entrepreneurship rather than productive entrepreneurship. The paper also suggests a link between the literature criticizing foreign aid and this view on microfinance.

Originality/value – The paper provides a survey of the empirical literature on micro finance as well as a novel framework that aids in understanding both the localized small-scale success as well as broader failure to generate economic growth.

Keywords Microfinance, Entrepreneurial action, Institutional quality

Paper type Research paper

1. Introduction

Microfinance was once perceived as the "next big thing" within policy and academic circles to be an effective way of alleviating poverty through the introduction of small-size loans and fostering entrepreneurship among the poor (Bateman, 2010). Built on the ideas of neoclassical growth theory that advances the idea of capital accumulation as the driving factor of growth (Glaeser *et al.*, 2004; Sachs, 2003; Nag, 1954; Narasimhan, 1960; Banerjee and Newman, 1993), microfinance was developed to transfer capital to developing countries in order to spur the process of small-scale entrepreneurship. In its past 30-year history, however, microfinance has achieved limited overall success, despite being widely implemented in many countries.

The purpose of this paper is twofold: we survey the empirical literature (critical as well as successes) on microfinance in its past 30 years and propose a dual criterion of evaluation. While microfinance has indeed achieved localized successes (primarily through better access to credit and consumption smoothing) in various locations, it has failed to achieve long-term poverty alleviation through economic growth within the regions it was implemented. We argue that this should be viewed as institutional failure caused by a lack of supporting institutions such as secure property rights, stable legal environments and protection from predation that would allow productive entrepreneurship to flourish.

Second, by viewing the broader failure of microfinance as an institutional failure, the paper provides a link between the literature on microfinance and the literature on new institutional economics. This provides the benefit of being able to borrow insights from that literature that views poverty alleviation and long-run development as a complex economic problem unlikely to be solved by top-down approaches focusing on just one variable such as access to credit or lack of capital. We specifically borrow from Baumol (1968) and apply the theory of productive and unproductive entrepreneurship as a lens to view the broader institutional failure

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of microfinance. We also suggest a link between these broader criticisms of microfinance and recent criticisms of foreign aid by stressing the role of incentives and information necessary to generate economic growth, which could be a fruitful area for future research.

The general idea that capital is the sole contributing factor to economic growth and development has been called into question by empirical evidence showing that countries with better economic and political institutions face high levels of income and economic growth (Acemoglu *et al.*, 2004; Rodrik *et al.*, 2002; Gwartney *et al.*, 1999, 2004; Williamson, 2009), through efficient allocation of resources, increased investment, productivity and employment (all through entrepreneurial activity). As it stands, institutions determine the rules of the game (relative payoffs from engaging in certain economic activity), which, in turn, determine if individuals will choose to invest their resources into productive or unproductive entrepreneurial activities (Baumol, 1968). When institutions exist that do not allow for individuals to privately benefit from productive entrepreneurial activity, entrepreneurship will be low, and individuals will engage in socially unproductive or destructive entrepreneurship.

Applied to microfinance, therefore, other factors considered, the economic and political institutional environment will determine the extent to which microfinance encourages productive entrepreneurship. Utilizing Baumol's theory of institutions to analyze the lack of productive entrepreneurship, thus, provides a missing link in explaining microfinance's inability to generate long-term economic growth.

This paper proceeds as follows: Section 2 reviews the literature on microfinance and its successes as well as failures, Section 3 reviews the literature on entrepreneurship and institutions, Section 4 links the theory of entrepreneurship and institutional quality as described by Baumol and what this means for microfinance Section 5 suggests a link between the literature criticizing the impact of foreign aid and microfinance and Section 6 concludes.

2. Literature review

Initially endorsed as a way of reducing poverty, microfinance received a great deal of publicity and promotion by the international development community, especially after the success of the Grameen Bank pioneered by Muhammad Yunus in Bangladesh in 1976. Grameen started as a tool to alleviate poverty among the rural poor of Bangladesh through encouraging entrepreneurship, especially women. Dr Yunus began operations in the village of Jobra in 1976 and Grameen Bank became an independent bank in 1983 with government providing 60 percent of capital and 40 percent provided by borrowers (Islam *et al.*, 2012). Though not initially intended to cause economic development, microfinance became explicitly linked to economic growth and development when it was included in the Millenium Development Goals (UNCDF, 2005; Dichter, 2007). Regardless of the explicit goals, alleviating poverty through encouraging entrepreneurship requires solving an economic problem, one that is crucially dependent on supportive institutional foundations not merely increasing access to credit in the absence of supportive institutions.

Here, we survey the literature on microfinance and find that instead of generating long-term economic growth, it can be broadly categorized as either providing improved access to credit, encouraging subsistence entrepreneurship, largely being used for consumption smoothing or some combination of the above[1].

One strand of microfinance literature shows there has been modest positive improvement resulting from access to credit (Morduch, 2016), but the results are not transformative, often localized, concentrated in specific markets and are restricted by regional institutional restrictions. For instance, Banerjee *et al.* (2015) found an increase in small business investments and profits of existing businesses but no statistically significant increase in either total household income or consumption for studies conducted in Bosnia, Herzegovina, Mongolia, Mexico, India and Morocco. In India specifically, individuals already well suited for entrepreneurship have been found to experience lasting impact with microfinance as well as people with preexisting businesses and longtime borrowers (Banerjee *et al.*, 2017). Introduction of micro credit programs have also led to poverty reduction and improved income in Malaysia among extremely poor clients Al-Mamun *et al.* (2012), and in Bosnia increase in self-employment and profits (Augusburg *et al.*, 2015). In Nigeria, microfinance has been found to have an impact on short term growth (Murrad and Ebosetale, 2017), and poverty reduction (Kasali *et al.*, 2015).

While some studies also find no effect of increased borrowing on socio-economic factors including income or women empowerment, for example, Tarozzi *et al.* (2015) study in Ethiopia, there have been substantive positive impacts from microfinance on increasing entrepreneurship development (Olu, Oju), especially when microfinance services were coupled with augmented services like business training and careful screening of clients (Karlan and Valdivia, 2010), or focused on already existing businesses or small firms (Banerjee *et al.*, 2017; Singh and Pushan, 2018). Foundation for International Community Assistance program in Malawi that is based on the village bank concept achieved reputable success through increased women entrepreneurship (Chirwa, 1999). Microfinance has also been found to fare more positively on other goals not relating to poverty reduction like building dynamic industries that deliver inherently useful services to millions of poor people (Roodman, 2012).

Nevertheless, more popular, however, have been the less successful stories of microfinance as pertaining to entrepreneurship in a lot of countries. Microfinance has often led to the creation of environment of subsistence or necessity entrepreneurship which tends to lock people into poverty (Bruton *et al.*, 2015), and some microfinance institutions have failed to survive due to high costs (Kanayo *et al.*, 2013). Funding for microenterprises, especially startups, has been found to fare as compared to other ventures in most markets (Singh and Pushan, 2018), especially in non-conducive environments. Microfinance therefore is not a cure for poverty and has generally failure to cater to the poorest among the poor, their initially intended clients (Morduch, 2016). The poor have been largely found to use loans for household consumption (Lard and Barres, 2007).

Research on microfinance has attributed various factors to the failure of microfinance to induce economic growth. Bateman (2010) holds that the new wave of microfinance is altogether a poverty trap that antagonizes sustainable social and economic development. Bateman contends microfinance lacks impact or has a negative on development triggers like economies of scale (microenterprises produced by microfinance are too small to utilize economics of scale); industrialization (facilitates deindustrialization of local economies due to its heavy support for short lived small enterprises); social capital (heavy informalization crowds out social capital and productive enterprise); and trade (promotes import dependency by supporting cross-border trade and small-scale retail operations that largely sell imported items) as the main factors. Other factors credited include lack of business knowledge and training among microenterprise owners, lack of underlying market demand for microenterprise products (Bateman, 2012), exorbitant interest rates faced by microentrepreneurs and low repayment rates (Bellman and Chang, 2010).

Banerjee and Jameel attribute MFI's failure to reduce poverty to the fact that the hype around microfinance led to aggressive lending practices on the part of MFI's, leading to over indebtedness among the poor. Additionally, corruption was rampant especially among politicians trying to capture some of the rents. Especially in India where lenders were growing too fast, the extremely poor were targets of aggressive lending and had to take multiple loans for repayment (Polgreen and Bajaj, 2010). There are success stories on microfinance's impact on income or profits, but the scattered success stories of microfinance do not manage to live up to the hype developed over microfinance in its initial development stages; they only work to undermine its potential transformative power. Given this lack of transformative impact there is a need for further analysis on institutional arrangements and how they affect entrepreneurship development as it relates to microfinance.

Microfinance has been used for cash flow smoothing and consumption by the poor, in advanced as well as low-income countries (Dichter, 2007; Morduch, 2016). Additionally, the poorest among the poor are being left behind by the microfinance community and their entrepreneurial potential has been impacted negatively. Where the poor are included the assumption that the poor have a strong desire to be entrepreneurs and that solely microenterprise entrepreneurship is the way out of poverty led to the pushing down of capital on people that at best had very small specialized skills with little knowledge of profitable business and little to no desire to operate competitive business in an environment with low demand. Entrepreneurship among the poor therefore ended up being a high fraction of self-employed individuals with very small enterprises not intended for growth, undercutting each other in the market.

Canales *et al.* (2013) after conducting randomized trials in India and Philippines find that traditional microfinance leads to development of microenterprises that do not grow into SME's which are the engines for growth. Both startups and existing businesses have a ceiling above which they do not excel even with the presence of capital. The poor are merely coerced into enterprises when they are believed to be credit worthy by microfinance institutions (Canales *et al.*, 2013) and many microenterprises are set up out of lack of alternative employment options for the owner in the formal sector and usually have no expansion plan because owners are looking for a formal job (Beck, 2016). Social entrepreneurship therefore creates microenterprises that have not been able to scale up and diverts resources from other (possibly more fruitful) development initiatives (Nega and Schneider, 2014).

There is some evidence that microfinance can also help facilitate community building (Nega and Schneider, 2014), which can act as a step ladder to community innovation or entrepreneurship. But ultimately the potential for microfinance to induce successful entrepreneurship depends on the socio-economic conditions of the countries (Lahimer *et al.*, 2013) and the ability of microfinance institutions to provide for business support and knowledge is contingent on how institutions affect their operating costs (Chakrabarty and Bass, 2013). Focus should therefore be given to studying the institutional arrangements under which microfinance operate, to learn how to better align microfinance development goals with developing nations' capacity to shoulder entrepreneurship.

3. Entrepreneurship and institutional quality

"Institutions provide the incentive structure of an economy; as that structure evolves, it shapes the direction of economic change towards growth, stagnation, or decline" (North, 1991, p. 97). By determining the rules of the game (relative payoffs from engaging in certain economic activity), institutions determine the type of entrepreneurship individuals will engage in (productive or unproductive) (Baumol, 1968). Only institutions that allow individuals to privately benefit from productive entrepreneurial activity will encourage productive entrepreneurship and expansion. For societies to move from subsistence production to market production (Bauer, 2000), conducive formal and informal institutions are needed to shoulder extensive transactions.

Theoretically, institutional factors such as private property rights, trust, respect and individual self-determination promote security and reduce transactions costs enabling trade expansion (Williamson and Kerekes, 2011) typically measured through increases in economic freedom (Sautet, 2005). Empirical studies have shown significant levels of entrepreneurship in societies with increased economic freedom, for instance the rest of Germany compared to East Germany (Runst, 2011), and Poland and Brazil compared to Russia which has a negative environment and lacks extensive networks (Aidis *et al.*, 2008). Freer economies make it possible for exchange to take place without fear of predation or prohibition thereby increasing productivity (Boettke *et al.*, 2005) while encouraging investment in capital as well as productive entrepreneurial productive processes (Gwartney *et al.*, 2004). Nystr¨om (2008) finds that entrepreneurial activity is positively correlated with a smaller government sector, better legal structure and security of property rights, as well as less regulation of credit, labor and business providing a framework for government reform.

Additionally, since, "formal institutions create opportunity fields for entrepreneurship; informal institutions determine the collective and individual perception of entrepreneurial opportunities" (Welter *et al.*, 2003, p. 248). Institutional arrangements (how formal and informal institutions relate to each other) also do affect level of entrepreneurship and growth (Williams and Vorley, 2017). Institutional asymmetry (negative relationship between formal and informal institutions) raises risks of investment and therefore reduces entrepreneurship (Sautet, 2005; Williams and Vorley, 2017). Interplay between formal and informal institutions can also inherently imbed negative factors like corruption in the system (Vorley and Williams, 2016). For instance, institutional asymmetry in Bulgaria has been found to obstruct productive entrepreneurship (Williams and Vorley, 2014).

Furthermore, how individuals view institutions and governance matters; entrepreneurs who perceive the attitudes of local authorities toward private business as positive and supportive are more likely to report plans for expanding their current activities (Vladimirov *et al.*, 2017). Societies where citizens view formal institutions as bureaucratic or highly corrupt, like Kosovo, entrepreneurial activity is reduced as entrepreneurs incur heavy costs from participating in economic activity that their benefits are ultimately reduced or alienated (Williams and Vorley, 2017). More than capital then, the right institutional context is crucial to jumpstart productive entrepreneurial activity; i.e. an institutional framework that allows for socially productive entrepreneurial activity to flourish or dwindle the supply of unproductive or destructive entrepreneurship (Sautet, 2005).

4. Productive and unproductive entrepreneurship

Baumol (1968) distinguishes between three types of entrepreneurship: productive, unproductive and destructive. For productive entrepreneurship to exist, formal institutions must specify and support rules of conduct and provide incentives for entrepreneurs to actively search for and capture socially beneficial opportunities. That means formal institutions, which define and enforce property rights over exchanged goods must be strong and enforcement costs of the legal system must be low. This allows for low transaction costs and a setting where entrepreneurs can easily discover and exploit profit opportunities. In the case of unproductive entrepreneurship, institutions create incentives for entrepreneurs to ignore the formal institutional framework either due to its weak enforceability or expropriation power that reduces value of gains from trade and therefore drives people out of formal arrangements (Sautet, 2005).

The failure of microfinance to induce socially productive enterprise lies in the documented lack of good quality institutions, a problem known to exist consistently in low-income areas. Low-income countries, where microfinance schemes are most popular do not have institutions that can shoulder large scale investments (Boettke *et al.*, 2008) or incubate and grow small-scale enterprises to a large scale. Due to their lack of institutions to enforce contracts or secure property rights, both of which favorably affect productive entrepreneurship, low-income countries do not realize gains from specialization and trade and can only support small-scale short-term investments. Hence it is not surprising that a large proportion of capital is used for small and unproductive enterprise. In African countries for instance, existing political and economic institutions create poor interlocking economic and political incentives; and markets are at best dysfunctional (Acemoglu and Robinson, 2010). Romania, where microfinance funding is common, has issues like legal uncertainty, rent seeking and black markets which prevent successful productive entrepreneurship (Sautet, 2005), even in the existence of capital.

Entrepreneurship is largely spurred by the presence of profit opportunities (Boettke and Coyne, 2009), which is decided by the institutional context. Often, microenterprise entrepreneurship in poor countries is driven by exclusion from other forms of employment leading to the creation of suboptimal ventures amidst inconducive environments. Because institutions in low-income countries do not provide stable rules or their enforcement to their citizens, subsistence entrepreneurship is often further reinforced.

The tendency for entrepreneurs to operate in the informal sector, which contributes to low productivity and less successful enterprise and has been associated with microenterprises (Williams and Vorley, 2017). For instance, Williams and Shahid (2016) find that 62 percent of entrepreneurs interviewed in Pakistan, a country with a substantial microfinance presence, operate wholly informal enterprises. There additionally exist issues with lack of education and market information in low-income countries due to the bureaucratic set up of institutions. Because individuals who are not yet self-employed do not tend to have knowledge of market opportunities; they may be unaware of the obstacles of financing (Sautet, 2005), and may misperceive the profitability of their expected venture.

In the cases where this is taken into account and business training is given to clients of microfinance, positive gains have been realized from trade and increase in profits incurred in some instances. However, operating costs increase for each additional service microfinance institutions perform, further leading to the introduction of short term, subsistence ventures that do not produce positive value to both the individual and society. Because microfinance is often presented as an easy way to get out of poverty, especially in places where people are facing desperate circumstances, other necessary factors like knowledge or existence of complementary institutions supporting entrepreneurship are not considered in one's decision to venture in a business startup.

Generally, the poor face a lot of obstacles, and while each development program introduced has the potential to lessen their burden (including microfinance), it becomes crucial to place microfinance services in their respective institutional contexts. Especially since it has been found that services to augment microfinance loan lead to loan effectiveness, there are complementary services microfinance institutions can provide to the poor to complement the lack of quality formal institutions. For instance, where individuals lack the most necessities loans should be emphasized on consumption expansion (which would later indirectly induce entrepreneurship). Repayment rates or loan terms can be made flexible to encourage low-income individuals in engaging in illiquid high returns projects (Field *et al.*, 2013) and long-term investments (Sandven and Thormodsen, 2012).

Less restrictive regulatory frameworks for microfinance institutions could induce microfinance growth and sustainability, increase access to funding reduce interest rates and allow for tailoring services to local demand and further widening overall impact especially among non-entrepreneurs mainly seeking income smoothing (Morduch, 2016). Additionally governments and microfinance institutions could work on expanding payment systems to previously unbanked populations (it reduces costs, connects more people to national and international payment systems and allows for more effective interpersonal exchange risk sharing across space and time) and also improving efficiency of the process of accessing to credit by replacing political connection with competition thereby channeling resources to the most credit worthy enterprise (Beck, 2016).

Certain microfinance methodologies, like the village banking model has been found to have the highest productivity and efficiency ratios leading to low cost per borrower's ration and therefore can be encouraged among the poorest clients. Micro credit institutions could also innovate more; discovering lending models that match more closely to cash flow needs of borrowers may prove more transformative (Banerjee *et al.*, 2015). Policy makers could concentrate on issues of responsible and ethical finance by concentrating on consumer protection and consumer financial education where over indebtedness is a possible risk, and microfinance institutions should perform training and including policies and procedures to manage their social performance (Tomilova *et al.*, 2011). Client training and provision of technology and information, skills and knowledge are important in improving loan effectiveness among latent entrepreneurs (Ferdousi, 2015). Microfinance institutions can moreover utilize mobile banking to facilitate loan payments, reach new customers and grow faster, especially those struggling with high operation costs (Kabir *et al.*, 2010) to effectively reduce costs and offer low interest rates.

5. Linking foreign aid and microfinance

The analysis in the previous sections provides a link between entrepreneurship and institutional settings more generally and then between the type of entrepreneurship generated under different institutional settings. It was argued that the success of microfinance has been localized and cannot be classified as having generated economic growth. This line of reasoning is similar to that advanced by critics of foreign aid (Easterly, 2009; Skarbek and Leeson, 2009) wherein the smaller and visible impact of foreign aid is compared to its larger failure to generate economic growth.

While foreign aid and microfinance do not share the same channels of operation or even have the same origins, both are aimed at helping and alleviating poverty in developing countries through a transfer of resources or providing access to credit. Williamson (2010) focuses on the role of incentives and information in foreign aid to provide reasons for its failure to generate economic growth. She argues that the recipient governments of foreign aid as well as donors face poor incentives when it comes to accountability as well as monitoring of the donations made. Additionally, the appropriate information and knowledge necessary to effectively disburse as well as invest in the most valuable projects in unlikely to be available to those in possession of the funding. Easterly (2001, 2007, 2008) provides similar arguments about the failure of official development assistance and the need for humility and better understanding of institutional change that promotes economic growth. Bauer (2000) and Leeson (2008) stress the role of private property in economic development and argue that contrary to popular belief, foreign aid does little to help recipient countries and may even retard the process of economic growth through deteriorating institutions.

The channels of microfinance as discussed above are different, the main purpose being to foster small-scale entrepreneurship directly through increased access to micro credit loans for the poor. One could argue that microfinance is more embedded and involved at the micro level of communities and towns in developing countries, thus escaping the poor incentives faced by potentially corrupt recipient governments. Additionally, microfinance is typically deployed using the self-enforcing mechanism of reputational collateral as opposed to donor monitoring. Yet, the goal of fostering entrepreneurship creates the importance of supporting institutions such as private property and rule of law that is much more salient in the case of microfinance, not less. This link between quality of entrepreneurship fostered and quality of institutional setting is provided by Baumol's (1968) theory as discussed above.

Hence, as far as the stated end goals of both microfinance and foreign aid are to foster economic growth in recipient communities and countries, the missing link of appropriate institutional settings that have been known to foster economic growth in wealthy countries allows us to link the two policy measures. Further research that delves into the broader failure of microfinance using institutional economics as an analytical lens is very likely to yield insightful research.

6. Conclusion

Generally, differences in economic outcomes do not convey differences in the presence of entrepreneurial spirit or presence of capital, but rather differences in institutions that shape and constrain entrepreneurial opportunities available (Boettke and Coyne, 2009). Baumol's (1968) theory implies that good institutions foster productive entrepreneurship while minimizing unproductive entrepreneurship. Microfinance therefore will require institutional change to make a transformative impact in inducing productive entrepreneurship. The presence of capital even though one of the determinants of development does not ultimately affect the presence of profit opportunities.

With low quality institutions, productive activities will not appear profitable, and microfinance will continue to fund subsistence entrepreneurship while keeping clients in poverty. Policy should be geared toward removing factors hampering productive entrepreneurship where capital is accessible; that is strengthening property rights, softening credit laws and regulations, overall promoting both economic and political freedom to encourage for profit entrepreneurship which ultimately creates societal value.

This paper argued for broadening the theoretical discussion on microfinance, its impact and its failure to generate long-term economic growth. By explicitly including the literature on new institutional economics as well as viewing microfinance through the lens of unproductive entrepreneurship, a framework that allows for understanding both small and localized success as well as broader failure is created. It was also argued that this line of reasoning is like recent criticisms of foreign aid and official development assistance. Though microfinance and foreign aid operate through different channels and have different origins, both must grapple with the fundamental issues of solving the economic problem and generating productive entrepreneurship that must begin with a focus on the underlying institutional setting. Future policy making endeavors concerned with understanding the muted success of microfinance could benefit from taking these broader factors into consideration.

Note

1. The literature review is based on a comprehensive survey of the empirical literature as it relates to developing countries. Our literature has included several empirical papers documenting actual or lack thereof of microfinance impact in specific regions most of which happen to be African and Asian countries (especially Bangladesh, Nigeria, India and Indonesia). We have further included details on the conditions under which microfinance clients borrow money and conduct their microenterprises to provide a clear picture of economic conditions in small markets of developing nations.

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Corresponding author
Malavika Nair can be contacted at: mnair@troy.edu