

Authors

Erica Field
Duke University

Rohini Pande
Yale University

John Papp
Research Institute for Compassionate Economics

Jeanette Park

Natalia Rigol
Harvard School of Public Health

Does the Classic Microfinance Model Discourage Entrepreneurship Among the Poor? Experimental Evidence from India

By ERICA FIELD, ROHINI PANDE, JOHN PAPP, AND NATALIA RIGOL*

Do the repayment requirements of the classic microfinance contract inhibit investment in high-return but illiquid business opportunities among the poor? Using a field experiment, we compare the classic contract which requires that repayment begin immediately after loan disbursement to a contract that includes a two-month grace period. The provision of a grace period increased short-run business investment and long-run profits but also default rates. The results, thus, indicate that debt contracts that require early repayment discourage illiquid risky investment and thereby limit the potential impact of microfinance on microenterprise growth and household poverty.

Lending to entrepreneurs is a risky proposition in the best of cases. In developing countries, where borrowers often do not have collateral to seize in the event of a default, this risk is even higher. Somehow microfinance, which has expanded rapidly from its roots in Bangladesh in the late 1970s (Daley-Harris, 2006), has structured debt contracts so as to limit the risk of lending to poor entrepreneurs and for that reason is considered an important tool for helping the poor.¹ Early initiation of repayment is widely considered an important means by which the classic “Grameen model” limits lending risk.² Yet there is growing evidence that microfinance, despite its success in achieving high repayment rates, has had little impact on microenterprise growth and poverty (Banerjee et al., 2009; Karlan and Zinman, 2011; Kabeck and Townsend, 2011). This is particularly surprising given substantial evidence that credit constraints inhibit small business expansion.

* Field: Department of Economics, Duke University 113 Social Sciences Building, Box 90087 Durham, NC 27708 (email: field@duke.edu); Pande: Bernard Research School, Harvard University, Alston 46, 79 JFK St., Cambridge, MA 02138 (email:rohinipande@harvard.edu); Papp: (Highbridge Capital Management), 40 West 57 St., New York, NY 10019 (email:johnpapp@nyu.edu); Rigol: Department of Economics, MIT, 80 Memorial Drive, Cambridge MA 02139(email: nrigol@mit.edu). We thank Ramkishan Datta, Shantanu Mukherjee and Arup Ray for expert field work, the Village Financial Services (formerly known as Village Welfare Society) and Center for MicroFinance for hosting the study and Heather Joshi at MIT for exceptional research assistance. Thomas Chen, Anne Datta, Sachinjit Dhar and Justin Oliver generously enabled this work. We thank ICDI Foundation, the Eileen-Mohr Foundation, the International Growth Center and the South Asia Initiative at Harvard for funding. We thank Arjun Banerjee, Tim Besley, Dominik Legnitz, numerous workshop participants, three anonymous referees and the editor for comments.

¹ The importance of microfinance as a tool for helping the poor was recognized in 2006 when Muhammad Yunus and the Grameen Bank were awarded the Nobel Peace Prize.

² In 2006, microfinance institutions had an estimated 130-150 million borrowers worldwide and outstanding loans exceeded \$43 billion (Grameen, 2006).

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