

**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.<sup>1</sup> Early initiation of repayment is widely considered an important means by which the classic “Grameen model” limits lending risk.<sup>2</sup> 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; Kabecki and Townsend, 2011). This is particularly surprising given substantial evidence that credit constraints inhibit small business expansion.

\* Field, Department of Economics, Duke University 213 Social Sciences Building, Box 9007 Durham, NC 27708 (ericaf@duke.edu); Pande, Bernard H. Weisbach School, Harvard University, 380 Divinity Ave., 79 JFK St., Cambridge, MA 02138 (pandeh@fas.harvard.edu); Papp, RightEdge Capital Management, 40 West 57 St., New York, NY 10019 (john@rightedgepp.com); Rigol, Department of Economics, MIT, 33 Memorial Drive, Cambridge, MA 02139 (nrigol@mit.edu). We thank Eswarath Datta, Shantanu Mukherjee and Anup Roy for superb field work, the Village Financial Services (formerly known as Village Wellspring Society) and Center for MicroFinance for hosting this study and Western Assets for field logistics and research assistance. Thomas Chen, Susan Datta, Sachinjit Dhillon and Justin Oliver generously enabled this work. We thank ICICI Foundation, the Ecom-Model Foundation, the International Growth Center and the South Asia Initiative at Harvard for funding. We thank Arjun Banerjee, Tim Besley, Daron Acemoglu, numerous research participants, three anonymous referees and the editor for comments.

<sup>1</sup>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.

<sup>2</sup>In 2008, microfinance institutions had an estimated 130-150 million borrowers worldwide and outstanding loans exceeded \$43 billion (Grameen, 2008).

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