MICROFINANCE FOR RURAL ENTREPREURSHIP: THEORY AND ISSUES

By Joy M. Kiiru[1]

Abstract

Rural development is an important policy issue in the 21st Century. Many interventions have been proposed to make rural households and economies more productive. Recently, there has been a sharp attention towards microfinance and the potential it holds for rural development.

The main objective of this paper is to trigger serious discussions in to the role of entrepreneurship in development. The paper takes a critical look at the theory supporting microfinance and entrepreneurship development vis the practice as witnessed so far. Case studies of the impact of microfinance on household incomes are reviewed to enrich the discussion. The climax of the paper is the question as to how entrepreneurship could be successfully integrated in rural development. In order to trigger discussions; the paper uses a theoretical model for analysis and comes to a conclusion that high concentrations of informal sole proprietorships within a locality may not necessarily be a sign of economic empowerment of the households but rather it could as well indicate a non performing economy.

In conclusion the paper holds that as long as there is a role for financial services in development then there definitely is a role for microfinance in rural development. On the other hand, when and how rural poverty can be reduced through microfinance and entrepreneurship depends among other things on whether the programs address the real constraints faced by the poor in a particular context. Making good use of microfinance in the task of reducing poverty in rural areas requires a good understanding of both its strengths and limitations and recognizing that there could be other policy interventions to complement it (Gulli, 1998).

[1] Lecturer School of Economics, University of Nairobi
Contact emai: joykiiru@yahoo.com

Introduction

The majority of the population in developing countries live in rural areas where they derive their livelihoods mainly from subsistence agriculture. Over the years the subsistence agriculture sector has continued to suffer declining productivity. The declining agricultural production for small scale farmers has to a large extent been caused by erratic rainfall since most of the subsistence agriculture is rain fed. Even when the rural areas of developing countries receive a reasonable amount of rainfall, peasant farmers who are the majority still suffer low yields and post harvest losses due to several factors including lack of proper or non utilization of farm inputs and poor preservation and storage. Declining agricultural production and loss of post harvest yields has serious implication on welfare not only in terms of food insecurity but also in terms of lost incomes and thus contributing to poverty.

Given the current circumstances, many households are diversifying their livelihoods by venturing in to such activities as entrepreneurship besides agriculture. Access to credit is therefore deemed very important in order for rural households to access farm inputs, improved technology and financial capital.

Since the 1960s and 70s, there have been policies to integrate microfinance in the rural development process. These policies focused on the provision of agricultural credit as a necessary support to the introduction of new, more productive agricultural technologies that would ensure that farmers improve their output (Moll 2005). Recently from mid 70s and 80s, the provision of microcredit and microfinance has broadened to include individuals involved in both small and micro- enterprises besides agricultural activity.

2. The Potential for Microfinance in Fighting Rural Poverty

Rural households in many developing countries are hypothesized to be trapped in a vicious cycle of poverty. The following figure demonstrates this cycle:

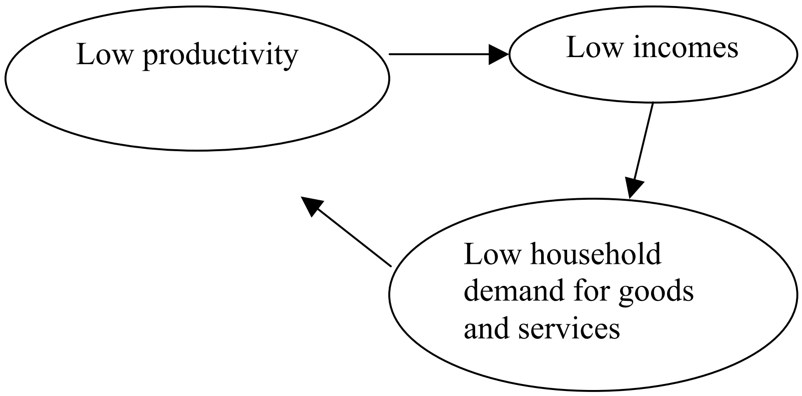

Figure 1: Rural households are held up in a vicious cycle of poverty
Adapted with modification from Kiiru 2007

Productivity is a function of several factors and may also be constrained by household liquidity. Economists argue that to break the vicious cycle of poverty, there needs to be an outside force that will shock the cycle to improve household demand for goods and services, and there by improve productivity. Theoretically, microfinance has the potential not only to break the vicious chain of poverty by injecting liquidity, but also to initiate a whole new cycle of virtuous spirals of self enforcing economic empowerment that lead to increased household well-being. Figure two illustrates the potential for microfinance.

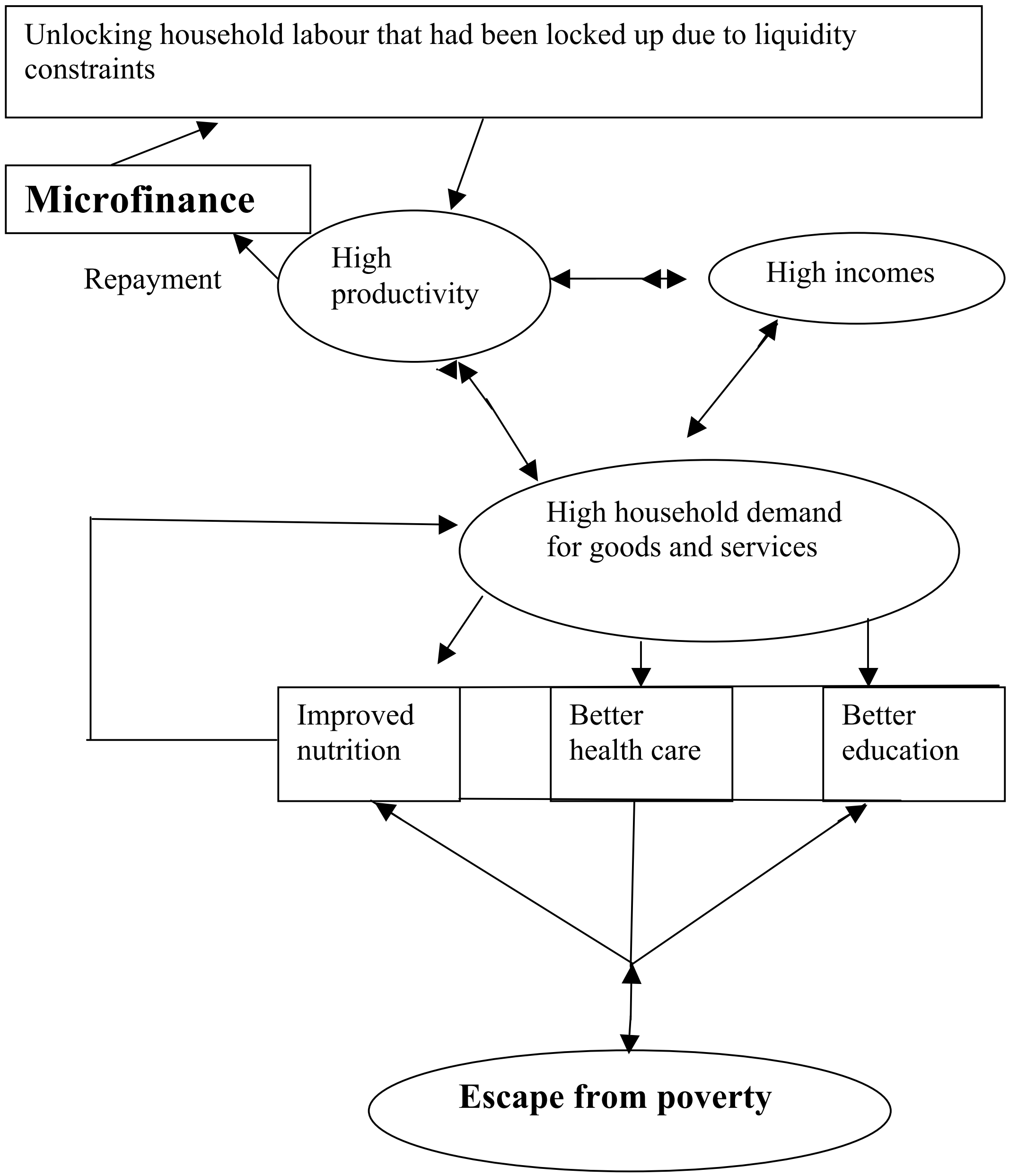

Figure 2: The potential for microfinance
Source: Kiiru 2007

This is the model that has been used to show what microfinance can contribute to rural development. Just like any other model there are assumptions behind this model. Two of the key assumptions are; that finance is one of the greatest challenges facing rural entrepreneurship and second; that there already exists a market for the goods and services produced through the rural enterprises. If any of the assumptions is violated, then the whole potential for microfinance stands to be compromised.

3. Affordability of Microfinance by the Rural Poor

Diminishing marginal returns to capital in relation to production could shed some light on the expected returns to capital for different sized enterprises. Given the concavity of the production function, we expect that smaller enterprises (in terms of capitalization) are able to earn higher marginal returns from an extra unit of capital invested than larger enterprises. See figure 3. Smaller entrepreneurs should therefore be willing to pay higher interest rate per extra unit of capital than larger entrepreneurs. These theoretical facts are some of the reasons behind the high interest rates charged by microfinance institutions. They also provide a rational case for the removal of usury rules in order to allow the setting of interest rates that reflect not only the ability to pay but also the risk of dealing with poorer borrowers.

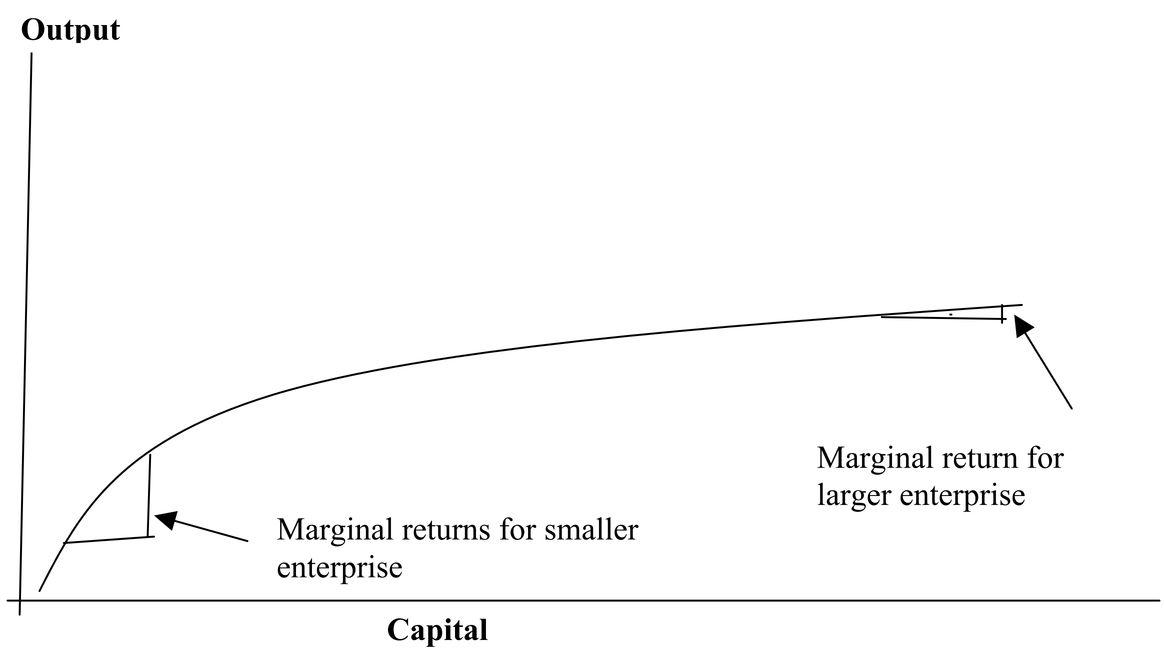

Figure 3: Marginal returns to capital with concave production function. Adapted with some modification from De Aghion and Morduch (2005)

Theoretically, the ability of poorer rural entrepreneurs to pay higher interest rates per unit of capital *ceteris paribus* is therefore unquestionable. If this were the case, then it would be logical to expect that banks would naturally lend to these groups of entrepreneurs not only out of social concerns but also out of the good business prospects.

However, the reality of the matter is that poor entrepreneurs have for a long time been isolated by formal credit institutions. The common perception of poor micro entrepreneurs is that they are risky and too costly to lend to. De Aghion and Morduch (2005) argue that the problems of lending to the poor has been aggravated by information asymmetries, and usury laws such that banks can not use appropriate interest rates to compensate for the risks and higher costs.

4. Past Efforts by Governments to Facilitate Credit Access by Rural Farmers

The idea that financial structure and output determination are interrelated can be traced to the earliest work in financial sector-economic growth done by Schumpeter (1959) who argued that financial services are paramount in promoting economic growth. When low income economies attempted to develop their economies after World War II, rural finance emerged as a big concern. Large state agricultural banks were given the responsibility of allocating funds with the hope that by availing subsidized credit, farmers would be induced to irrigate, apply fertilizers and adopt new crop varieties and technologies. The aim was to increase land productivity, increase labor demand and there by increase agricultural wages (Armendariz de Aghion and Morduch 2005).

This was the early micro credit practice which was a reaction to sound theory that in order to improve output, farmers needed credit. Since the farmers were generally poor, the credit had to be offered at below market rates. Besides subsidizing credit, governments also operated on well thought plans of capital allocation in order to deliberately target specific groups of borrowers (Aghion and Morduch 2005). For example, India's Integrated Rural Development program tried to allocate credit according to social targets, where by 30 % of loans targeted members from a scheduled tribe or caste and another 30 % targeted women. Heavy subsidies were deployed by governments to compensate banks for entering in to markets where they feared taking huge losses due to high transactions costs and inherent risks.

5. The Consequences of subsidized Credit

Providing loans below the market rates is in essence a distortion to the markets. Interest rates are ideally a way of credit rationing such that only those with viable projects are the ones willing to pay for it. Given subsidies the cost of credit is driven below market rates and the rationing is likely to break down creating an excess demand for loans. When interest rates are not allowed to reflect the costs of financial intermediation due to government subsidies, wealth and political power are likely to replace profitability as the basis of loan allocation (Aghion and Morduch 2005) and this did happen in many states. Many writers argue that even with subsidized credit, the poor rural small scale farmers were excluded from the credit markets (Morduch 2000). The end result was high costs of state backed banks and little benefit for the indented beneficiaries (Khandker *et al* 1993).

Diverting loans to wealthier persons may not have been necessarily a bad thing to do. From efficiency point of view, efficiency is only achieved if loans are given to those who can invest them wisely and get the most returns out of them. It is not efficient to give loans to simply anybody based on their socio economic background, because then returns from investments may not be maximized. In reality, the major problems with the state backed programmes arose because of the political nature that surrounded them. Many borrowers especially the rich and well politically connected individuals defaulted and soon most borrowers were defaulting. This led to pressure that government forgive the loans especially before elections. Braverman and Guasch (1986) conclude that credit default rates in countries within Africa, Middle east, Latin America, South Asia, and South East Asia were between 40 to 95%. The programs either ran out of money or they drained government accounts (Morduch 2000). Not surprising that subsidized credit failed almost universally. Experts argue that the costs of government subsidies were so high that they nearly swamped whatever economic benefits realized: if any (Khandker *et al* 1993).

It could be argued that the failure of subsidized credit hinges on the failure to account for the incentives that arise out of the fungibility of loans and the politics associated with government subsidies that channel direct funds to the citizens. This led to a situation where by rural financial markets were highly distorted creating monopolies and removing market tests (Aghion and Morduch 2005). The general end feeling was that poor rural households would have been better off without the subsidies. McKinnon (1973) argued that government restrictions on the banking system (financial repression) restrain the quality and quantity of investment and therefore they also constrain economic development.

6. The Microfinance Revolution

The real genius in microfinance is the ability to find a suite of techniques in product design and management that solve the fundamental problems of controlling costs, building volume, keeping repayment rates high and preventing fraud while operating with poor people (Roodman and Qureshi 2006).

Perhaps the best known story in microfinance is that of Mohammed Yunus, the founder of the Grameen Bank that has inspired many other microfinance institutions world wide. The Grameen Bank started during the aftermath of the country's war of independence. During this time Bangladesh was plagued by desperate poverty that was made worse by very high birth rates. The economy was still very rural, coupled by a government that was perceived to be weak and corrupt.

In order to deal with the poverty situation, there was a strong preference for non bureaucratic 'grass roots' and other collective approaches. This prompted the formation of self help groups for equally disadvantaged groups in order to pool resources for mutual benefit of the group members. It was in this environment that Muhammad Yunus, an Economics professor at the University of Chittagong, began an experimental research project providing credit to the rural poor of Bangladesh. He began by lending little money from his pocket and realised that it was enough for villagers to run simple business activities like rice husking and bamboo weaving. He later found that borrowers were not only benefiting greatly by accessing the loans but they were also repaying reliably even though they could offer no collateral. Later with the support of the Central Bank of Bangladesh and donor support, that humble experiment developed in to the world's most famous microfinance institution; the Grameen Bank, and institutions that replicate its pioneering methodology world wide. The Grameen Bank today boasts a Nobel Prize, 1,700 branches, 16000 employees, and six million customers of which 96 %

of them are women (Roodman and Qureshi 2006) Over 120 million people currently benefit from the services of over 10,000 microfinance institutions paying interest rates of between 15 and 40 % .

7. Empirical Evidence on the Impact of Microfinance on Household Income

Rigorous empirical analysis on the statistical impact of microfinance began in the 1990s. The results of these studies are highly provocative and sometimes they are in contradiction. There are mainly two schools of thought. The first school questions the relevance of microfinance as a poverty reducing policy. (Adam & Von Pische, 1992) argued that "debt is not an effective tool for helping most poor people to enhance their economic condition be they operators of small farms or micro entrepreneurs". There are other more important constraints that face small agricultural households other than finance. These constrains include product prices, land tenure, technology, market access and risk. Also in support of the same view, Gulli (1998) argues that credit is not always the main constraint for micro enterprises´ growth and development, and that poor people demand a wide range of financial, business development and social services for different business and household purposes. Mayoux (2002) argues that the logical assumption of virtuous spiral[2] of economic empowerment to the household due to microfinance does not in reality exist. This is particularly so given that there exists gender relations in society in relation to loan uses; a scenario that more often that not leaves poor women borrowers highly indebted, and not much wealth to show for it (Mayoux 2002).

Rigorous studies have shown that micro entrepreneurs below the poverty line experience lower percentage income increases after borrowing than those above the poverty line. Studies have also demonstrated that households below the poverty line tend to use the loans for consumption purposes to a greater extent than households above the poverty line; thus their income should be expected to increase less (Gulli 1998).

On the other hand, there exists another school of thought that argues that microfinance is quite relevant for poverty reduction. Khandker (2006) argues that microfinance is

[2] Virtuous spiral of economic well being refer to the positive chain of economic wellbeing that is assumed to originate from access to credit by a poor household. For example, access to micro credit may lead to micro entrepreneurship, leading to increase in household income, leading to increased household demand for goods and services and the alleviation of poverty.

relevant to poverty reduction not just for the beneficiaries but also there are positive spill over effects to the rest of the community. In his study Khandker (2006) uses a panel household survey from Bangladesh and observes that access to microfinance contributes to poverty reduction, especially for female participants, and to the overall poverty reduction at the village level. Pitt and Khandker (1998) find, using data from three programs in rural Bangladesh, that borrowing from group-lending schemes increased consumption of poor households. However, Morduch 1998b has argues that Pitt and Khandker's result reflect program selection effects rather than the impact of borrowing per se.

Morduch (1999) argues that microfinance has had positive impact on poverty reduction. However he is keen to add that "Even in the best of circumstances, credit from microfinance programs helps fund self employment activities that most often supplement income for borrowers rather than drive fundamental shifts in employment patterns. It (microfinance) rarely generates new jobs for others and success has been especially limited in regions with highly seasonal income patterns and low population densities (Morduch 1999)".

Other studies have reported mixed results suggesting the possibility of both positive and negative impacts for different households. Coleman (2006) found that microfinance programs have a positive impact on the richer households but the impact is insignificant to the other poorer households. In Coleman's (2006) study, richer households were able to commandeer larger loans to themselves because they sat in influential positions in the village banks as committee members. Coleman (2006) argued that it is the size of loans that households were able to acquire that was very important in determining the impact of those loans in household incomes. According to Coleman (2006), many poor women borrowers dropped out of the borrowing programs citing the size of loans as too small to make any significant investments that could significantly improve their incomes. In his study of Bolivia's Bancosol, Mosley (1996) reports that in any given cohort roughly 25 % showed spectacular gains to borrowing , 60-65% stayed about the same, and 10 to 15% went bankrupt (Mosley 1996). Kiriti, (2005) found that microfinance tend to indebt too poor women leaving them more vulnerable and exposed. In the study, Kiriti (2005) concentrates on the impact of microfinance repayment on household assets. The findings are that microfinance for the poor had a negative impact on household assets in that households depleted livelihood assets in the course of loan repayment since the income generating activities were not raising enough profits to repay the loans on time.

Aghion and Morduch 2005, observe that microfinance can make a real difference in the lives of those served, but microfinance is neither a panacea nor a magic bullet against poverty, and it can not be expected to work every where and for every one. Much as there have been mixed statistical impacts of microfinance, there also has been no widely acclaimed study that robustly shows strong impacts, but many studies suggest the possibility of good welfare impact (Aghion and Morduch 2005). More research should therefore be directed towards not just specific results but also the context within which particular results are expected. The results obtained in a given socio cultural and economic context may not necessarily hold if the socio cultural and economic conditions were varied.

8. Rethinking Entrepreneurship and Rural Development

The question we pose at this point is: Is persistent increase in informal micro entrepreneurship in the rural areas a good sigh of the economic empowerment of the households?[3] This question may not necessarily have an obvious simple answer like yes or no. One position could be that, as long as micro entrepreneurs create new businesses and new businesses in turn create jobs and intensify competition, and may even increase productivity through technological change; then high numbers of informal micro enterprises in the rural areas will thus translate into high levels of economic well being (Acs 2006). However, the reality about persistent high levels of informal sole proprietorship in the rural areas and what it would theoretically imply in terms of economic well being could be much more complicated; at least in theory.

In a strictly theoretical analysis it is possible to distinguish three major stages in transforming rural economies in developing countries from poverty stricken to relatively better off with the intervention of micro entrepreneurships. Initially, the households engage in subsistence farming, spending most of their expenditures on food. Sachs,

[3] In modeling this rural economy I was greatly inspired by the works of ACS (2006) where he models entrepreneurship and economic growth.

(2005) observes that "farm households in the rural sector live pretty much in economic isolation. There are no roads within the villages, and there is no electricity. Households are mainly subsistence farmers consuming most of what they produce and commercial activity in the village is very low". The first stage of a rural setting in a developing country is thus characterized by disease, hunger and general poverty.

If microfinance was to be used as poverty intervention policy, each household chooses whether or not to participate in the programmes depending on utility preferences. They participate if the utility of participation exceeds the utility of not participating

Theoretically, real income improvements due to micro entrepreneurships will be realized depending on whether the following preconditions are met.

(i) There is entrepreneurship capability within the household,

(ii) There must be at least some reasonable infrastructure facilitating easy inter-village and inter shopping-centre movements in order to improve local demand and provide a market for locally produced goods and services. Overall there must be adequate demand for goods and services produced by the informal micro entrepreneurships.

(iii) The rate of return from micro enterprise investments must be greater than the rate of loan repayment.

If the above conditions hold, it is rational to expect that *ceteris paribus* there is going to be enterprise growth. If enterprises are growing then we expect decreasing rates of informal micro sole-proprietorships. There are reasons to expect that entrepreneurial activity in terms of number of enterprises should decrease as rural economies pick up. One of the reasons is that individuals have different endowments of managerial ability. This implies that as the rural economy expands, the average enterprise size should increase as better managers run enterprises (Acs 2006). Average enterprise size is an increasing function of the wealth of the rural economy if capital and labor substitute. When capital and labor are substitutes, an increase in the capital stock increases the returns from working and decreases the returns from managing. In other words, marginal managers find they can earn more money while being employed by somebody else (Acs 2006). Overall we expect that, as the rural economy becomes wealthier, with lower absolute poverty incidences then it is expected that the rate of people starting informal micro sole proprietorship decreases. This would imply that the number of informal micro sole entrepreneurships would decrease with time.

The discussion so far is in favor that “high concentrations of informal entrepreneurships within a locality may not necessarily be a sign of economic empowerment of the households but rather it could as well indicate a non performing economy, or that that there are many bottleneck to the formalisation of enterprises. This conclusion is similar to that drawn by Acs 2006.

It is imperative for policy makers to distinguish when households are using micro-sole proprietorships to “adapt to poverty” as opposed to escaping poverty. This discussion was mainly intended to provoke empirical research in to the issues of rural development and the role of microfinance. Research has to focus more in finding an effective and sustainable mix of policies that could work to alleviate rural poverty.

CONCLUSION

This paper has discussed both theoretical and empirical issues surrounding microfinance and rural development. As long as there is a role for financial services in development then there definitely is a role for microfinance in rural development. When and how rural poverty can be reduced through microfinance depends among other things on whether microfinance programs address the real constraints faced by the poor in a certain context. Making good use of microfinance in the task of reducing poverty requires understanding both its strengths and limitations and recognizing that there could be other policy interventions to complement it (Gulli, 1998).

References

Acs, Z. (2006): How Is Entrepreneurship Good for Economic Growth? *Journal of innovations Technology / governance / Globalization* Vol 01 (01) page 97-107

Adams, D., Graham, D., and Von Pischke, D. (1984). *Undermining Rural Development with Cheap Credit.* Boulder, Colorado: Westview Press.

Adam, D., & Von Piscke, J D. (1992). Microenterprise Credit programmes: deja Vu. *World Development,* 20, 1463-1470.

Aghion, and Morduch, J. (2005): The Economics of Microfinance, The MIT Press Cabridge, Massachussets London, England.

Braverman, A. Guasch, L. (1986): Rural Credit Markets and Institutions in Developing Countries: Lessons for Policy Analysis from practice and modern Theory. *World Development* Vol. 14, Issue (October November) pg. 1253-1267.

Coleman, B. (1999): The Impact of Group Lending in Northeast Thailand. *Journal of Development Economics 60*: 105-142.

Coleman, B. (2006): Microfinance in North East Thailand: Who Benefits and How Much? *World Development* Vol. 34, (9) pp 1612-1638.

Gulli, H. (1998): Microfinance and Poverty, Questioning the Conventional Wisdom. Inter American Development Bank, Washington, Dc.

Hulme, D., & Mosley,P. (1996). Finance Against Poverty. London: Routledge.

Khandker, S., Zhan, Z., and Khalily, B. (1993): Sustainability of Government Targeted Credit Program: Evidence from Bangladesh: World Bank Discussion Papers, No. 316.

Khandker, S. (2003): Microfinance and Poverty: Evidence Using Panel Data from Bangladesh: World Bank Policy Research Working Paper 2945, January.

Khandker, S. (2006): Microfinance and Poverty: Evidence Using Panel Data from Bangladesh: *World Bank Economic Review*: 19, 263-286.

Kiiru, J. (2007): The Impact of Microfinance on Rural Poor Households' Income and Vulnerability to Poverty: Case study of Makueni District, Kenya. PhD Dissertation; Bonn University, Faculty of Agriculture. http://hss.ulb.uni-bonn.de/diss_online

Kiriti-Nganga, T. W. (2007), Micro-Finance and Poverty Alleviation: How Effective is it in Alleviating Gender Based Poverty? In Clem Tisdell (ed.). Poverty, Poverty Alleviation and Social Disadvantage: Analysis, Case Studies and Policies. Serials Publications, New Delhi.

Mayoux, L. (2002): "Womens Empowerment or feminization of Debt? Towards a new Agenda in African Microfinance". Report Based on a One World Action Conference, London March 2002.

Mckinnon, R. (1973): Money and Capital in Economic Development. Washington, Dc: The Brookings Institution.

Moll, H., (2005) Microfinance and Rural Development: A long term perspective: *Journal of microfinance,* Vol. 7 (2) pg 13 -23.

Morduch, J. (1999): The Microfinance Promise *Journal of Economic Literature:* Vol XXXVII Pp. 1569-1614.

Morduch, J. (1999): Does Microfiance Really help the Poor? New Evidence from Flagship Programs in Bangladesh. Mimeo, Princeton: Princeton University.

Morduch, J. (2000): The Microfinance Schism, *World Development* Vol. 28, No.4, pp. 617-629

Pitt, M. and Khandker, S. (1998): The Impact of Group Based programs on Poor Households in Bangladesh: Does the Gender of Participants matter? *Journal of Political Economy Vol.* 106 No. 6, Pg 958-996

Roodman, D. and Qureshi, U. (2006), Microfinance as Business, Centre for Global Development Working paper No. 101, Washington DC.
Sachs, J. (2005): The end of Poverty: Economic Possibilities for our Time. The Penguin

Press-USA.

Schumpeter, A. (1959): The Theory of Economic Development. Cambridge: Harvard University Press