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Microcredit and Business-Training Programs: Effective Strategies for Micro- and Small Enterprise Growth?

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The World Bank's most recent *Global Financial Development Report* (World Bank 2013) has once again stressed lack of both financial capital and business-related knowledge as key impediments to firm growth in developing countries. Yet, the most popular instruments to relax these constraints are largely unsuccessful in spurring firm growth.

Analysis

Most people in developing countries are employed in micro- and small enterprises. Therefore, promoting these firms by providing access to financial capital and basic managerial skills through microcredit and business-training programs has been considered a matter of common sense among experts. However, recent empirical results unambiguously show that these programs are no panacea for poor enterprise development and growth.

- Many firms have limited access to financial capital, and many owners lack basic managerial skills. These deficits have been frequently assumed to be major impediments to firm growth in developing countries.
- Microcredit and business-training programs are the most widely used strategies to promote enterprise development. Findings from recent empirical impact evaluation studies suggest that these programs are insufficient to trigger firm growth or job creation.
- The empirical studies have some limitations, and it remains largely unclear what types of entrepreneurs these programs work best for and why these programs seem to have largely failed to improve business performance.
- Amendments in key design features of these programs and the development of screening tools to identify and target high-potential entrepreneurs might help improve their effectiveness.
- Yet, the results show that microcredit and business-training courses are no panacea for stagnant enterprise development everywhere and call for a stronger emphasis on a holistic strategy mix that takes into account context-specific interrelations among different binding constraints.

Keywords: micro- and small enterprises, firm growth, managerial skills, microfinance

Micro- and Small Enterprises in Developing Countries

Entrepreneurship plays a fundamental role in economic development. Entrepreneurs create jobs and implement new ideas, or adapt existing ideas to local contexts, and hence crucially contribute to productivity enhancement and overall economic growth. In the developing world, self-employed entrepreneurs are estimated to make up approximately one-third of the nonagricultural labor force. The overwhelming majority of these entrepreneurs, most operating in the informal sector, run micro-sized enterprises (up to 10 employees); the rest are considered small-sized (11–100 employees). In low-income countries, for example, the contribution of micro- and small enterprises (MSEs) to employment amounts to 59 percent on average, but reaches well above 80 percent in countries such as Angola, Burundi and Niger (World Bank 2013). Therefore, MSEs constitute a major source of employment, income creation and output in developing countries.

At least until the late 1980s, micro- and small-scale activities in developing countries were mainly regarded as unproductive subsistence activities that would eventually be absorbed by the modern sector in the course of economic development. However, research conducted in the last decade has revealed that MSEs are much more diverse than posited by these conventional views on structural change, not only in terms of activities and size but also with respect to profitability, factor endowments and productivity. For example, a consistent finding reported across various countries is that a considerable share of MSEs are able to generate very high marginal returns on investments in physical capital (see, for instance, de Mel et al. 2008; Grimm et al. 2012). Hence, it appears that subsistence-oriented MSEs operating at the breadline coexist alongside high-performing firms with substantial growth potential. However, MSE growth is heterogeneous across and within countries, and many of these firms, particularly in low-income countries, fail to accumulate capital, generate sufficient employment and raise productivity. Given the high relevance of MSEs in these countries, a key question academics and practitioners alike are concerned with is what main constraints need to be alleviated in order to spur MSE growth and productivity.

MSEs in developing countries face a plethora of obstacles to business development. Many have insufficient access to finance, lack basic business-related skills, face narrow markets and are poorly integrated into national or international value chains. They typically operate in fragile environments characterized by underdeveloped physical infrastructure, political and macroeconomic uncertainties, and high levels of corruption and other institutional deficits. Among these constraints, lack of access to finance and deficient managerial skills have received by far the most attention in the contemporary academic and policy debate about MSE promotion. Indeed, many experts consider lack of access to financial capital one of the most fundamental barriers to firm growth and poverty alleviation; expanding access to finance has become a key component of development strategies worldwide. There is also an increasing recognition that "managerial capital" is another form of missing capital that may impede firm growth. Over the last five years, scholars have begun to rigorously evaluate the impact of strategies that aim to relax financial and business-skill constraints. The results suggest that these strategies are largely insufficient to spur firm growth.

The following note argues that many MSE owners do indeed lack access to capital and managerial skills and that both deficiencies can be crucial determinants of firm development. We review the main findings of the most recent empirical studies that evaluate strategies to promote enterprise development and go on to discuss their limitations along with possible ways to improve the effectiveness of these strategies. We conclude that the current strategies are no panacea for the absence of enterprise growth.

Many MSEs Lack Managerial Skills and Access to Financial Capital

A large part of the world's poor has only insufficient access to formal sources of finance, and the prevalence of capital market imperfections and resulting lack of access to financial capital has been frequently stressed as a major (if not the main) impediment to firm growth in developing countries. For example, the World Bank informal enterprise surveys reveal that lack of access to finance is perceived to be the most pressing obstacle that small firms in developing countries face (World

Bank 2013). MSEs typically lack sufficient collateral or personal guarantors to pledge against formal loans, or they are unfamiliar with the bureaucratic procedures. Capital market imperfections result from information asymmetries between lenders and borrowers and from a lack of enforcement mechanisms. Financial capital is the catalyst for firm expansion. Hence, insufficient access to it is evidently harmful to overall economic growth. Financial constraints slow capital accumulation, impede productivity improvements and increase the time it takes entrepreneurs to reach their potentials.

A couple of academic studies report high returns on grants of cash or in-kind capital among microenterprise owners in developing countries that are typically well above prevailing market interest rates. Cash transfers can spur investments only in the presence of market distortions and financial constraints: if capital markets worked perfectly and access to finance was not restricted, firm owners would be able to borrow money at a given interest rate until the marginal return on capital became equal to the interest rate, and cash transfers would not have any effect. Probably the most prominent contribution in this vein is the study by de Mel et al. (2008). The authors conducted a randomized experiment with a sample of Sri Lankan microenterprise owners. Half of their sample received an unconditional cash or in-kind grant of either 100 or 200 USD, while the other half did not receive a grant and hence constituted the control group. These amounts were quite sizeable, equivalent to approximately three to six months' profits from the typical enterprise in their study. The authors of the study report monthly marginal returns on these investments of approximately six percent on average for grant recipients. In other words, an investment of an additional 100 USD generated an extra profit of six dollars per month, or 72 dollars per year! Importantly, it appears that one-off cash injections can have long-lasting effects. De Mel et al. (2012) show that, five years after the intervention, cash recipients had persistently larger profits and higher enterprise survival rates than nonbeneficiaries. High returns on capital have also been reported for MSEs in sub-Saharan Africa and Latin America and have been interpreted as evidence of the presence of binding financial constraints in those regions.

Another potentially important constraint to firm growth and productivity improvements that has (re)gained increasing attention in the current academic literature is the lack of basic managerial skills and knowledge. In the context of MSEs, managerial skills can be understood as basic knowledge about financial planning and one's own market, as well as familiarity with standard business practices such as record-keeping, accounting, inventory management, marketing activities and customer care, among others. Several authors argue that managerial skills can improve the productivity of other firm inputs (see, among many others, Bruhn et al. 2010) and can thus play an important role in firm development. Better managerial skills could encourage the implementation of better business practices, such as regular maintenance of machinery to reduce the failure probability, which would improve the productivity of physical capital. Entrepreneurs with strong managerial skills may also be better able to motivate their workers (Bruhn et al. 2010) and more efficiently coordinate working tasks, which may increase labor productivity.

Many MSE owners in poor countries do not keep business records or even distinguish household funds from business funds, and they are often unaware of basic accounting and marketing practices. The neglect of these practices can strongly affect profitability. For example, a study conducted among Kenyan retailers found that many of them forgo substantial profits due to daily stockouts and missed opportunities to receive discounts for purchasing in bulk, which could have been avoided if the owners had engaged in inventory planning (Kremer et al. 2013). The lack of implementation of basic business practices can also aggravate other binding constraints. A Zambian business survey from 2010, for example, revealed that 73 percent of Zambian MSEs have no access to formal credit due to insufficient business records. There is also ample evidence that many MSE owners have only poor financial knowledge, and often do not properly understand or are unfamiliar with the range of existing financial products and services principally available to them. Yet, a proper understanding of financial products is arguably crucial for selecting the most appropriate investment alternative and minimizing the risk of misinvestment or over-indebtedness.

Evidence from Impact Evaluations of Microcredit and Business-Training Programs

Given the importance of MSEs in developing countries as well as the ample evidence for the lack of financial and managerial capital, expanding access to finance and improving managerial skills have become pillars of development strategies worldwide over the last twenty years. This is reflected in the sharp rise of microfinance institutions since the beginning of the 2000s, which is mainly based on the premise that relaxing financial constraints will spur economic growth and development. Similarly, there is a growing recognition of the importance of financial literacy and business training in order to promote MSE development and financial inclusion in general; indeed, national and international programs have sprung up around the world to provide such training.

In the following, we will present some main findings of recent impact evaluation studies on microcredit programs and business-training courses that challenged these established convictions. Most of these studies are randomized controlled trials that allow for unambiguous causal inference. A major challenge to empirical assessments is the fact that microcredit clients (or business-training attendees) are self-selected and, therefore, may systematically differ from nonclients such that separating the causal effect of microfinance access (business-training attendance) from other aspects that may simultaneously affect firm performance (for instance, ambition or commitment) is difficult (Banerjee et al. 2014). It is argued that the random assignment of individuals to either the "treatment group" (the group provided with training or access to finance) or the "control group" avoids this *selection bias*, by which most earlier empirical studies in this vein were plagued.

Microcredit Programs Do Not Foster Firm Growth or Job Creation

By far the most prominent microfinance instrument is microcredit: small, typically collateral-free loans provided to borrowers who would otherwise have almost no access to finance. The majority of recently conducted randomized experimental studies have mainly focused on the introduction of microcredit in contexts where no such formal financial institutions existed before. Although the empirical basis is still small, it is possible to summarize some initial findings consistently reported in most of these studies:

- First, and somewhat surprisingly, uptake rates tend to be fairly low. For example, Crépon et al. (2013) analyze the impact of a microfinance institution's expansion into hitherto unserved rural areas in Morocco and find that only 13 percent of the population have taken a microloan. Low uptake rates have also been reported for India, Bosnia and Mexico.
- Second, enhanced access to microcredit appears to only slightly increase overall household consumption. However, there is some evidence that access to microcredit may both cause consumption patterns to shift towards productive investments and help some households smooth consumption. One long-term impact evaluation study in India shows that access to finance is positively associated with investments in durable assets and negatively related to the consumption of temptation goods such as alcohol, tobacco and small snacks (Banerjee et al. 2014).
- Third, there is only little, if any, evidence that access to microcredit increases expenditures for healthcare and education. Similarly, and counter to popular narratives, it does not seem to improve female empowerment.
- Fourth, while some studies report that access to formal loans increases self-employment activities, they rarely find proof of long-lasting impacts on business sales, profits or employment creation for the average microcredit client. However, there is some evidence that microcredit can be quite effective in helping already-successful firms to improve their profits. For example, Banerjee et al. (2014) report a doubling in business profits relative to the control group for firms that existed before the expansion of microcredit and further show that this increase is almost exclusively concentrated among firms along the upper tail of the income distribution. A similar observation has been made for an individual microcredit program in the Philippines, where male (but not female) entrepreneurs with high baseline incomes were able to improve firm profits (Karlan and Zinman 2011). However, there, profit improvements were mainly realized by shedding unproductive employees, hence coming at the cost of overall employment.

Business Training Improves Knowledge but Not Key Business Outcomes

Based on the premise that improved financial knowledge and business skills could promote firm development, business-training programs have been provided as a development strategy for more than thirty years. Their ultimate goal is to improve the economic outcomes of the participating businesses. The critical assumption in the causal chain from business-training participation through to the improvement of business outcomes is that the training helps to improve the knowledge of the business owner and results in the adoption of taught practices.[1]

- Most of the experimental studies evaluating business-training courses indeed find that participants' business-related knowledge improves and that they end up implementing at least some of the practices taught. However, pre-training levels of knowledge are usually relatively low, and the magnitude of the impact is often small in absolute terms. It seems that the effectiveness of trainings can considerably depend on the degree of complexity: people attending simplified rule-of-thumb trainings are found to be more likely to adopt taught practices than those participating in traditional business accounting training.
- Only few studies observe increases in sales and profits for training attendees compared to the control group, but in most cases these effects are statistically insignificant or tend to disappear in the long run. Some authors further show that participating in training can help firm owners better respond to periods of low sales and profits, but this observation does not apply across the board. While evidence that profits and sales increase is at best mixed, none of the studies document positive effects on employment creation.
- However, some studies provide evidence that trainings can extend the life of a business and facilitate new start-ups. Yet, this does not necessarily translate to increased employment, since it may represent people simply switching to self-employment from wage work (McKenzie and Woodruff 2013).

1 A comprehensive review of the empirical literature on business trainings is provided in McKenzie and Woodruff (2013).

Limitations of Empirical Studies

The empirical studies summarized above provide initial evidence that better access to finance helps people to smooth consumption (through the expansion of business activities) and to reprioritize expenditures in favor of productive investments. Moreover, people seem to acquire financial knowledge and tend to adopt some of the practices taught during business trainings. Yet, the results also reveal that the overall impact of these strategies on profits is at best small and that they are largely insufficient to spur job creation.

It is important to note, however, that there are some limitations to these studies. First of all, most of them cover a rather short time period and typically rely on a single follow-up survey. Hence, they may fail to capture important effects that require more time to materialize. In addition, many studies rely on relatively small and very heterogeneous samples, features that make it hard to establish statistically significant estimates of sales or profits, which are generally difficult to measure due to reporting errors (recall that most entrepreneurs do not keep books) and substantial, genuine (temporary) variations in profits across and within firms. Hence, it is possible that the actual effects of training courses on profits might be somewhat underestimated.

Small sample sizes and truncated time spans also limit researchers' abilities to examine *heterogeneous treatment effects*: to scrutinize who actually benefits from these strategies and who does not. There is some evidence from India and the Philippines hinting that male entrepreneurs with relatively high incomes (those typically not targeted by microfinance institutions) are more likely to benefit from access to microfinance. Generally, however, relatively little is known about what types of entrepreneurs existing programs work for best. Another limitation is the neglect in current empirical studies of potential *spillover effects*. Spillover effects occur when the provision of business training or financial capital has positive or negative effects on those not attending the training or not receiving finance. Closely related to that is the question of through which channels these strategies affect business outcomes. To stay with the example of business trainings, whether the higher profits or sales achieved by business owners who have received training originate from the MSEs' more efficient use of existing input factors or from taking customers away from other firms constitutes a huge difference in terms of general societal gain (McKenzie and Woodruff 2013).

Avenues for Improving Current Strategies

The current studies do not reveal why standard microcredit and business-training programs seem to have largely failed to trigger firm growth. Some scholars argue that microcredit programs might contain suboptimal design features that could create negative trade-offs and undermine their ultimate goals, and that amendments in their design could help improve their effectiveness.[2] The common observation that many people in developing countries still rely on informal sources of finance – often at interest rates higher than those charged by microfinance institutions – indeed suggests that standard microcredit products might not be adequate for their needs. For example, group liability (a typical component of classic microcredit products) may repel risk-averse individuals not willing to stand bail for their fellow credit group members but who otherwise would greatly benefit from better access to finance. Similarly, the requirement of attending regular meetings, often on a weekly or biweekly basis, and the rigidity of loan sizes might make people reluctant to take loans from microfinance institutes. Moreover, microcredits typically involve regular repayments at short intervals that begin immediately after loan receipt. This may discourage lumpy investments and, more importantly, prevent firm owners from making investments that require a longer period of time before yielding returns. Indeed, recent evidence from India suggests that a grace period could spur business investments and increase profits. Hence, critically evaluating key components of most microcredit programs, like group liability or immediate loan repayments, identifying those that hamper or facilitate success and amending programs accordingly could improve their effectiveness. Whether such improvements would be sufficient to spur firm growth, however, is another story.

Another way of improving the effectiveness of current strategies is to develop screening tools that help identify and target those MSE owners who are particularly likely to have high untapped growth potential. Such attempts could build upon recent attempts in the literature to pinpoint key personal and firm characteristics that are likely to correlate with the probability of being a top-performing MSE. Applying such an approach to seven Western African countries, Grimm et al. (2012) identify, alongside survivalists and top performers, a third segment of firms that possess very similar characteristics to the small minority of top-performing firms (for instance, in terms of educational background, skills, activities, profitability) but operate with substantially lower levels of physical capital. These firms, dubbed *constrained gazelles*, realize very high marginal returns on investments – meaning, they have substantial growth potential – and comprise approximately 20 to 30 percent of all MSEs in these countries. Targeting those firms may be another way to improve the effectiveness of current microfinance programs.

There Is No Panacea for Sluggish Enterprise Development

The rapid expansion of microcredit and business-training courses over the last decade has generated considerable enthusiasm and hope in the development community that these programs may help overcome binding financial and managerial constraints and ultimately spur firm growth. The results of rigorous impact evaluation studies show that these expectations were too high: neither microcredit programs nor business-training courses seem to be effective tools for improving profits and fostering job creation.

The ineffectiveness of these programs does *not* imply that insufficient access to financial capital or missing managerial skills are irrelevant constraints to enterprise development. By contrast, capital constraints in particular are omnipresent in developing countries, and plenty of evidence indicates that sustained firm growth can be obtained only through sufficient access to finance. Yet, the results reviewed herein strongly indicate that there are other pressing obstacles to enterprise development beyond the lack of finance and managerial skills and that these need to be addressed simultaneously. Experts have long acknowledged that MSEs in developing countries face multiple, interrelated constraints. These interrelations need to be better understood. Char-

2 A similar argument might apply to some standard content of business-training courses.

acteristics of the overall structure of the economy, like the size of markets or the depth of value chains, as well as the overall institutional framework, may strongly affect the effectiveness of microfinance strategies and the scope of promoting enterprise development in general. Grimm et al. (2012), for example, find that the rate of necessity-driven firms with low growth potential is particularly high in countries with a poor overall business climate and low rates of employment in both the private formal sector and the public sector. In such contexts, institutional or structural deficits may render strategies that exclusively focus on promoting access to finance and skills largely ineffective.

The promotion of MSEs as a means to improve human and economic development will remain a high priority in development policy and strategy. However, blueprint solutions applied across the board to heterogeneous contexts will not bring us closer to this important goal. Instead, what is warranted is a stronger emphasis on a holistic mix of strategies, one that attempts to understand and address country-specific interrelations among different constraints to firm growth.

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Related GIGA Research

GIGA researchers investigate the opportunities and constraints of micro- and small enterprises in developing countries in the framework of GIGA Research Program 3. This article is part of a short-term consultancy with the GIZ and the research project "Employment, Empowerment and Living Standard," which is being carried out in cooperation with the KfW Development Bank and funded by the Federal Ministry for Economic Cooperation and Development (BMZ).

Related GIGA Publications

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