

Microfinance and Entrepreneurship: An Introduction

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Abstract

As microfinance gains increasing attention and application as a financing mechanism for entrepreneurs at the base of the economic pyramid, this special issue of *International Small Business Journal* aims to enhance scholarly understanding of how microfinance fosters entrepreneurial activity. Microfinance brings a range of financial services, including microcredit loans, savings, and insurance, within the reach of millions and millions of poor households not served by traditional banks. This introduction summarizes the articles in this special issue of *International Small Business Journal* on “Microfinance,” which address a range of topics in this important domain of research and practice.

Introduction

Despite tremendous growth in microfinance services worldwide over the last three decades, the impact of such services on entrepreneurship is not well understood. Indeed, the size of the microfinance industry – in terms of small, unsecured microcredit loans provided to poor households and individuals – is estimated at more than US\$ 80 billion in outstanding loans to more than 90 million clients (Roodman, 2013). In addition, in recent years, the definition of microfinance has expanded to include a broad range of products encompassing insurance, savings, funds transfers, mortgages, and retirement plans for people underserved by traditional banks, primarily in emerging economies (Khavul, 2010). Yet it remains unclear if this huge investment is achieving its primary goal of enabling the poor, many of whom live on less than US\$ 2 per day (Cruz et al., 2015), to start or expand their businesses (Phan, 2009).

This special issue of *International Small Business Journal* aims to enhance the understanding of how microfinance fosters entrepreneurial activity in emerging economies, as a mechanism for economic growth and poverty reduction (Ahlstrom & Ding, 2014; McCloskey, 2016). Although the management literature on microfinance and entrepreneurship is growing (Bruton et al., 2011), and a small number of studies have begun to examine whether and how microfinance contributes to the creation and development of new ventures (Banerjee et al., 2015; Newman et al., 2014; Shahriar et al., 2015), knowledge in this area is still limited. Extant research, primarily in economics, has typically focused on how microfinance lending influences broad development outcomes such as poverty alleviation, rather than looking at its effects on key entrepreneurial outcomes such as new venture creation and growth, performance, and survival (Chliova et al., 2015). This special issue represents a first step to address this key issue, with the goal of seeding future research in this important domain.

Microfinance, poverty, and entrepreneurship

Microfinance has been widely hailed as the solution to abject poverty (United Nations, 2006) ever since its modern development in Bangladesh in the 1970s (Yunus, 1999). In providing access to finance for the so-called unbankables, microfinance aims to bring credit, savings and other financial services within the reach of millions of people too poor to be served by regular banks, often because they are unable to offer sufficient collateral or simply do not have easy access to banks. In this way, microfinance can provide minimal capital for the start-up and expansion of small enterprises, mainly to low-income individuals and households in the emerging world.

In 1970s rural Bangladesh, economist Muhammad Yunus, then a professor of economics at the University of Chittagong, became disillusioned with the regular famines in Bangladesh. He began visiting local villages, where he found a group of 42 women who made bamboo stools. Because they lacked funds to purchase raw materials, they were tied into a cycle of debt with local traders, who would lend them the money for the materials on the agreement that they would sell the stools at a price barely higher than the raw materials. Yunus was shocked to find that the borrowing needs of the 42 women amounted to the equivalent of US\$ 27. He lent them the money from his own pocket at zero interest, enabling the women to sell their products for a reasonable price and break out of the cycle of debt. The solution seemed obvious, as capital was

the main problem. That is, give the poor access to capital in the form of small loans that can be used to grow small businesses which, in turn, allows them to raise their living standards.

Based on this idea, in 1983, Dr. Yunus created Grameen Bank (derived from the Bengali word *gram*, which means rural or village) to specialize in microcredit. As the scope and success of Grameen grew, the number of microfinance institutions expanded globally (Bruton et al., 2011). Microfinance pioneers and leaders were recognized with awards, including the 2006 Nobel Prize to Grameen Bank and Muhammad Yunus. In these early days, microfinance was seen as a key weapon that could be utilized to pull millions out of poverty and aid economic development.

Over the subsequent three decades, the total number of microfinance loans provided has come to total well above 100 million. Yet the question remains: have these loans actually reduced the poverty level of the borrowers? To date, research by economists has not found consistent benefits from microcredit loans in terms of venture outcomes (Armendáriz & Morduch, 2010; Karlan & Valdivia, 2011).

There have been few published studies that evaluate the impact of microfinance on entrepreneurship and poverty using a randomized, comparative methodology (Roodman, 2012). Extant studies have not been able to demonstrate a decrease in poverty for those receiving the microloans, compared to a matched set of borrowers that did not the loans. One major study (Banerjee, et al., 2015) showed that business investment and profits of pre-existing ventures did increase in the presence of microloans, but the entrepreneur's consumption did not significantly increase. This study also found that no significant improvements occurred in health, education, or women's empowerment outcomes. Meanwhile, other studies have shown that access to microfinance increases the savings rate of the poor, compared to those without such access, and this enhanced their living standards but not their entrepreneurial activity (Dupas & Robinson, 2013; Karlan & Ratan, 2014). The evidence suggests that despite billions lent by microfinance institutions (MFIs) across the globe, its effects on borrowers and entrepreneurial activity are not always positive (Bruton et al., 2015; Khavul, 2010).

The focus on microfinance and entrepreneurship is timely and interesting for several reasons. First, microfinance has gained increased attention from researchers and the general public alike, particularly as economic growth and development has shifted toward emerging economies where microfinance is particularly important (Lewin, et al. 2016). Second, it is well understood that innovation and entrepreneurship are important to economic growth and development (Ahlstrom, 2010; Link & Siegel, 2011; Siegel, 2016). Yet MFIs tend not to fund what might be thought of as truly entrepreneurial or innovative activities. Indeed, most loans issued by the Grameen Bank tend to fund small retail operations or farming. Even if these small businesses do not close down, they rarely generate enough revenue and profit to raise their owners beyond subsistence levels or generate much growth in a regional economy.

Limited research at both the level of the entrepreneur and that of the microfinance institution has identified the factors that enhance venture outcomes amongst microfinance borrowers. This is an important issue given that MFIs are not funding the kind of entrepreneurial ventures typically associated with growth and wealth creation (Alvarez & Barney, 2014). Instead, microfinance loans may be used as a form of revolving credit much like a credit card. This enables the poor to

gain access to necessities, after which the small credit is paid down, and more necessities are purchased (Roodman, 2012). While this may be a useful objective, it generally does not fall under the rubric of innovation and new venture creation, upon which economic development is based (Ahlstrom, 2010; McCloskey, 2013, 2016).

The lack of definitive research regarding the potential for microfinance to alleviate poverty and enhance entrepreneurship suggests that microfinance, as currently structured, does not have the capacity to universally reduce poverty. For example, microfinance practice is based on the assumption that the main factor preventing the poor from exploiting entrepreneurial opportunities is the lack of financial capital. As economists and management scholars have argued, such capital is necessary but is not sufficient for encouraging innovation and the creation of sustainable, growth ventures (Alvarez & Barney, 2014. McCloskey, 2011; Wang et al., 2008). That is, entrepreneurs in poor settings encounter more than credit constraints (De Mel et al., 2008; Liu et al., 2017), as other resources, such as human capital, social capital, and effective institutions are needed (Acemoglu and Robinson 2012; Berge et al., 2010; Karlan and Valdivia, 2011). Not all poor people are equally skilled at recognizing or developing entrepreneurial opportunities (Alvarez, et al., 2013). Nor is it reasonable to assume that all poor people want to become entrepreneurs (Shane, 2008).

In spite of mixed findings from previous research, it would not be appropriate to conclude that microfinance has *not* had a positive impact on abject poverty. Clearly, the success of microfinance lenders and the large numbers of loans made over the last 30 years taps into a critical unmet need. However, whether or not microfinance institutions and the loans they provide actually help to boost new enterprise and reduce poverty is less clear (Bruton et al., 2011), thus motivating the present special issue of *International Small Business Journal*.

Articles in special issue

This special issue includes a range of work by both established and emerging scholars, beginning with an invited commentary by Chen, Chang, and Bruton, which sets the stage by reviewing management research on microfinance initiatives, entrepreneurship, and poverty. The commentary highlights prior work which has examined the effect of microfinance on new ventures, as well as the financial sustainability of lending organizations. Examining 32 articles from top journals spanning a decade (2005-2015), the authors highlight gaps in the literature and recommend an agenda for future research in this area.

The subsequent articles in the issue represent empirical work designed to address gaps in our extant knowledge on microfinance and entrepreneurship. They (1) employ a range of methods, (2) feature both multi-country and regional studies, and (3) examine the outcomes of microfinance for nascent entrepreneurs and MFIs in less developed countries. The studies draw on samples from a wide range of countries in Latin America, the Caribbean, Africa, East and Central Asia, and apply methods including surveys, qualitative interviews, analyses of large multi-country datasets, and fuzzy set analysis.

A key issue addressed in the special issue is the influence of the institutional environment on the success of microfinance. Based on a fuzzy set qualitative analysis of 19 countries in Latin

America and the Caribbean, Kimmitt and Muñoz examine entrepreneurship and financial inclusion from the viewpoint of instrumental freedoms. Reflecting the capabilities approach of Amartya Sen (1999), they explore the role of institutional arrangements, including political freedom, and the complex causal processes involved in financial inclusion. In doing so, they expand our understanding of the potential impact of microfinance amidst varied institutional systems.

Another issue addressed in the special issue is the effectiveness of different models of microfinance, for instance, regarding the configuration of lender-client relationships. While prior research suggests that benefits may accrue from long-term enduring relationships between lenders and microfinance-funded ventures, Shahriar and Garg argue that long-term lending relationships increase credit risk for lenders, threatening financial sustainability. Based on MIX data from 1087 lenders in 69 countries between 2003 and 2014, they find a U-shaped association between relationship-based lending and credit risk, as seen in increased defaults and delinquencies, indicating limits to the benefits of such ties. The risk is particularly acute for smaller MFIs and for those issuing individual loans, a significant finding given the shift away from group lending in recent years.

A further issue addressed in the special issue is how microfinance institutions can assist micro-enterprises to exploit business opportunities. In their paper, McKelvie and Engstrom find that financial literacy is positively associated with two key measures of micro-enterprise performance. This demonstrates the importance of financial training for entrepreneurs in the informal economy, with which micro-lenders can assist.

The articles in this special issue aim to bring new insights to the important domain of microfinance and entrepreneurship. The present issue builds on the history that the *International Small Business Journal* has in publishing research on small and medium-sized enterprise funding in emerging and transition economies (Adekunle 2011; Newman et al. 2014; Shahriar et al. 2016; Siwale & Ritchie 2012). We hope you enjoy reading the articles and will find them helpful.

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