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Poverty reduction through microbusiness

Microbusiness can be an effective way out of poverty. Returns to capital for microbusinesses in poor rural areas can be so high that people with microbusinesses can double and even triple their capital within a year. Yet, few reinvest their profit and overall investment remains low. Key policy issues are thus both to expand markets and to remove the barriers that prevent microbusinesses from investing in highly profitable opportunities. This policy brief identifies effective policy measures that can increase profitable microbusiness. The recommendations are based on research in rural Nepal.

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MICROBUSINESS DIVERSITY

The economic transition of poor countries to higher levels of development and less poverty implies changing from low levels of salaried employment and large share of microbusinesses to high level of salaried employment and high share of employment in larger firms. Many developing countries try to support such transitions through their education and infrastructure policies, through regulatory frameworks and through macroeconomic management, but the transformation takes decades of development. However, despite the fact that microenterprises are important sources of income for half or more of the labor force in developing countries, government policies seldom focus on the immediate potential and current role microbusiness can play as a way out of poverty.

One reason for this lack of attention could be the large number of microbusinesses that have very low returns without any potential for growth. However, as mentioned above, research shows that there are large variations among small enterprises when it comes to profitability – ranging from negative to very high returns. One reason for this diversity could stem from the fact that many start such business and then close them down soon after, which could be a result of entrepreneurs learning from their mistakes and trying to do better when starting up a new business. The diversity in returns can also reflect what has been termed "push and pull factors" of starting microbusiness: Poor people with few resources and low abilities, often without capital, are pushed into businesses with low returns because they have no other alternatives. Entrepreneurs in a more favorable position - often with some capital - are pulled into new microbusinesses by expectations of higher profit than their present engagement. These entrepreneurs may be more successful and have higher returns, and thus have the largest potential for further investment and growth. Realizing this potential may create employment opportunities for poor people with less entrepreneurial talent and resources, and hence contribute to poverty reduction.

LIMITED MARKETS

Potential investors have limited markets in poor villages. People produce their own food, and limit their purchases to small amounts of readymade food, transport and a few services while they reserve larger purchases for visits to towns or cities. They consume most of their income, and savings and investments are low. Without any investments from outside the village or other inflow of resources, these people will remain poor. The local demand is stable and the markets do not grow. A new microbusiness is only likely when replacing another since the demand is already covered by other microbusiness. Fierce competition in the market for products and services drives the profit down to a minimum.

Interventions to support savings in order to increase the capital stock of the microbusiness operators, is important under these circumstances. Another opportunity is to stimulate innovative entrepreneurship by targeting more productive business operations through diffusion of higher yielding technologies. Higher productivity will make it possible to produce the same at a lower cost, which in turn could stimulate more demand and hence expand the markets. A frequent recommendation to foster growth opportunities when markets are limited is to stimulate linkages to larger markets in the adjacent cities through lowering transport and communication costs and facilitate information flows and networking. However, the effect of such linkages on microbusiness could be both positive and negative as this also enhances the opportunities for customers to do more of their purchases outside the villages and facilitates the entry of more productive firms into the rural markets.

SUBSISTENCE CONSTRAINTS

High competition in the villages may lower product prices so much that they barely cover the costs and generate very low over all returns. Yet, those who own some capital may still have large returns on their limited capital. In the plains of Nepal, the transport markets are characterized by many rickshaw pullers who either rent or own their rickshaw. There are many owners. A few of them own many rickshaws, and they seem to keep the rental price high and hence maintain a good profit. In this market one would expect a drive to invest in a rickshaw to get a share of the profit. We have systematically investigated this issue, and the conclusion is that the poor survive on a subsistence level making them unable, or unwilling, to sacrifice anything in their daily consumption to be able to save and invest in a rickshaw (for example by paying a small amount every week on a rickshaw loan) even if this would make them less poor within one or two years. In this case, the subsistence level acts as a poverty trap. They would be able to invest and increase their income only if they could get above the minimum consumption level. A feasible solution, which has been introduced in a large number of poor countries, is to provide cash transfers to the poorest to ensure that they maintain a certain standard of living. Such cash transfers could be tied up to a requirement that families send their children to school. In this way, cash transfers would both represent an investment in the future of the children and the society at large.

FINANCIAL CONSTRAINTS

Credit is usually available in the Nepalese villages, but only in small amounts, and with rigid repayment schemes. Investors may get individual loans in an informal credit market. Here interest rates vary a lot depending on the local supply of credit, which in turn depends on the income and borrowing capacity of the local lenders, as well as on the characteristics of the informal borrowers. There is clear evidence of segmentation in the credit markets in Nepal. Lenders give different terms to different types of borrowers. In particular, the low castes (Dalits) have to pay very high interest rates to get informal credit.

Microcredit schemes, which have a wide coverage in Nepal, can finance profitable investments among the poor. However, the challenge for investors relying of such funding is the small size of the loan, and the fact that the repayment is not linked to the business and investment cycle. Most micro-credit loans have to be repaid within a year. An investment loan requires calculations of expected future cash-flow and ability to service the loan. Usually it takes time before an investment generates profit. An investor needs a loan with a repayment schedule commensurate to the profit generation. Rigid repayment schedules deters investors from starting businesses where it takes time to get profitable, and instead forces them to choose microbusinesses with immediate cash generation. This explains the current concentration of microbusiness with small returns to capital like in rickshaws, small shops, teahouses and milk sales. Lack of suitable finance mechanisms thus acts as a deterrent to long term profitable enterprises.

For larger investments, traditional banks are often the only option. Banks often lack funding themselves. They require collateral which many poor people do not have. Quite often banks are not normal profit maximizing entities. A branch manager can earn more personally from loans to friends than to potential best businesses, as his own income and position is not linked to performance.

Another financial policy issue concerns the fact that many business failures are related to factors outside the owner's control. Unexpected events, like the death of a buffalo may destroy the milk sale. The close-down of a nearby factory may lead to loss of customers. An immediate need for funds to cover health related costs causes hardship if their capital is locked into the business and there is no other way to cover the costs. Such events seem to make small entrepreneurs cautious of new investments. Without insurance it is likely that high risk deters potential entrepreneurs from engaging in highly profitable activities, and this seems to be an opportunity for the microfinance industry. An additional problem, as with all insurance, is that it is difficult for the insurance company to prevent or detect irresponsible behavior that increases the likelihood of insurance payments. Joint group responsibility where insured individuals monitor each other's behavior to ensure continued insurance, similar to group lending in microfinance schemes, could be a solution to this problem. It is essential for the sustainability of the insurance scheme that people only get support in cases of non self-inflicted bad outcomes.

LACK OF KNOWLEDGE AND SKILLS

In a recent CMI study of barriers to investments in microbusinesses in Nepal, lack of knowledge and skills were pointed out as the most important obstacle to business both by people in and outside of microbusinesses. Simple business practices like keeping record of transactions, separating household and business finances, feasibility assessments of product ideas, profit calculations, marketing and inventory monitoring of the most sold goods are seldom implemented even in more advanced microbusinesses. Despite the fact that microbusiness is an important contributor to people's livelihood, very few have received any business training. Every third household in the study was involved in business in one way or another, but only one percent of the households had received any type of business training. The high degree of illiteracy among those who do microbusiness, and those who could potentially start such business, indicates that business training programs feasible also for people without any prior numeracy and literacy skills should be designed. For those who rely on farming only, 94 percent of the households reported that lack of knowledge and skills are a main obstacle for doing business. Hence, in order to enable this group to diversify and grasp profitable investment opportunities, targeted basic microbusiness training programs would be a viable policy intervention. Business idea competitions have proved to be a particularly promising approach combining learning about search for profitable opportunities with business skills for microentrepreneurs with high growth potential.

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Across all social groups, lack of knowledge and skills and access to capital were highlighted as the most important obstacles for doing business.

Improving business skills would most likely increase economic growth in these villages. One opportunity is to directly support skill creation tailored to individual interests, qualifications, knowledge and abilities, in particular a design of business and skills training in accordance with the entrepreneurs' own interests, and an opportunity to select modules they find most attractive. In South-Asia caste-based discrimination may hinder entrepreneurs in developing their full potential. This is the case both for the low castes themselves, but also for those who may not hire the most competent workers due to social prejudices. It will be important for the government to continue developing policies that may counteract caste-based discrimination, and help people develop their full entrepreneurial potential, which in turn would create higher economic growth.

INVESTMENT CLIMATE FOR MICROBUSINESS

Evidence from investment climate surveys suggests that the cost of enforcing contracts, property rights, the availability of public goods, corruption, social strife and risk of losing assets (expropriation, theft, natural disasters etc.) all impact on investment decisions. The investment climate is often referred to as the degree to which these factors create an environment favorable to private sector investments. Despite its importance, not much has been done to investigate the investment climate for the microbusiness segment as they are excluded from investment climate surveys despite existing evidence suggesting very different constraints for smaller as compared to larger companies.

Our investment climate research in Nepal suggests some government priorities that would remove barriers for microbusinesses. Across all social groups, apart from those who run larger microbusinesses, lack of knowledge and skills and access to capital were highlighted as the most important obstacles for doing business. We also find that microbusiness operators are not concerned with obstacles relating to government regulation, informal or formal taxes, difficulties with labor, physical threats, unavailability of fuel and transportation issues. Nevertheless, this does not imply that reducing these barriers would not be important for stimulating the microbusiness segment. Larger businesses are likely to suffer from such obstacles – businesses that can create profitable opportunities for microbusiness through demand linkages. Factory workers spending their salary on goods and services produced by microbusinesses and microbusiness provision of inputs through the supply chain of larger enterprises are two evident channels where micro investors can prosper from improving the investment climate for larger businesses. Hence, stimulating growth among the larger companies is likely to create larger markets that would allow for more rapid expansion of microbusinesses and attract factory workers so that the fierce competition is lessened and profits increased. This, in turn, would have a positive impact on poverty reduction.

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