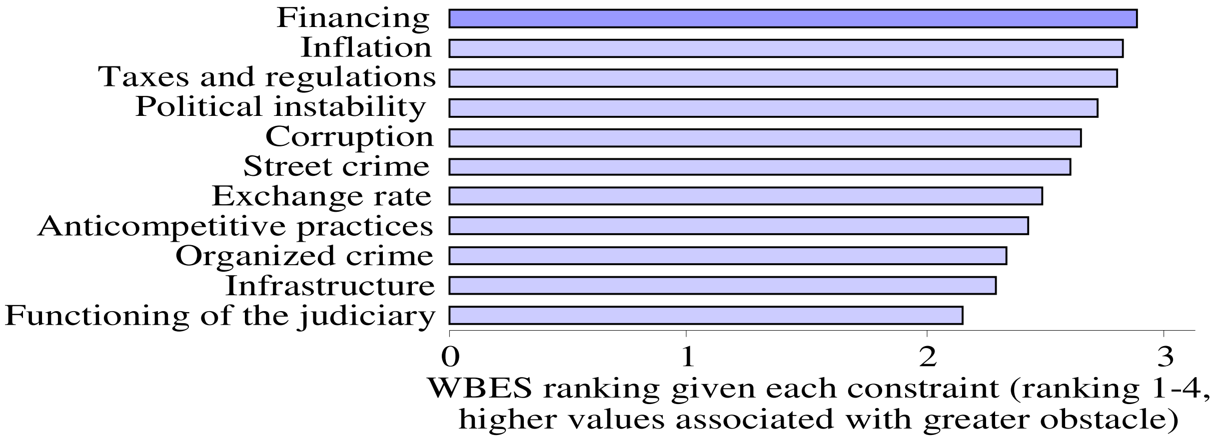
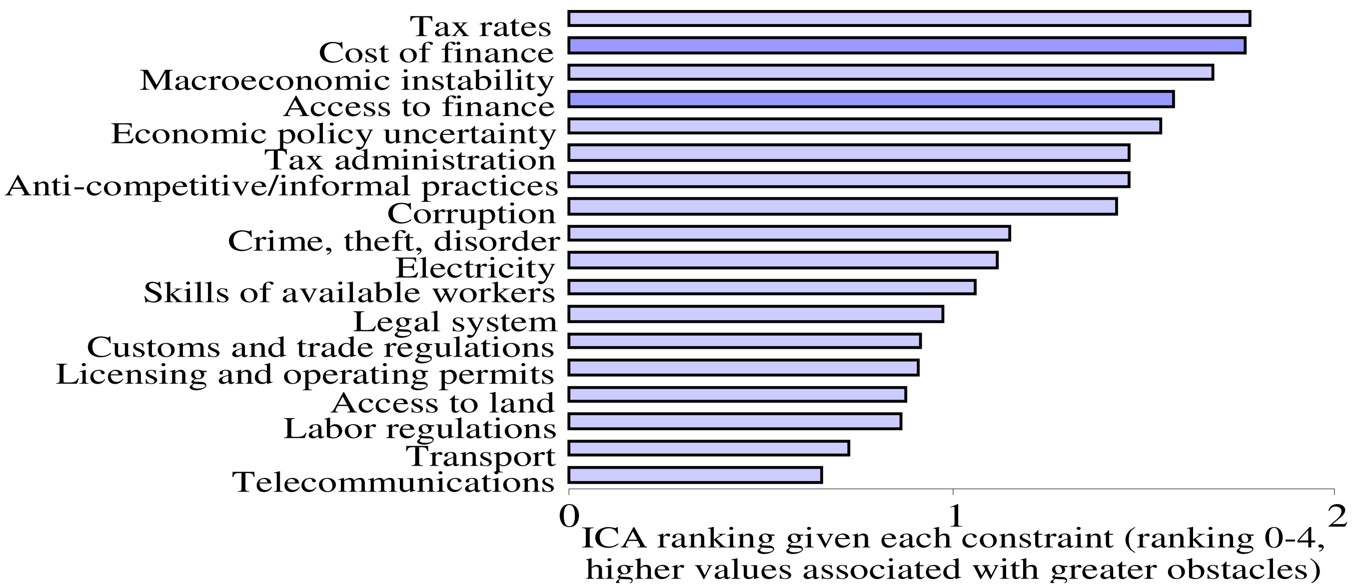
UNIVERSITEIT VAN TILBURG

Finance as binding constraint for entrepreneurs – Evidence and Policies

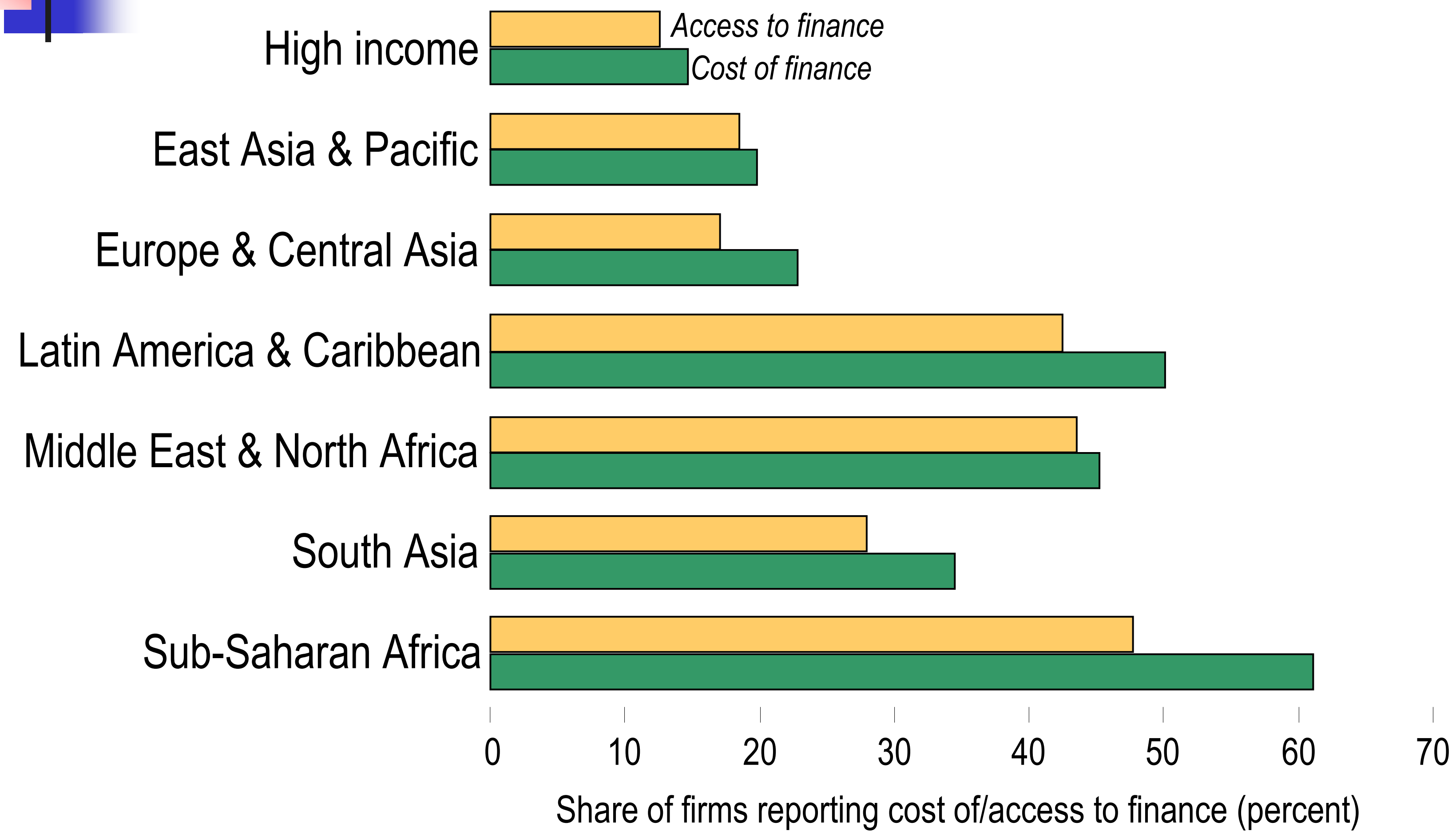
Thorsten Beck

There are many obstacles to enterprise growth..



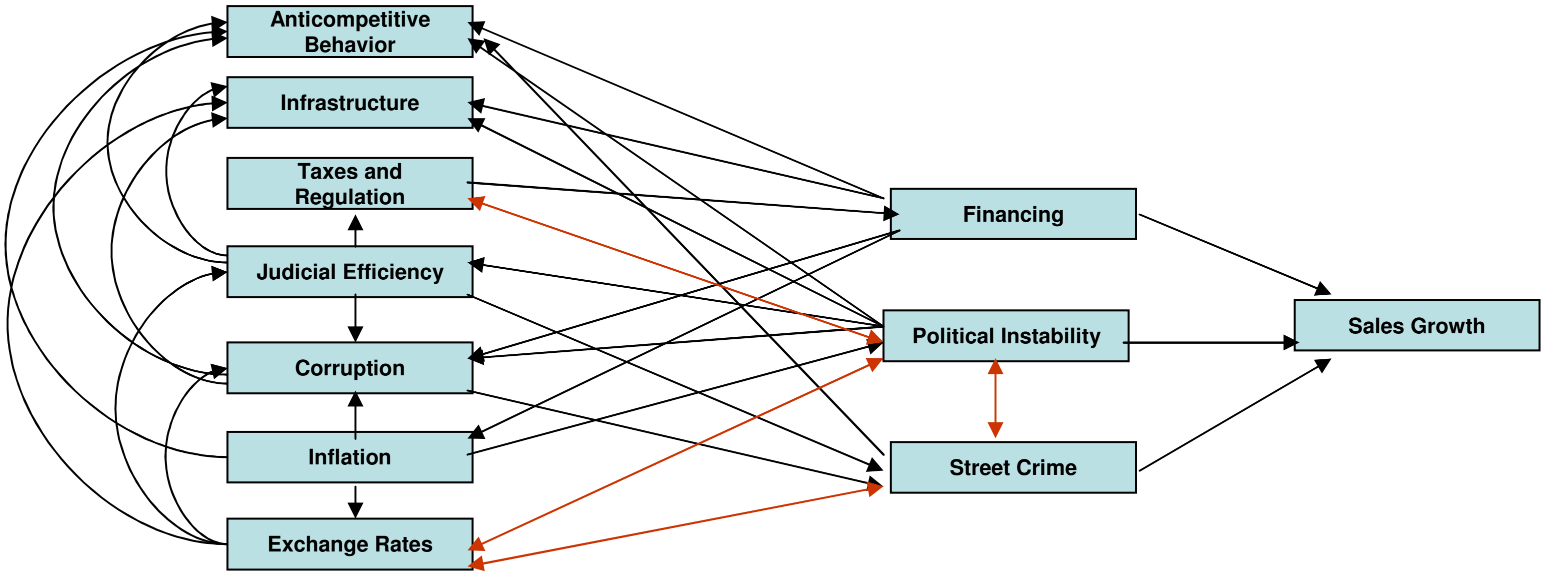


...and they vary across regions



.. and some are more binding than others

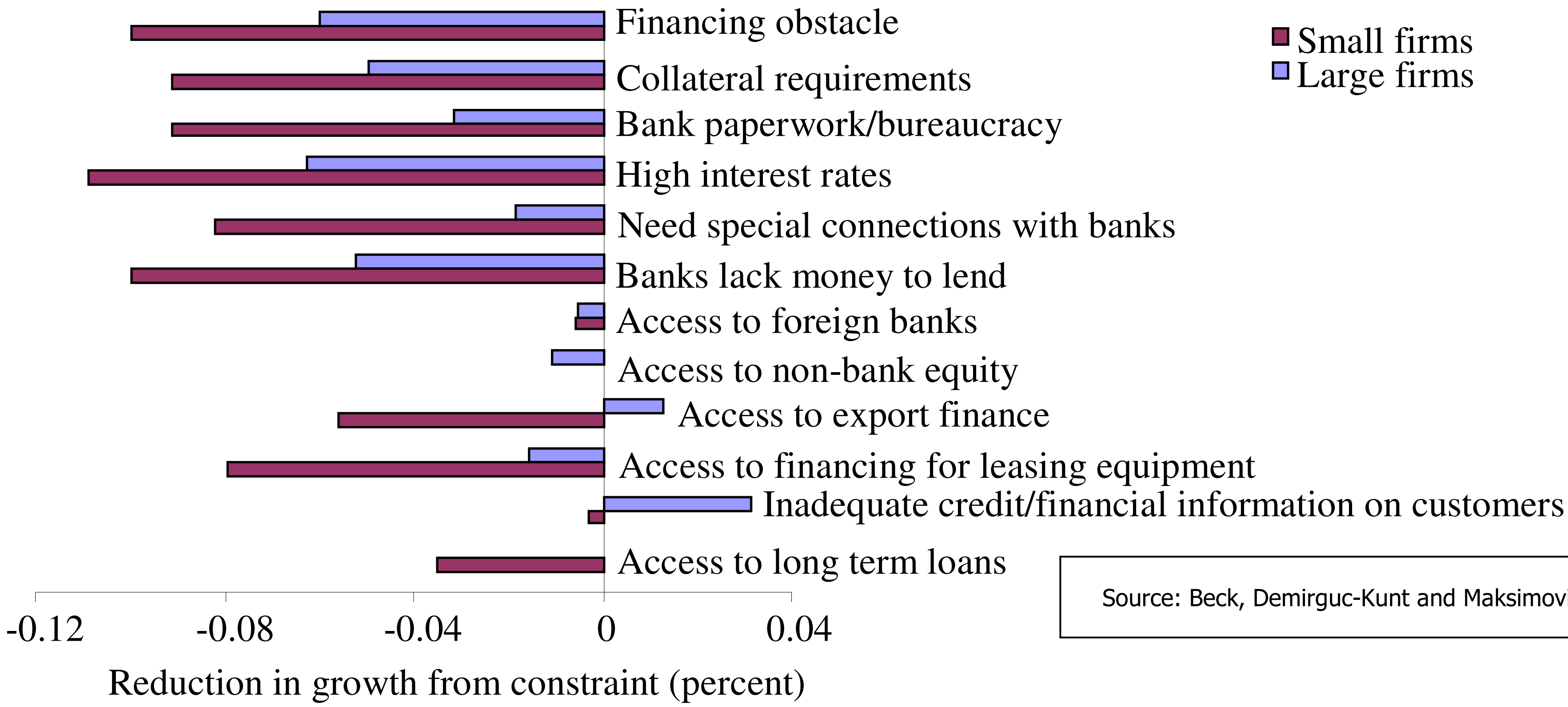
Figure 1: Impact of General Obstacles on Firm Growth



Source: Ayyagari, Demirguc-Kunt and Maksimovic, 2008

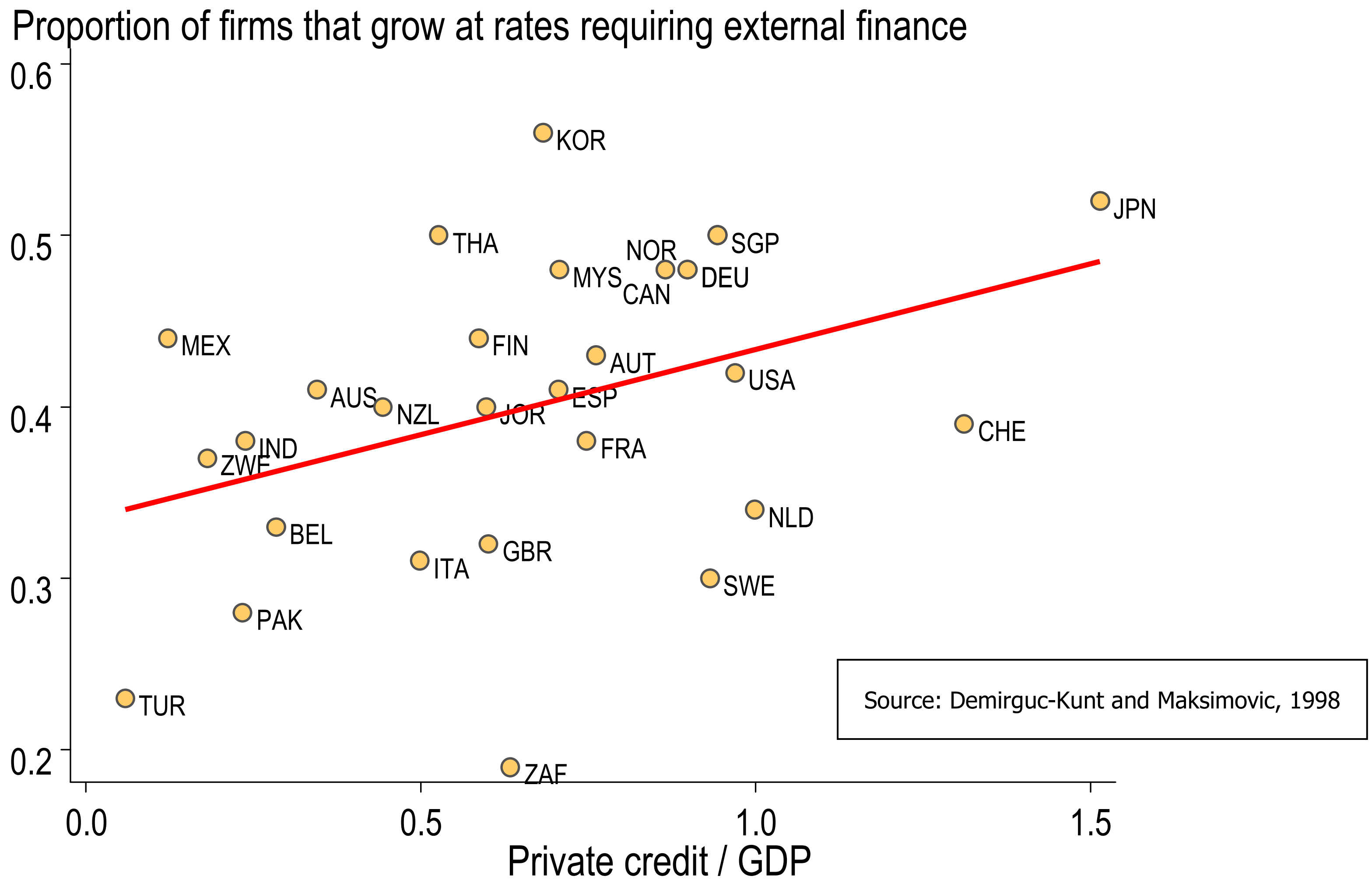
Variables with Common Latent Causes
Tax Regulation <> Anti-Competitive Behavior;
Tax Regulation <> Infrastructure;
Tax Regulation <> Inflation;
Street Crime <> Inflation;
Street Crime <> Infrastructure

There is a large difference between small and large firms



Source: Beck, Demirguc-Kunt and Maksimovic, 2005

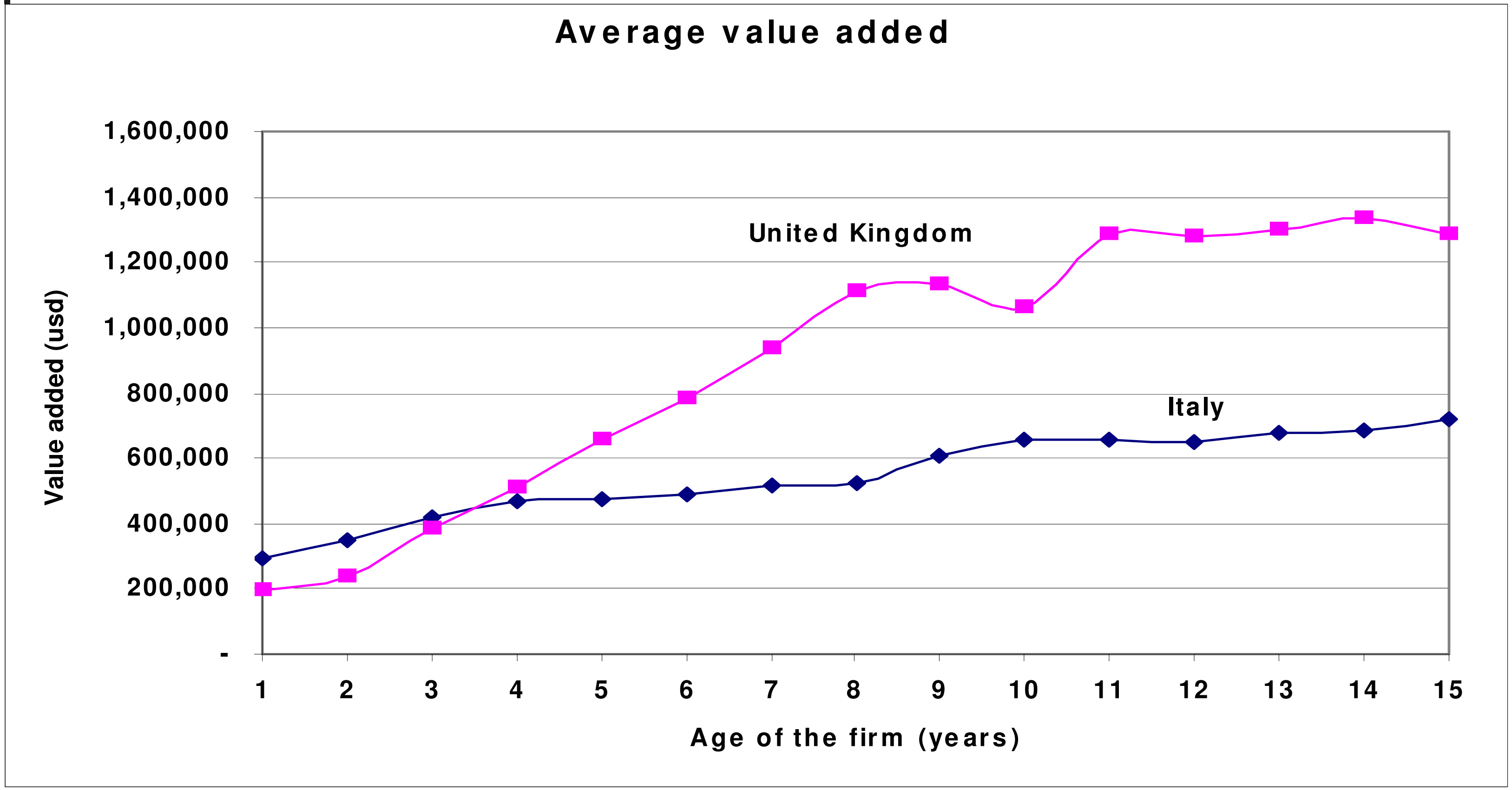
The end result: finance promotes firm growth



Finance and growth - channels

- Improvements in resource allocation
  - Faster reallocation of capital
  - Provide external finance where it is needed most
- Small firms benefit more from financial development
- Number of firm start-ups, firm dynamism and innovation
- Greater equilibrium size of incumbent firms
- More efficient organizational forms such as incorporation

SMEs, entry and exit of firms



Source: Klapper, Laeven and Rajan (2006)

Empirical findings match theory

- Theoretical models of entrepreneurship see financing constraints as critical in impeding realization of investment projects
  - Adverse selection
  - Agency problems and moral hazard
  - Limited liability
- Lack of access to finance impedes entrepreneurship and perpetuates
  - Income inequality and poverty
  - Low levels of economic development

What helps ease financing constraints and develop financial systems?

- Macroeconomic stability
- Contractual framework
  - Laws and their enforcement
- Information framework
  - Accounting and Auditing standards
  - Credit information sharing
- Competition

Finance or property rights?

- Conflicting evidence:
  - Eastern Europe
  - China
  - Cross-country
- Even if the relationship is directly through contractual framework and business environment, in general, policy implications would not change much

Why are SMEs left out?

- Transaction costs
  - Fixed cost component of credit provision effectively impedes outreach to "smaller" and costlier clients
  - Inability of financial institutions to exploit scale economies
- Principal-agent problems
  - Related to asymmetric information
  - Adverse selection: High risk borrowers are the ones most likely to look for external finance
    - Increases in the risk premium raise the risk of the pool of interested borrowers
    - Lenders will use non-price criteria to screen debtors/projects
  - Moral hazard: The agent (borrower) has incentives that are inconsistent with the principal's (lender) interests
    - Agents may divert resources to riskier activities, loot assets, etc.
- It is the overall lending environment that affects small business lending, not necessarily the difference between large and small

SMEs’ access to credit and financial market structure

- Most state-owned are large and while sometimes having specific SME lending programs, they often fail.
- Subsidized credit programs crowd out private bank lending to SMEs
- Foreign banks might face greater informational and agency constraints, but might be better at transaction-based than relationship lending
- Empirical evidence :
  - Latin America: lending of foreign banks to SMEs function of bank size
  - Across 36 developing countries: Financing obstacles (High interest rates and access to long-term loans) are lower in countries with high levels of foreign bank penetration, even for small enterprises

The role of governments? A conceptual framework

- Access Possibilities Frontier (APF): constrained optimum; maximum access to credit given "state variables": macroeconomic environment, contractual and informational framework, technology etc.
- Define observed access relative to APF:
  - Self-exclusion/too few investment projects
  - Outcome below APF: lack of competition, regulatory constraints, coordination problems, first-mover problem etc
  - Outcome above APF: excessive, imprudent access
  - APF too low: state variables

Access to credit – policy choices

- Market-developing policies: focus on state variables
  - Macroeconomic stability; improvements in contractual/informational framework;
  - Long-term institution building process; how to prioritize?
  - Information infrastructures (credit registries.) over enforcement of creditor rights; ease of recovery on individual debt contracts (collateral) over resolution of conflicts between different claimants (bankruptcy laws)
- Market-enabling policies: help maximize access given state variables
  - Promote cost-effective technologies - legislation for leasing, factoring etc. reduce costs of registering and repossessing collateral; financial education
  - Competition - including foreign entry - is likely to improve access over time
  - Regulatory policies – no bias against SME lending
  - Infrastructure open to all financial institutions
  - No regulatory barriers to innovation
- Market-harnessing policies: prevent financial system from moving to imprudent outcome beyond frontier
  - Incentive compatible financial safety net that minimizes moral hazard risk
  - Disclosure requirement, predatory lending regulation and education to prevent individual overborrowing

SME financing techniques

- Leasing: Lending based on value of specific collateral provided by borrower rather than overall creditworthiness of borrower.
  - Better security since lessor is owner of asset
  - Dedicated use of funds
  - Tax advantages
- Factoring: Sale of accounts receivable at discount
  - Does not rely on good collateral laws or efficient judicial systems
  - Reverse Factoring allows small, risky firms with large high-quality buyers to transfer credit risk and borrow on the credit risk of customers

Credit for all?

- Aggregate studies – that take into account spill-over effects - suggest strong pro-poor impact of financial development
- Rigorous microcredit studies find mixed results on the impact of access to credit by the poor
  - Large share of microcredit used for consumption purposes
  - Aggregate effect limited due to limited resources in MF segment
- General equilibrium models for Thailand also suggest indirect effects of financial development may be quite significant for the poor – i.e. transiting into formal sector and higher wages
- ⇒ **To promote pro-poor growth it is important to improve access for all excluded (not only the poor)**
- ⇒ **Effect of financial development on poverty alleviation comes through improved capital allocation, not necessarily through extending access to credit to all.**

Conclusions

- Financing constraints are among the more binding ones
- Especially binding for small firms
- Long list of institutional reforms, some prioritization possible
- Short-cuts possible