Helpdesk Research Report: Private Investment Constraints in the Poorest Countries
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Query: Review literature on evidence of what constrains private investment in business in the poorest countries. In particular identify whether businesses are prevented from being commercially viable by lack of access to capital.
Enquirer: DFID

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1. Overview
The private sector in the poorest countries faces many constraints of which poor access to affordable capital is one. It is not the case that there is no access to capital for many entrepreneurs in the poorest countries. Rather the cost of borrowing may be too high, the institutional environment may make formal borrowing seem onerous or potential borrowers may be unaware of the available options. Private capital flows into the poorest countries are generally lower than that to other developing countries suggesting less available capital in the poorest of the developing countries.

Constraints and Enablers in the Private Sector
A 2003 UNDP Commission to identify obstacles to the development of the private sector in the developing countries identified three major structural challenges:

- **Microenterprises and many small and medium enterprises (SMEs) operate informally.** The informal sector can in some cases provide employment where the formal sector can not. At the same time informality can restrict access to finance and prevent legal redress in relation to property rights for entrepreneurs and in relation to workers rights for employees.

- **Many SMEs have barriers to growth.** SMEs can lack the finance and skills to scale up their business.

- **A lack of competitive pressure shields larger firms from market forces, the need to innovate and become more productive.** Large companies can take advantage of the weak institutional environment to raise anticompetitive barriers. They can use their lobbying power to slow development of market institutions and benefit from subsidies or special privileges.

There are a number of other factors which if favourable would benefit businesses in the poorest countries. These are:
- **Global macro environment** with favourable trade rules; the open exchange of goods, capital and information; and effective development aid.

- **Domestic macro environment** with political stability, good governance, policy predictability, transparency and accountability, and sound macroeconomic policies.

- **Physical and social infrastructure** with good roads, railways, power and water; and basic education and health. Good physical infrastructure can be dependent on capital investment but also on efficient contracting, open bidding and regulatory credibility. In terms of social infrastructure many developing countries suffer from low levels of human capital investment through poor education and training. This is aggravated by the outward migration of highly skilled professionals – the “brain drain” phenomenon.

- **Rule of law** where rules are applied consistently, transparently and fairly.

- **Level playing field** with predictable, clear rules and basic trust in the system. Procedural requirements should not inhibit business start-up and operation. Credit information should be comparable, taxation should not discourage formalisation and there should be effective insolvency regulations.

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**Lack of Access to Domestic Capital**

Where available firms access capital through formal bank financing or through informal channels, such as trade creditors or family and friends. One survey found that no more than 6% of the funds borrowed by the poor came from a formal source (Banerjee and Duflo, 2010). Preference for informal and formal finance varies between firms. Recently-established firms tend to rely more on informal financing than formal bank financing (Chavis et al., 2010). Enterprises may favour informal credit in order to avoid the additional regulatory scrutiny and harassment associated with the formal financial sector (Safavian and Wimpey 2007). This preference is stronger where the regulatory environment is weak, particularly in relation to the quality of tax administration and overall governance, and where there is limited availability of credit information.

However, interest rates in informal markets tend to be very high, largely because of the greater perceived risk of default and high administrative costs (Banerjee and Duflo, 2010). Other reasons for high interest rates can be vulnerability to market fluctuations and high mortality rates (Ruffing, 2006). High interest rates can make borrowing money unattractive except where the marginal returns to capital are so high as to make it profitable.

People with few assets rarely borrow whereas richer people borrow more and can do so at much lower interest rates (Banerjee and Duflo, 2010). In some poor countries the borrower’s education and training have a significant positive impact on the probability of borrowing (Green et al., 2007). Few entrepreneurs in developing countries can leverage assets as collateral the way they do in developed countries because of informal property rights and the lack of mortgage markets. Collateral requirements thus act as a filter that favours wealthy borrowers and crowds out many entrepreneurs, even those with high growth potential (UNDP, 2004). Even when entrepreneurs have access to collateral and property rights are well defined, the enforcement of mortgage contracts is often impossible, for both political and judicial reasons. In addition, bankruptcy laws are typically lacking, increasing the risk to creditors and further deterring them from investing in SMEs.

Financial institutions often lack the skills for SME lending. Banks are accustomed to extensive risk assessments for large clients which would be too costly for SMEs. Microfinance institutions, in contrast, lend with very limited analysis, relying mostly on social networks to select borrowers and ensure repayment. This does not work well for the larger amounts that SMEs require.
Lack of Access to International Capital

The poorest countries, except for resource-rich countries such as Angola, tend to attract the least amount of private capital (World Bank, 2010; Prasad et al., 2007). This can be attributed to a weak institutional environment, inadequate infrastructure, a poorly educated labour force, corruption, and a tendency to default on debt from abroad (Prasad et al., 2007; Alfaro et al., 2008). At the same time the poorest countries receive significant capital from multilateral and bilateral donors in the form of official development assistance (ODA) which has been steadily increasing in recent years (World Bank, 2010).

2. Constraints and Enablers in the Private Sector


The Commission on the Private Sector & Development convened in July 2003 to identify the legal, financial and structural obstacles blocking the expansion of the indigenous private sector in developing nations - especially in the poorest regions and communities in those countries.

The Commission found three major structural challenges confront the private sector in all developing countries, to varying degrees:

- Microenterprises and many small and medium enterprises operate informally.
- Many small and medium enterprises have barriers to growth.
- A lack of competitive pressure shields larger firms from market forces and the need to innovate and become more productive.

Widespread Informality for Microenterprises

Informality can provide benefits in some circumstances:

- It can act as a form of employment substitution for labourers who have difficulty finding jobs. Home-based enterprises provide women with opportunities to earn money in societies that limit the economic role of women.
- Entrepreneurs can use their talents in the informal sector where formal rules, enforcement systems and cultural conditions in a country are highly restrictive.

There can be also disadvantages to the informal sector:

- There are difficulties in accessing finance as often they do not have legal status or title to the land they occupy. This can trap developing country entrepreneurs in subscale operations or force them to borrow from illegal moneylenders. Such moneylenders may charge high rates and may only be able to lend small sums relative to the needs of a growing enterprise.
- Legal system benefits are limited. The formal legal system should enforce contracts and protect property rights more fairly than informal enforcement systems do.

Predictable rules and dispute resolution mechanisms are essential for entrepreneurs to engage in the long-term arrangements that enable them to innovate, to scale up and to diffuse their knowledge and benefits. Cruel and arbitrary informal enforcement systems limit the ability of entrepreneurs to be productive. Local debtor prisons and mafia-like punishments can hurt an entrepreneur’s full access to crucial human inputs.
Entrepreneurs who operate formally can be disadvantaged by the implicit subsidies that informal enterprises receive through uneven enforcement and by poor mechanisms for protecting property and contracts, both of which distort competition. Both aspects create an uneven playing field and reduce formal entrepreneurs’ access to inputs and markets, discouraging entrepreneurs who operate formally from making investments to increase productivity.

Informal firms can sometimes charge less because they avoid paying taxes or complying with other regulations. They can undercut productive formal firms by avoiding the taxes and other contributions, which increases formal firm costs significantly. More productive formal firms are thus less able to drive the less competitive informal firms out of business. Poor enforcement thus permits the informal firms to continue to exist, holding back the productive firms from reaching maximum scale. Yet, given the significant productivity advantage held by formal firms, the inability to compete may reflect an unwillingness to serve some parts of the market rather than the cost advantages offered by informality.

Worker rights and protections in the informal sector stand up poorly to those in the formal sector. And consumers—able to purchase only goods of inappropriate quality and safety standards—do not have access to the greater choice and lower prices in truly competitive consumer markets.

There are many constraints on entering the formal sector. The overarching issue is one of costs versus benefits for the individual entrepreneur who has to choose between formal and informal operations. In most developing countries it is costly to be formal. Formal players are often overtaxed as there are fewer formal companies who must carry most of the tax weight. Registering a business can be a long and expensive proposition. Regulations and government requirements are complex—and compliance costs high. The opportunities for bribery increase with the complexity of regulations, exposing smaller players who lack the legal resources to defend themselves. Entrepreneurs may see little benefit in going formal.

While formal businesses in developed countries can raise capital by mortgaging their assets, this is often not possible in many developing countries where mortgage laws are weak and banks prove reluctant to finance small players. In theory, being formal would facilitate selling beyond geographic boundaries, but poor local infrastructure and customs abuse limit the opportunities. Bankruptcy laws, which protect formal players in developed countries, are often ineffective in developing countries, exposing formal entrepreneurs to even more risks (due to greater visibility) than if they remained informal.

***Few Competitive Small and Medium Enterprises***

Small and medium enterprises often could compete effectively in niche markets, but the advantages that accrue to established large players fend off competition from the small and medium enterprise sector. Without the reasonable compliance costs that exist only in a fairer system of competition, small and medium enterprises cannot grow and become more productive. Ineffective or arbitrary tax laws, onerous business regulations and other restrictions penalize them.

Widespread informality and the lack of skills also affect the ability of entrepreneurs to scale up a business. While often animated by innovative ideas or addressing untapped markets, small and medium enterprises suffer from lower total factor productivity, by using older technologies or employing inferior workforce practices. The cost of business services is often more than small and medium enterprises can pay, or is not in tune with their needs. Lower export sales from small and medium enterprises come in large part from lack of access to knowledge about foreign standards of quality.

Small and medium enterprises lack access to financing and long-term capital, the base that companies are built on. High risks associated with small and medium enterprises, whether real or perceived, exist in the absence of financial instruments that manage and diversify the risk. Banks face high costs or cannot acquire information that they can trust, even when small and medium enterprises are creditworthy. These factors raise interest rates and reduce
lending volumes, setting up price and quantity barriers to small and medium enterprise growth. Small and medium enterprises have to resort to financing from networks of family or friends, from retained earnings, or from short-term credit from other small buyers or suppliers, rather than from larger institutions providing dedicated long-term financing vehicles for specific purposes.

**Lack of Competitive Pressure on Large Companies**

In many developing countries large incumbent companies can stifle entrepreneurial energy and initiative. They can take advantage of weak institutional environments to raise anticompetitive barriers and protect their dominant position. While local informal markets can often function without much regulation, more mature and complex markets need appropriate regulations to function effectively.

Companies with a protected position in these markets can have strong incentives to use their lobbying power to slow government progress in improving the institutional infrastructure for markets. Such practices directly hurt poor people, through higher prices and lower quality products. At the same time such anticompetitive policies are often perpetuated by an unlikely alliance between large protected incumbents and poor people, who fear a loss of jobs in competitive markets.

Corruption combined with weak and arbitrary legal enforcement buttresses incumbent firms at the expense of potentially more competitive ones. Specifically, incumbents might receive subsidies, special licenses or other privileges that preserve their position and dampen the incentive to innovate and reduce prices. Such firms may respond to perverse incentives to strip assets or dole out contracts to uncompetitive suppliers even when more efficient providers exist. The poor domestic macro environment encourages wasteful rent-seeking and retards the growth of competitive firms based on productivity.

Building a sound private sector requires:

- **Foundations:** Global macro environment; Domestic macro environment; Physical and social infrastructure; Rule of law
- **Pillars of entrepreneurship:** Level playing field; Access to financing; Access to skills and knowledge

**Global macro environment**

The foundations for growth in the private sector start with a well-functioning global macro business environment involving a dynamic global economy that provides markets, as well as adequate trade rules that enable competitive access to market opportunities. The open exchange of goods, capital and information—and the transfer of technology and ideas—stimulates private sector development. This occurs through several mechanisms: open markets, good-quality foreign investment, effective development aid and efficient transfers of technology and knowledge. It requires such reforms as dismantling the agricultural subsidies and other forms of protection that impede export-oriented private sector development in the rural areas of developing countries.

There is broad agreement that open markets have supported economic growth. An open trade policy fosters productivity growth by opening the private sector to competition. Free trade helps countries allocate their resources towards their most productive areas of comparative advantage. Cheaper imports raise the domestic standard of living and allow for the use of lower cost inputs as the private sector produces for domestic or foreign customers. Such a regime provides open market access through lower tariff and nontariff barriers.

**Domestic macro environment**

The central elements of a strong domestic macro environment for business include peace and political stability, good governance with policy predictability, transparency and accountability,
and sound macroeconomic policies. For businesses, internal or external conflict increases cost and uncertainty, deterring both domestic and foreign investment. Conflict forestalls private sector development, because it often leads to the destruction of human capital, the misallocation of scarce public funds, the devastation of land, the seizure of natural resources and the elimination of market access.

Physical and social infrastructure

A country’s physical and social infrastructure includes roads, power, ports, water and telecommunications as well as basic education and health. Building up these basic services has a dual benefit: improving the lives of poor people directly and enabling the growth of businesses.

Technical inefficiencies in roads, railways, power and water alone caused an estimated $55 billion a year in losses in the early 1990s— an amount equal to 1% of the GDP of developing countries or twice the annual budget for financing infrastructure in the developing world. These losses fall on firms large and small—and on individuals, especially the poorest. Low quality roads can shut small producers off from regional markets— and encumber large producers with shortages of critical inputs.

Well-maintained infrastructure improves commerce by speeding the transport of goods and raw materials, sustaining energy intensive production and making information readily accessible and communication timely. Poor physical infrastructure often precludes business activity.

Ensuring connectivity through telecommunications and information technology has become particularly important in recent years, helping to overcome some of the barriers of inadequate physical infrastructure. Efficient access to information is clearly a vital part of the basic infrastructure need of modern economies.

Maintaining high quality physical infrastructure is largely, but not solely, a matter of capital investment. Efficient contracting, open bidding, regulatory credibility and private and public managerial capability are also important.

Studies demonstrating the social and private returns from investments in education and health highlight their efficacy. High levels of investment in human capital, especially in education and health, lay the groundwork for private sector growth. A healthy, educated workforce is a productive workforce. Private firms profit from investments in education. Ensuring that such education is appropriate for a future workforce is a core task of a well-functioning education infrastructure. Educating women has particularly positive effects on their future earnings and society’s.

Investments in health and education involve both the public and private sectors, and counter to conventional belief, many education and health services in developing countries are delivered through private initiatives, including cooperatives and mutual health insurance organizations. In some systems 70–80% of health care expenditures are through private actors. Often, but not always, private involvement is a response to government underinvestment.

Improving the social infrastructure and ensuring that those surviving on the lowest incomes have access to affordable and high quality health and education services is an important foundation for private sector development.

The rule of law

The rule of law means that government decisions are made according to a set of written laws and rules, to be followed by every citizen. The rules are applied consistently, administered by a professional bureaucracy and adjudicated by a fair and transparent judiciary that is adequately compensated. In nearly all cases, courts provide reasons for their decisions based on the law, through some form of due process. Countries may subscribe to different legal
systems arising from different political and social cultures, but the fair administration and enforcement of a just system of laws is a cardinal principle. Both elements matter—laws and their administration.

Laws form an intrinsic layer of the foundation for a robust private sector. Without a transparent legal framework and a fair judicial and administrative system, other efforts to foster private sector development cannot work as intended, and may even do harm. Home governments must establish the “rules of the game”, a system that reduces transaction costs by making them predictable and enforceable. Legal and administrative systems influence whether and how transactions take place.

The rule of law manifests itself in the private sector with commercial laws, customs laws and contract laws, among others. Critically, the assignment and protection of property rights circumscribe private sector behaviour. Confusing and contradictory legal systems make formal business practices difficult and push businesses to become or remain informal. Poor legislation buttresses oligarchic and corrupt firms against competitive forces, often at the expense of small and medium enterprises. Cosy relationships between business and regulator impair the development of open, free market competition. The poor are likely to be the first victims of lawlessness.

Even though a written set of laws may exist, the legal system in many developing countries works informally. In the shift from informal to formal systems, many countries have old and new systems coexisting, often in conflict. The loser is often the more formal new system, implemented in a shallow and ineffective manner. One estimate suggests that as many as 80% of the legal issues facing the poor are addressed through customary or informal systems.

Corruption and confusion over the enforcement of rules are often to blame for high compliance costs. Bureaucratic red tape, backlogs, arbitrary decision making and other onerous requirements and inefficient practices hamper private activity. Arbitrary or corrupt enforcement subvert laws intended as benevolent protections, including laws for worker safety, environmental protection and consumer safety. Corrupt practices distort prices and markets, and hinder free and fair competition.

A level playing field—with fair rules, fairly enforced.

A level playing field for firms can be created only by a system of rules and enforcement mechanisms that is fair, trustworthy and effective. Predictable rules ensure that entrepreneurs have open access to markets and can do business efficiently. Basic trust in the system encourages entrepreneurship and attracts talent (local, foreign and diaspora) to embark on entrepreneurial ventures. Rules, if excessively complex and incorrectly applied, can turn into significant barriers for enterprises and hamper business growth. This applies to rules for entry, operating, market and exit.

- **Entry rules.** Excessive procedural requirements for business registration and licensing procedures raise the cost of entry into the formal sector and tilt the playing field in many developing countries. For example, the World Bank’s Cost of Doing Business survey estimates that starting a business requires $5,531 in Angola (more than eight times the per capita income) and about $28 in New Zealand (far less than 1% of the per capita income). Cumbersome entry regulations are directly correlated with lower productivity. Longer registration processes are directly associated with higher levels of corruption.

- **Operating rules.** Disclosure requirements can have a positive impact at the industry and business environment by giving consumers and investors the information they need to make choices about the products they purchase and the capital they allocate. Labour market rules are critical to protecting employees from exploitation. A number of developing countries have excessively complex labour rules, more than wealthier countries. For laying off employees, companies in middle and low income nations face higher barriers on average than their counterparts in developed economies. The
mechanisms for social dialogue to find ways of mitigating the effects of layoffs, and safety nets to protect the poor are often weak or non-existent in most developing countries. Complex tax rules and structures also impose high costs that fall more on small and medium enterprises than on large enterprises, which can afford tax experts.

- **Credit rules.** Many countries lack rules for sharing credit information, which makes it virtually impossible for creditors to check how indebted a potential client already is. In addition, creditors have limited protection in the case of default, significantly lessening their willingness to assume the risks associated with small and medium enterprise lending.

- **Tax rules.** High tax rates and complex tax administration is a significant constraint for small and medium enterprises and can lead them to the informal sector if tax burdens become excessive. A large informal economy can mean lower government revenues and higher taxes for firms in the formal economy, creating more incentives for informal operation.

- **Market rules.** The arduous process discourages people from formally purchasing land, making it impossible to use land as collateral for getting credit, one of the main sources of capital in developed countries. Product market barriers also stifle growth. Many developing countries raise barriers to entry—say, by forbidding small companies to distribute electricity in rural areas, even when state monopolies do not serve those areas. Restrictions on pricing can also cloud the business environment. For example, many governments charge excessively high prices for fixed-line domestic and international telecommunications services. The monopolies that operate in these conditions are highly profitable as a result, but their capital and labour productivity are low. The high prices provide few incentives for telecommunications players to use their resources more effectively.

- **Exit rules.** Inadequate bankruptcy rules and protections can create additional hurdles for financing enterprises. Countries with better insolvency regulations tend to have more and cheaper lending. Poor enforcement by formal institutions permits enterprises to avoid some or all of these rules, advantaging some of them over others. Government officials may not have the will to enforce the laws because the institutions they work for do not provide the right incentives. The institutions may not reward officials for applying the law fairly and equally, and the organizations may lack transparency and may not supervise officials sufficiently. In addition, government officials may not have the skills and resources they need to enforce the laws. They often require additional training or tools.

Access to financing

While foreign direct investment has had an essential role in the development process, it is impossible for a country to progress without domestic investment based on domestic savings. This requires domestic financial institutions that can efficiently manage risk and allocate capital to productive investments. Many developing countries have had weak, state-dominated financial sectors unable to act as a catalyst for development. But where genuine reform has been implemented, the benefits have been quick and evident, even if creating and restructuring an efficient domestic financial sector is a long task.

Large companies are well served by existing banking systems, and there has been good progress in microfinance over the last 10 years— with 41 million poor people served in more than 65 countries. But the progress on small and medium enterprise financing has been slow at best. It is not only about money needed, though. Small and medium enterprises are risky ventures. They require risk capital, but the sources of such capital are difficult to tap. So small and medium enterprises generally have to turn to classic debt financing. This can be difficult for them. Few entrepreneurs in developing countries can leverage assets as collateral the way they do in developed countries because of informal property rights and the lack of mortgage markets. Collateral requirements act as a screen that selects wealthy borrowers and crowds out many entrepreneurs with high growth potential.
Most emerging markets finance up to 90% of their investments locally, although for Sub-Saharan Africa the figure is closer to 65% (and most productive enterprises generate revenue in local currency, so the reliance on local financing is sustainable). Private credit as a percentage of GDP rises from 12% in low income countries to 25% in lower middle-income countries, 30% in upper middle income countries and 85% in high income countries. A web of factors is at work, more than just the lack of capital.

- Rules and their enforcement are often at the core. Most countries have weak property rights, making the use of assets as collateral difficult. Even when property rights are well defined, the enforcement of mortgage contracts is often impossible, for both political and judicial reasons. In addition, bankruptcy laws are typically lacking, increasing the risk to creditors and further deterring them from investing in small and medium enterprises.

- Poor financial institutions are also a problem. Domestic financial institutions can operate in oligopolistic or monopolistic conditions, with limited shareholder pressure to enter new and more difficult markets, such as lending to small and medium enterprises. Added to the lack of incentives is the public borrowing that crowds out private borrowing.

- Even when financial institutions have the will, they often lack the skills for small and medium enterprise lending. Banks are accustomed to full-blown risk assessments working with large clients—too costly for small and medium enterprises. At the other end of the spectrum microfinance institutions lend with very limited analysis, relying mostly on social networks for repayment. This does not work well for the larger amounts that small and medium enterprises require.

- A lack of reliable credit information also hampers the growth of small and medium enterprise lending—usually because there are no credit information agencies and disclosure requirements are weak or not enforced.

- Investors lack exit opportunities. Capital markets are absent or highly illiquid in many poor countries, making public offerings impossible. Private offerings can work, but most markets are far from liquid, with very few transaction opportunities.

- Entrepreneurs often lack the skill and the will for receiving risk capital. On skill, management talent is limited. On will, private equity investors report the reluctance of small and medium enterprises to open their books to outsiders in environments where parallel accounting is widespread.

**Access to skills and knowledge**

Technological innovations and the shift towards knowledge-based economies make human capital investment a prerequisite for sustained economic growth and central to the start-up, growth and productivity of firms. Human capital can determine the potential for a firm’s growth and survival. It contributes directly to a firm’s productivity by enabling the adoption of innovative technologies and processes. A firm’s competitive advantage comes from its entrepreneurial capabilities; its management and technical know-how, including labour management relations; and the skills, education and adaptability of its employees.

Many developing countries suffer from low levels of human capital investment, aggravated by the outward migration of highly skilled professionals. The cumulative “brain drain” since 1990 has been estimated at 15% for Central America, 6% for Africa, 5% for Asia and 3% for South America. The International Organization for Migration estimates that some 300,000 professionals from the African continent live and work in Europe and North America.

By some estimates up to a third of R&D professionals from the developing world reside in OECD countries. This persistent brain drain deprives developing countries of the know-how of thousands of their most talented people. It reduces the stock of human capital at home,
erodes the domestic tax base and shrinks the educated middle class, a stabilizing factor in most societies. The migration of talented risk-seeking entrepreneurs from the developing world seeking opportunities in more entrepreneurially minded societies spotlights the obstacles to starting and scaling up businesses in their native countries. The underlying cause is a disabling social environment that limits both the number of potential entrepreneurs and the degree to which they can unfold their potential.

3. Lack of Access to Domestic Capital


This note uses the World Bank Enterprise Survey datasets to study the use of different financing sources for young firms. In all countries, younger firms rely less on bank financing and more on informal financing. At the same time the younger firms have better access to bank finance, relative to older firms, in countries with stronger rule of law and better credit information. The reliance of young firms on informal finance decreases with the availability of credit information. These results suggest that improvements to the legal environment and availability of credit information are disproportionately beneficial for promoting access to formal finance by young firms.


The authors tested the hypothesis that enterprises may forgo formal finance in lieu of informal credit by choice. They do so to avoid the additional regulatory scrutiny and harassment that engaging with the formal financial sector invites. This hypothesis was tested using enterprise level data on 3564 enterprises in 29 countries. In the sample, enterprises finance approximately 57% of their working capital requirements with external finance. This external finance comes from formal sources, such as commercial banks (53%) and informal sources (42%), such as trade creditors, or family and friends. In the sample, 14% of enterprises rely exclusively on informal finance. The analysis shows that the likelihood of enterprises preferring to only use informal finance is inversely related to the quality of the regulatory environment, particularly the quality of tax administration and overall governance. For example, when an enterprise has been asked for bribes by tax inspectors, it is 17% more likely to prefer informal finance.

Banerjee, A. and Duflo, E., 2010, ‘Giving Credit Where it is Due’, MIT Department of Economics

This paper summarises some of the literature relating to credit in developing countries. Most people in the developing world have no access to formal credit and rely essentially on informal credit. In a survey of 13 developing countries no more than 6 percent of the funds borrowed by the poor came from a formal source. The vast majority of the rest comes from money lenders, friends or merchants. Informal credit markets are characterized by the following facts:

- Lending rates can be very high relative to deposit rates within the same local area. Gaps of 30 or even 60 percentage points between these rates on an annual basis (in other words deposit rates of 10 to 20 percent and lending rates of 40 to 80 percent) are common.
- Lending rates can vary widely within the same credit markets. Gaps of 50 percentage points or more between rates charged to different borrowers within the same local credit market are normal.

- Richer people borrow more and pay lower (often much lower) interest rates. People with few assets often do not borrow.

- These divergences in interest rates are not driven by the fact that a lot of these loans are not being repaid. The reason is that in this sector defaults are relatively rare.

- Monopoly power of the lenders over particular borrowers does not appear to cause the high levels of interest rates either. The data about high interest rates mostly comes from settings where there are a number of potential lenders available.

The reason the interest rates are so high may well be due to the cost of making sure that the loan gets repaid, in the presence of moral hazard or adverse selection. Suppose that an individual, endowed with some wealth, seeks to borrow in order to start a project. The returns of the project are risk free, but the borrower can chose to default after the project is completed and the returns are realized, at a cost proportional to the sum invested (in other words, there is moral hazard). If the cost of default were lower than the interest payment, the borrower would always choose to default. Therefore the lender must ensure that the borrower has enough “skin in the game,” and borrowers will be credit constrained: they will only be able to borrow up to some multiple of their own wealth. In addition, imagine that the cost of default to the borrower drops to zero unless the lender exercises due diligence. Think of this as a combination of what the lender has to do before he makes a loan (e.g., finding out where the borrower lives, what he does, what he owns, what type of person he is) and the cost of maintaining enough “enforcers” that the borrower knows that if he tries to default he will pay a price. Part of this cost is likely to be fixed, rather than proportional to the amount borrowed: A lot of basic information about the borrower (location, occupation, references) has to be collected irrespective of how much he borrows. These fixed costs of administering a loan can explain why interest rates for small loans are so high, why they vary so much across borrowers, and why the poor pay higher interest rates. Since borrowers with little wealth must get small loans, the fixed administrative cost has to be covered by the interest payment, which pushes the interest rate up. But high interest rates exacerbate the problem of getting borrowers to repay. Total lending therefore shrinks further, pushing up interest rates even more, and so forth until the loan is small enough and the interest rate high enough to cover the fixed cost for even a small borrower.

The presence of fixed costs introduces a multiplier into the process of determining the amount lent and the rate charged. As a result, small differences in the borrower’s wealth, or in the cost of monitoring the borrower, can lead to very large interest rate differences. If the borrowers are poor enough, or the fixed administrative cost is high enough, the interest rate could become infinite: these borrowers will be unable to borrow at all.

The same intuitions would hold even if default happens only through bad luck, if borrowers know how likely they are to be affected by such luck, but lenders do not (what is often called adverse selection). The reason is that borrowers who are less likely to repay are less affected by high interest rates, because they know that they may not pay in any case. Raising interest rates therefore tends to push out the borrowers who expect to repay but not the ones who have a high chance of defaulting, and, as a result, average default rates go up. Faced with adverse selection, lenders will tend to cut back on the amount they lend, which will tend to reduce default rates across the board. But this increases the administrative cost per dollar lent and pushes up interest rates, causing a credit contraction just as in the moral hazard case. Therefore, like in the moral hazard case, there can be substantial potential social benefits from even a small reduction in the administrative costs of lending.

High interest rates in developing countries are not the only reason why firms don’t borrow. In some countries the marginal returns to capital are much higher than the rates charged by banks, and would be happy to borrow much more if they were offered credit at those rates or even substantially higher rates. There is therefore an enormous scope for improving
intermediation—at least as far as the poor are concerned. They are able and willing to pay much higher rates than the banks are charging, and if there was some way to improve credit delivery models to allow these banks to lend more to the poor, both sides could be greatly benefitted.


Despite the importance of SMEs to the economies of both developing and developed countries, SMEs have traditionally faced difficulty in obtaining formal credit or equity. Commercial banks and investors are reluctant to service SMEs for a number of reasons:

- SMEs are regarded by creditors and investors as high-risk borrowers due to insufficient assets and low capitalization, vulnerability to market fluctuations and high mortality rates;
- Information asymmetry arising from SMEs’ lack of accounting records, financial statements or business plans makes it difficult for creditors and investors to assess the creditworthiness of potential SME proposals;
- The high administrative/transaction costs of lending or investing small amounts do not make SME financing a profitable business.


This study uses a dataset, drawn from the 1999 baseline survey of some 2000 micro and small-scale enterprises (MSEs) in Kenya. The financing behaviour of these enterprises are analysed within the framework of a heterodox model of debt-equity and gearing decisions. The study also assesses the determinants of the success rate of loan applications. There are three major findings. First, MSEs in Kenya obtain debt from a wide variety of sources. Second, debt-equity and gearing decisions by MSEs and their success rates in loan applications can all be understood by relatively simple models which include a mixture of conventional and heterodox variables. Third, and in particular, measures of the tangibility of the owner’s assets, and the owner’s education and training have a significant positive impact on the probability of borrowing and of the gearing level.

http://www.sciencedirect.com/science/article/B6VBX-4MWPVDG-1/2/7d0b8f2c5370abaf4275344ec3c2b371

Recent research in the development of private credit markets across countries points to an important role of institutions, such as legal investor protection and credit bureaus, in supporting these markets. This paper investigates cross-country determinants of private credit, using data on legal creditor rights and private and public credit registries in 129 countries. Both creditor protection through the legal system and information sharing institutions are associated with higher ratios of private credit to GDP, but that the former is relatively more important in the richer countries. An analysis of legal reforms also shows that credit rises after improvements in creditor rights and in information sharing. Creditor rights are remarkably stable over time, contrary to the hypothesis that legal rules are converging. Finally, legal origins are an important determinant of both creditor rights and information
sharing institutions. The analysis suggests that public credit registries, which are primarily a feature of French civil law countries, benefit private credit markets in developing countries.

4. Lack of Access to International Capital


This section summarises the trends in financial flows to developing countries based on 2008 data. The global financing crisis had a pronounced impact on net capital flows to developing countries in 2008. Net inflows fell, reversing an upward trend that began in 2003 and peaked in 2007. Private flows (debt and equity) declined whereas foreign direct investment (FDI) flows, typically more resilient in times of crisis, moderated but continued to rise in 2008.

Official creditors responded by providing emergency financing to developing countries most severely impacted by the global financial crisis.

The high commodity prices that persisted for much of 2008 continued to support investments in resource-rich developing countries such as Angola, Brazil, Chile, Kazakhstan, and the Russian Federation. The concentration of FDI flows has changed little over the past.

Official creditors responded to the turmoil in global financial markets by increasing their support to both low- and middle-income countries. Multilateral institutions, especially the IMF and the World Bank, stepped up their activities in order to provide emergency financing to the countries most impacted by the global financial crisis, and IMF standby programs were put in place for a number of countries. These were typically accompanied by additional commitments from bilateral and multilateral lenders. Official grants (excluding technical cooperation grants) rose in 2008, reflecting donors’ commitment to a substantial increase in official development assistance (ODA) to help developing countries, particularly those of Sub-Saharan Africa, achieve internationally agreed development objectives, including the Millennium Development Goals (MDGs).


Standard economic theory states that financial capital should, on net, flow from richer to poorer countries. It should flow from countries that have more physical capital per worker—and hence where the returns to capital are lower—to those that have relatively less capital—and hence greater unexploited investment opportunities. In 1990, Robert Lucas pointed out that capital flows from rich to poor countries were very modest, and nowhere near the levels predicted by theory. Despite a growth of financial globalisation this paradox has intensified over time.

This paper argues that perhaps the ‘Lucas paradox’ isn’t such a paradox. In many developing countries there are a variety of problems—inadequate infrastructure, a poorly educated labour force, corruption, and a tendency to default on debt from abroad, among other factors—that reduce the risk-adjusted returns to investment. The risk-adjusted return that foreign investors get from investing in these countries may be much lower than the rate of return that might be anticipated just on the basis of the relative scarcity of capital and relative abundance of labour.

http://www.mitpressjournals.org/doi/pdf/10.1162/rest.90.2.347
This paper examines the empirical role of different explanations for the lack of capital flows from rich to poor countries—the “Lucas Paradox.” The theoretical explanations include cross-country differences in fundamentals affecting productivity, and capital market imperfections. This paper shows that during 1970–2000, low institutional quality is the leading explanation. Foreign investment might be a channel through which institutions affect long-run development.

5. Additional Information

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Selected websites visited
UNDP Commission on the Private Sector and Development, UNCTAD, World Bank Group – Enterprise Surveys

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