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Finance and Growth for Microenterprises: Evidence from Rural China

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Summary. — Using a survey dataset of Chinese rural households, we find that access to external finance is positively associated with the decision to become entrepreneur and the initial investment for microenterprises. Also, we find that use of informal finance, especially financing from friends and family, is positively associated with sales growth of microenterprises with employees, but not of self-employed. We do not find any significant relationship between the use of formal finance and firm growth. Our findings underline the importance of finance for entrepreneurship and microenterprise growth, and the role of informal finance in the absence of efficient formal financial institutions.
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1. INTRODUCTION

Firms face multiple growth constraints in developing countries, including the lack of access to markets, decrepit energy, and transportation infrastructure, and lack of security. A large and still growing literature, however, has documented the importance of financing constraints for small firms, especially in less developed countries (Ayyagari, Demirgüç-Kunt, & Maksimovic, 2008; Beck, Demirgüç-Kunt, & Maksimovic, 2005). A recent controversy has focused on the relative importance of formal *versus* informal financial providers for alleviating firms' financing constraints in developing countries. Allen, Qian, and Qian (2005) posit that alternative financing channels, such as internal financing and trade credits as well as informal coalitions of firms, investors, and local governments are more important than formal bank credit in fostering the growth of private Chinese enterprises, while Ayyagari, Demirgüç-Kunt, and Maksimovic (2010) show that it is bank rather than informal financing that fosters firm growth in China. Even less is known, however, about micro- or household-based enterprises, [1] especially in rural China.

This paper gauges the importance of informal and formal financing sources for microenterprises in rural China. Using a unique household survey conducted in 2009, we relate the decision to start a microenterprise and its success to different gauges of access to and use of informal and formal financing. In doing so, this paper complements recent studies that focus on small- and medium-sized enterprises (SMEs), mostly in urban areas of China.

Access to finance, whether from informal or formal sources, may alleviate credit constraints for both the initial investment of microenterprises and their subsequent expansion. There are important differences, however, between informal and formal finance, related to screening and enforcement mechanisms (Jain, 1999). Banks rely on hard information such as financial reporting, often require collateral which is scarce in rural areas, and rely on government and courts for enforcement, while informal lenders rely on soft information, which is often proprietary, and on personal networks, and enforce loan contracts through reputation, social sanction, and coercion (Besley & Levenson, 1996).

Given the lack of formal financial statements, microenterprises face severe information asymmetries in developing countries, which hinder the credit availability from formal financial institutions, such as banks and credit cooperatives. Informal finance may therefore be essential for microenterprises in China under its special economic and legal institutions (Allen *et al.*, 2005) and especially in rural areas that have experienced a withdrawal of formal financial institutions since the mid-1990s. On the other hand, formal finance might be more effective in alleviating financing constraints, as informal finance carries high interest rates, is of limited scale, and has pro-cyclical trends. [2] It is therefore a priori not clear whether micro- and household-based enterprises can benefit more from informal or formal financing sources in rural China, which leaves the question for empirical research.

The evidence on the effect of informal *versus* formal finance on firm growth is mixed in the literature. On the one hand, Allen *et al.* (2005) show that alternative financing channels and governance mechanisms support a high growth of the private sector in China. Degryse, Lu, and Ongena (2013) show that co-funding of informal and formal finance is an optimal financing choice for firm growth in China as the informal finance has an information advantage while the formal finance has a cost advantage. On the other hand, Ayyagari *et al.* (2010) use a survey of private firms in China, and find that bank finance is associated with faster growth while informal finance is not. [3] Cheng and Degryse (2010) show that the

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development of banks has a positive impact on provincial economic growth in China, while non-bank financial institutions do not.

We use data from a survey undertaken in 2009 of almost 2,000 households across nine counties in three provinces, 27% of which run microenterprises. This allows us to explore both the covariates of the decision to start a microenterprise and the role that the use of informal and formal financial service plays in the growth process of microenterprises.

Our results suggest that, controlling for characteristics of the family head and village, characteristics, wealthier households with larger families and located closer to financial institutions are more likely to start microenterprises, and also have higher initial investment. In addition, we find that higher use of informal finance, especially funding from friends and family, is associated with higher sales growth for microenterprises with employees, while it has no effect for the self-employed. The use of formal finance, on the other hand, is not associated with higher sales growth, which is consistent with the inefficiency of bank loans in China (Bailey, Huang, & Yang, 2011). These findings confirm the importance of finance for entrepreneurship and firm growth, but also underline the important role that informal financial service providers play in the absence of efficient formal financial institutions.

Our paper contributes to the literature by using firm- and household-level survey data to explore the relationship between access to and use of financial services and the behavior of microenterprises. Beck *et al*. (2005) show that the small firms' growth rates are most constrained by financial, legal, and corruption obstacles, while financial and institutional development weakens these constraining effects, from which the small firms benefit the most. Beck, Lin, and Ma (2014) show that banking systems with more effective credit information sharing and higher branch penetration can help reduce the informality of enterprises. In addition, access to financial services can help new entrepreneurs survive beyond the first year, as evidence from Bosnia and Herzegovina shows (Demirgüc-Kunt, Klapper, & Panos, 2011), and can help enterprises innovate at a faster rate (Ayyagari, Demirguc-Kunt, & Maksimovic, 2011). Furthermore, using subnational data for Italy, Guiso, Sapienza, and Zingales (2004) show that local financial development enhances the probability that an individual starts a business, favors the entry of new firms, and promotes growth, and these effects are weaker for larger firms. We contribute to this literature by adding empirical evidence on the microenterprises in rural China.

While our paper's inference is based on household survey data, our paper is also related to a series of recent randomized control trials that explore the effect of interventions alleviating micro-entrepreneurs' financing constraints.[4] De Mel, McKenzie, and Woodruff (2008) use shocks to capital stock through randomized grants in Sri Lanka, and find that the average real return to capital is much higher than the market interest rate, while a similar exercise in Philippines that expanded credit to micro-entrepreneurs did not show any positive effect on borrowers' business (Karlan & Zinman, 2011). More recent evidence has shown differential effects of credit on individuals and households with different characteristics, linked with different uses of credit. Specifically, Banerjee, Duflo, Glennerster, and Kinnan (2013) and Crepon, Devoto, Duflo, and Parenthe (2011) use randomized controlled trials in India and Morocco, respectively, and show that only some clients use micro-credit loans to start up enterprises. New clients that did not start businesses consumed more non-durable goods, with existing businesses reducing consumption and increasing savings.

Our paper relies on household survey data and thus faces the constraints of not being able to infer causality from cross-sectional data. On the other hand, we capture a larger array of financial service providers across a broader geographic area than randomized controlled trials can capture. While randomized controlled trials can often provide a cleaner identification on the effect of finance, they are also restricted in external validity as the experiments are often conducted in a specific location with limited participant groups. Being aware of the caveats with respect to survey data, we try to provide some first evidence on the role of finance plays for the rural microenterprises in China. As we do not have a clear instrument for the access to or use of finance, we describe our findings as correlations and associations rather than implying causality. Given the limited availability of data for rural China, however, we think that our findings still provide useful insights.

Our paper also contributes to the recent debate on the enhancing policies of rural financial market in China. The Chinese government enacted the first law on micro-credit companies in 2008, while other types of rural financial institutions such as village banks, rural cooperative banks, and rural commercial banks, have also sprang up dramatically since then. As the Chinese government gradually recognizes the essential role of informal finance in the rural area, the financial authorities have tried to bring the informal financial market into the regulatory perimeter. Thus, many informal financial institutions in the rural area can gain a legal status through setting up micro-credit companies and village banks, and also through investing in rural cooperative banks and rural commercial banks. If these new types of rural financial institutions can bring a substantial proportion of informal finance under proper regulation, the informal finance may become even more effective for the development of microenterprises in the rural area.

The paper proceeds as follows. Section 2 provides an introduction to the Chinese rural financial market. Section 3 introduces data and summary statistics, and develops the hypotheses and methodology. Section 4 presents the results, and Section 5 concludes.

2. RURAL FINANCIAL MARKETS IN CHINA

Although China has had an annual GDP growth rate of around 10% during the past three decades, rural areas have lagged behind urban areas, and the gap has been widening over the past decade. During the 1980s and 1990s, the rural areas were the engine of China's high economic growth, especially the town and village enterprises which were collectively owned by community governments (Jin & Qian, 1998). However, rural enterprises have witnessed a sharp decline since the mid-1990s due to a wave of bankruptcies and privatization. In contrast, the privatization of state-owned firms in the urban areas since the late 1990s has shifted the urban economy to a higher growth track. Non-farming activities in the rural areas are often undertaken by private microenterprises, and a large labor force has migrated to the urban areas for jobs since the mid-1990s. The outflow of labor force, most often young and talented, contributed to a further contraction of the rural economy in China.

The expression "microenterprise" is often interchangeably used with *Getihu* in the Chinese context. However, the Chinese law (i.e., *Provisions on the individual industrial and commercial households*, enacted in 1987 and revised in 2011) stipulates an official definition of microenterprises according to the total

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