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Is Micro too Small? Microcredit *vs*. SME Finance

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Summary. — Microcredit and small and medium enterprise (SME) finance are often pitched as alternative strategies to create employment opportunities in low-income communities. So far, though, little is known about how employment patterns compare. We integrate evidence from three surveys to show that, compared to Bangladeshi microcredit customers, typical SME employees in Bangladesh have more education and professional skills, and live in households that are notably less poor. SME jobs also require long work weeks, clashing with family responsibilities. The evidence from Bangladesh rejects the idea that SME finance more efficiently creates jobs for the population currently served by microcredit.

Key words — South Asia, Bangladesh, small and medium enterprises, microfinance, poverty

1. INTRODUCTION

The original promise of microcredit was to reduce poverty by fostering self-employment in low-income communities, an idea first promoted at mass scale in Bangladesh (Yunus, 1999). But critics of Muhammad Yunus and the Bangladesh microcredit model argue that supporting larger businesses (small and medium enterprises [SMEs]) may instead create more and better jobs for poor individuals (Dichter, 2006; Karnani, 2007). That is only possible, however, if those larger enterprises employ poor workers in large numbers. We argue that that cannot be assumed.

Most studies of SMEs implicitly or explicitly compare them to large firms (Beck & Demirgüç-Kunt, 2006). In this paper, we instead compare the employment and poverty outreach of SMEs to that of microenterprises. Because we're interested in jobs, our focus is not on the owners of SMEs, but on their employees. If it is true that SMEs create ample jobs for poor workers, there should be a robust correlation between SME growth and poverty reduction, but little correlation is found in cross-country data (Beck, Demirgüç-Kunt, & Levine, 2005). We use micro-data from Bangladesh to explore related issues.

There are surprisingly little data on the profile of microcredit borrowers, and even less that might be matched to comparable surveys of SME employees. We draw on a series of surveys of both microcredit borrowers and SME employees, building from a 2008 survey of Bangladeshi SMEs which obtain loans from BRAC Bank, a for-profit arm of Bangladesh's largest Nongovernmental organization (NGO). In focusing on BRAC Bank, we narrow attention to SMEs that are most likely to align with Bangladesh Rural Advancement Committee (BRAC)'s broader imperatives of development, social welfare improvement, and poverty reduction.

The "micro is too small" view rests on the assertion that supporting larger businesses might be a more efficient way to achieve similar ends to microcredit. We show that the proposition is only half right in our data from Bangladesh. SME finance at BRAC Bank is more profitable than microcredit lending in Bangladesh, and can create larger financial multipliers than investing in microcredit institutions. But we do not find that patterns of job creation (and, by implication, the distribution of social benefits) will be similar.

The data show that the average employee of a small enterprise in our sample is a 26 year old male with almost 5 years of formal education and who is semi-skilled. In contrast, Bangladeshi microcredit borrowers are mostly women, about half have no formal education and most have few professional skills. Analysis of the average likelihood that employees live in poor households shows a similar bifurcation.

Bangladesh's labor market is atypical in the extent to which women do not participate in the formal labor market. Microcredit, which funds home-based production, was successful in Bangladesh precisely because it offered a way to serve women without requiring them to enter the formal labor market. In line with this, we find that microcredit borrowers are far more likely to be female (91% *vs*. 7% of SME employees). This finding is hardly surprising: Microcredit was designed to serve women, and SMEs are constrained in their ability to hire women.

Our contribution is to go further to show, first, that SME employees are not typically drawn from *households* that are similar to those of microcredit borrowers. The BRAC survey is particularly valuable in including questions that can be used to predict the likelihood that the SME employees' households are below global poverty lines. We then compare household-level predictions from the BRAC survey to similarly-constructed likelihood scores taken from independent data on microcredit borrowers in Bangladesh.

Second, we show that, were cultural barriers to women's entry into labor markets to fall, microcredit borrowers would find themselves competing for SME jobs where current workers are more educated and more highly skilled. Third, even were cultural barriers to women's entry into labor markets to fall, the nature of SME jobs would be challenging for workers carrying central family responsibilities. The data show that SME employees work long weeks (on average 11 h a day, 6 days a week).

In sum, SMEs in Bangladesh are not typically creating jobs that reach the kinds of workers supported by microcredit, nor

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does the evidence show that SMEs are reaching many members of the same kinds of families as microcredit customers. If these findings generalize to other labor markets, they help explain the lack of a cross-country correlation between SME growth and poverty reduction found by Beck, Demirgüç-Kunt, and Maksimovic (2005).[1]

The rest of the paper is organized as follows. Section 2 reviews the evidence on the role of SME finance in poverty reduction, particularly through employment. Section 3 describes our data. Section 4 presents evidence on the characteristics of SME employees and microcredit borrowers in Bangladesh, and Section 5 analyzes the characteristics of jobs offered by SMEs. Section 6 focuses on the efficiency of SME lending *vs*. that of microcredit. Section 7 concludes by pulling together the evidence presented in Sections 4–6 and describing an alternative explanation.

2. SMES IN DEVELOPMENT

The promise of microcredit rests with the potential to grow the "micro-enterprises" of poor entrepreneurs by providing loans for working capital. Muhammad Yunus, pioneer of the microcredit movement and founder of the Grameen Bank in Bangladesh, argues that microcredit creates new employment opportunities for the underserved (Yunus, 1999). In a paper prepared for 1986's World Food Day conference, Yunus hypothesized that "self-employment, supported by credit, has more potential of improving the asset base than wage employment has" (Yunus, 1987). Moreover, focusing microcredit toward women, Yunus has argued, will bring about larger increases in household welfare than when targeting men. Several studies indeed support this idea (see for example Duflo, 2003; Duflo & Udry, 2004). At Grameen Bank, 97% of borrowers are women, and in Bangladesh 94% are women. Globally, the fraction of women in microfinance is 63% (Microfinance Information eXchange, 2010).

Creating jobs, particularly in small and medium enterprises, can be another way to reduce poverty. As Karnani (2007) highlights, individuals who start a microenterprise and borrow from microfinance institutions may prefer to find employment at steady wages, but turn to self-employment when wage jobs are unavailable.[2] These individuals may lack the skills or motivation to be successful entrepreneurs, which could be part of the reason that recent microcredit evaluations show mixed results (e.g., Banerjee, Duflo, Glennerster, & Kinnan, 2010; Crépon, Devoto, Duflo, & Parienté, 2011). Karnani and others argue that "micro" is too small (Dichter, 2006).

In creating BRAC Bank, Fazle Abed commented that "microfinance clients don't create jobs for others; they create work for themselves, which is called self-employment... [BRAC Bank's role] is important. So we are not only creating self-employment. We thought we need to create jobs in our economy so a large number of people can get jobs... If some people show signs of light in their lives and need bigger loans, they can go to BRAC Bank. We are providing them with a ladder to get out of poverty" (Devnath, 2009). By 2005, the World Bank Group had spent more than $10 billion to fund SME support programs (Beck *et al.,* 2005), and the G-20 committed $528 million in 2010 to support its SME Finance Challenge which aims to promote SME financing (G-20, 2010).

Small and medium enterprises are defined in several ways, but most commonly as firms that have up to 250 employees. As a group, these enterprises already provide wide-scale employment: jobs in small and medium enterprises account for more than half of all formal employment worldwide, and 45% of formal employment in developing countries (Ayyagari, Beck, & Demirgüç-Kunt, 2007).[3] SMEs are seen by many national governments and international development organizations as important engines of innovation, economic growth, employment, and poverty reduction. The 2005 Bangladesh Industrial Policy, for example, specified that "SMEs will be established on a greater scale across the country in order to bring about poverty alleviation, unemployment reduction, and creating more employment opportunity so that national economic growth can be attained" (Bangladeshi Ministry of Industries, 2005).

SMEs have alternative sources of financing even when formal-sector funds are limited (Vandenberg, 2003). Previous research, however, has established that SMEs can face large financial constraints (Beck and Demirgüç-Kunt (2006) provide a review of the literature), and that these constraints impede their growth (Beck *et al.,* 2005). For example, Beck, Demirgüç-Kunt, Laeven, and Maksimovic (2006) conclude from a survey of 10,000 firms in 80 countries that the size of the firms is a major determinant of financing obstacles of firms, with smaller firms facing larger constraints. Banerjee and Duflo (2008) exploit two policy changes that included, then excluded, some mid-size Indian firms from a direct lending program. They found no evidence that firms substituted credit from the program for other credit. Instead, having access to the lending program allowed firms to expand production and increase sales and profit, showing that many of the firms were credit constrained.

The empirical evidence on the capacity of small and medium enterprises to generate employment and reduce poverty is mixed. Some studies argue that SMEs are responsible for a large part of job creation (Mead, 1994; Sleuwaegen & Goedhuys, 1998), while others highlight that SMEs are both creators and destructors of jobs, so that the net impact is minimal (Davis, Haltiwanger, & Schuh, 1996; Van Biesebroeck, 2005).

Few studies have focused on the wages paid by SMEs and the poverty level of their employees (Hughes, 2000). Bigsten and Söderbom (2006), in a review of the literature developed from the World Bank's Research Program on Enterprise Development in the 1990's, concluded that wages were higher in larger SMEs than in smaller ones, although they are not able to explain the source of difference. The relationship between SME employment and poverty has been measured across countries by Beck *et al.* (2005). They find that the share of total manufacturing employment accounted for by SMEs in a country was not associated with a country's growth in gross domestic product (GDP) per capita of the lowest quintile, nor with a decrease in the Gini coefficient, headcount ratio, and poverty gap.

Unlike microcredit, which can be used to finance consumption needs, SME finance is targeted to entrepreneurs with skills and management capacity, and supports investments. SME borrowers need capital in larger amounts than is typical of microcredit. The average SME loan in our sample is about US$7000, whereas the average loan outstanding is US$114 for BRAC's microcredit customers (Microfinance Information eXchange, 2010).

3. DEFINITIONS AND DATA

There is no single definition of "small and medium enterprises." Commonly-used criteria include the amount of sales, number of employees, and/or amount of investment. While the most common criteria is employment, again there is no agreement on the cut-off points defining "small" and "medium" enterprises, as opposed to "micro" and "large" firms.