



Emerging Issues in Microfinance

The Psychology of Debt

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Background

Micro-entrepreneurs, around the world, pay exceedingly high rates of interest in order to finance working capital. In some cases this expensive investment does not translate into growth for their enterprise. Given that a significant portion of their profits is spent on servicing debt, it appears that they could considerably increase their long term income by using savings for working capital. Understanding this behavior can provide great insights into the functioning of micro –enterprises.

The Debt Traps project aims at understanding this behavior of entrepreneurs who take on high interest debt for working capital without a corresponding increase in the size of business activity. The sample population consists of 1000 small-scale fruit/vegetable/flower vendors in Chennai who have been selected on the basis of two criteria- buying goods on credit at a premium or taking a daily loan for working capital. The baseline survey collected information on business activities, debt and expenditure. The main results are summarized below. Following the baseline survey, the study experimented with two interventions- financial training and a grant equal to working capital, using a randomized design. Two follow up surveys after the intervention have been completed. The final end survey will be soon administered to the respondent population.

Findings – Debt Burden

Table 1 – Business characteristics of sample population			
Detail	Percentage of respondents	Average amount purchased*	Profits per day*
1. One trip a day to the market- normal days	89.7%	Rs. 1075.3 (589.2)	Rs.110.5 (54.7)
2. Twice or more trips a day(total amount purchased per day)	8 %	Rs.707.5 (422.6)	Rs.95.6 (46.1)
3. Once in two days trip to the market (amount purchased per trip)	2.3%	Rs. 1034.8 (515.8)	Rs.97.2 (44.3)
4. Good days a week	98.9%	Rs. 1666.3 (834.3)	Rs. 186.6 (83.4)
5. Festival days	91.5%	Rs. 2580.7 (1543.7)	Rs. 318.2 (187.3)

* Standard deviations are given in parentheses.

These are the findings from the baseline survey that was administered before the interventions. The sample population has been selected from twelve markets in Chennai. Table 1 presents some information on the business flows and the rotation of working capital for the sample population. The sample population had been selected in such a manner that working capital requirements on a normal day are less than Rs. 3000. As can be seen from the table, majority of respondents make one trip to the whole sale market to buy goods that they resell. For those who make more than one trip a day to the market, they typically do it twice a day. It is mainly flower sellers who make two trips to the market to buy goods for resale.

The table presents information about three scenarios-normal days, good days and festival days. Good days are recurrent days in a week when the respondent knows with certainty that business will be good. Good days for flower sellers are Friday and Tuesday because of the increased temple visits on these days. Festival days are also marked by increased working capital because of the expected high business. It is to be noted that the phenomenon of good days and festival days is not applicable for all vendors. The table also shows the profits earned in each of the three scenarios. Profits have been defined as “take home profits,” i.e. money taken back home after all expenses of business have been incurred.

The respondents in the sample use two main sources of financing for working capital. The first is the meter loan/daily loans. These are high interest loans taken every day for the purpose of working capital financing. The interest rates on these loans vary from individual to individual and it is possible that two people working next to each other in a market get this loan from different moneylenders and pay different rates of interest on them. The second source of financing is buying goods on credit. A vendor who buys goods on credit incurs a charge for being able to do so. This charge is the difference between the goods bought on credit and the cost of the same bundle of goods if bought on cash. As can be seen in tables 2 and 3, 40 % of the respondents buy goods on credit and close to 70%, finance their working capital through meter loans.

Another main point that emerges from the tables is the number of years that the sample vendors have been borrowing persistently for. If one looks at the figures from the table on meter loans, 9.5 years of borrowing 1000 Rs daily translates into 1,67,580 rupees of just interest payments¹. This constitutes close to half their income for the same period.²For the 500 respondents who were randomly selected for the financial training classes, this was the main idea that was conveyed to them.

¹ 1000 Rs borrowed for 30 days a month at the average 4.9% rate of daily interest. 1000 Rs is close to the sample average for working capital on a normal day for those who make one trip a day. This is not taking into account variations in working capital needs on good days, low season and festival days.

² Income calculations are made on the assumption, that the average respondent takes home 110 Rs daily.

1. % of sample size that buys goods on credit	40%
2. % of sample size that buys goods on credit for more than 15 days a month	34.6%
3. Average number of days in a month that the respondent buys goods on credit	19.9 days
4. Average number of years of buying goods on credit	13.4 years
5. Average premium paid for goods bought on credit*	17.3%
6. Average of maximum that can be bought on credit	Rs. 3420
7. Alternate to buying on credit	
a. another moneylender	72.25%
b. friend	3.75%
c. family/relatives	1.75%
d. no one else	24%

1. % of sample size that takes daily loans	69.4%
2. % of sample size that takes daily loans for more than 15 days a month	65.7%
3. Average number of days in a month that respondent takes a daily loan for working capital	25.8 days
4. Average number of years of taking daily loans	9.5 years
5. Average daily interest rate	4.9%
6. % of total meter loan borrowers who borrow from the same moneylender daily	67.7%
7. Average of maximum that can be borrowed as a daily loan	Rs. 4098.6
8. % of meter loan borrowers who feel there is no other way of doing business and the interest is unavoidable	63.8%

Savings product	Usage by respondents (in %)
Cash at home	77.5
Cash lent out	5.7
Cash saved with family/friends	1.5
Chit funds	11.2
MFI/SHG	29.2
Bank account	12.8
Gold	74.6

One possible explanation for people being stuck in this debt trap may be that people cannot save easily. The final table (Table 4) looks at the different savings products that are available to respondents and the percentage of the sample population using these. As can be seen from this table, except for gold, the usage of formal savings is fairly low. The good thing to note is the relatively higher savings with MFI's /SHG'S.

Policy Implications

The preliminary results point towards both a debt trap for some and a lack of a formal savings vehicle. The two main policy implications to take from this is (i) despite spread of credit to the poor, many of the poor for whom credit is absolutely essential, do not have access to low cost finance and (ii) despite being in urban areas these poor do not have access to formal savings that would help them escape a debt trap.