

Debt Traps

Project background and significance

Why are some entrepreneurs perpetually in debt? Around the world, individuals pay high interest rates to moneylenders or microfinance institutions in order to finance their working capital. In most cases, however, the micro-enterprises are not growing. Hence, it is not clear in the long run why these businesses need financing. Why are the entrepreneurs not able to save sufficiently from their income in order to finance the business through the accumulated prior earnings? Given the high rate of interest, such an approach no doubt would lead to higher consumption for the entrepreneur and family.

Research design and analysis

In this experiment, we will study the characteristics of individuals who will repeatedly get into debt. Once we identify the sample, we will randomly select individuals for whom we pay their debts off and observe who will get back into debt after a few months.

There are simple stories one can tell about individuals who never escape the debt because they cannot afford to make longer term investments because of the short-term of the debt, or because there is insufficient excess income (after paying the interest) to save anything at all. An alternative story is simply that savings requires more discipline than paying debt (because nobody punishes you for failing to form and adhere to a savings habit).

Our sample frame will be individual micro-entrepreneurs that are in debt with moneylenders. We believe the vegetable markets provide an excellent opportunity: a high proportion of sellers use moneylenders, the debt is high relative to income, but the nominal debt levels are low enough that we can afford to pay some debt down. We randomly will select 50% of the individuals and pay off their debt (the payoff could be in cash to them, or to the moneylender, or we could do two treatment groups in order to test whether this matters). We then want to observe whether after a certain delay (one month, three months, six months and one year), they are back in debt again. Alternatively, did they use the proceeds we gave them and invest it in the business, hence making their business grow?

The experiment as explained so far only establishes whether there is a behavioral discipline explanation to why people are continuously in debt (rather than a more typical debt trap story that is based on high interest rates that are difficult to overcome). The important question remains, what can be done about it? The second component of the experiment will include a training or mental accounting treatment to 50% of the sample (independently drawn from the above, hence a 2x2 design, training vs no training, and debt payoff vs no debt payoff). In this training or mental accounting treatment, we will provide the individuals with a simple savings device that helps to simulate the debt payment they would otherwise have been making, but now will accumulate savings instead. This may include a deposit collector (or if sample size permits, will include a test of whether a deposit collector is a critical component of such an intervention).

Baseline surveys will be critical to (a) measure the history of their debt over the past few years, (b) identify their basic cognitive skills and educational level, (c) collect further measures on mental health that could be linked to ability to fulfill plans, and (d) provide baseline information on the business, its assets, etc.

Follow-up surveys will be critical to measure (a) whether they are back in debt again, (b) what changes have occurred in the business (i.e., if the business has expanded and they are back in debt, then this is evidence not of a behavioral lack of discipline, but rather a credit constrained business that took our money but still needed debt to expand, and (c) any shocks the household has experienced in order to observe the impetus behind falling back into debt.

Funding has already been secured from Yale University for all of the debt payments. Research funding is needed for the study.

Timeline

- September-October: Ground work and feasibility assessment of the project
- November-December: identification of possible interventions and possible partner
- December: Preliminary data collection for 30 vendors.
- January: freezing on the interventions and the structure and design of the project
- February-March: design questionnaires, financial training intervention, and how to implement the project
- April: Complete Baseline and start intervention
- October: study completion