Peer Effects in Group Lending:
Does an opportunity entrepreneur influence other group members towards growth entrepreneurship?

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ABSTRACT

While the provision of Microfinance to poor households through group lending has been widely publicized as an effective way to reduce poverty, there is ongoing debate on whether microfinance actually succeeds in uplifting individuals from poverty. This is due to the fact that a high percentage of the business it spans is largely subsistence and contributes little if any additional employment in the community. A number of scholars have addressed the issue of social capital and its effect on repayment patterns (Basargekar 2010, Dahl Nielsen 2012 Ghatak 1999 Aghion et al., 2000); however these works have not adequately addressed the effect of social capital on behavior of entrepreneurs. The main objective of the study was to establish how borrowers who create successful businesses in situations of poverty are different from those who do not and if these successful individuals are able to influence their peers towards positive entrepreneurial behavior. The study adopted a descriptive design. The target sample was credit groups from Kenya found within Nairobi region. Regression models were used to test the relationship between entrepreneur skills on peer influence and business growth. Questionnaires were administered to 12 credit groups from 4 different microfinance lenders and a total of 82 interviews were conducted. Descriptive statistics and inferential data analysis method was used to analyze collected data. The study found that previous industry experience influences the level of growth of a microenterprise. The study also found that an opportunity entrepreneur within a group is likely to positively influence the entrepreneurial behavior of other group members if they are receptive to mentoring.
Arising from these findings the study recommended that policy formulation in indentifying and funding opportunity entrepreneurs be enhanced.

Key words
Social Capital, Microfinance, Entrepreneur Characteristics

INTRODUCTION

Lack of access to credit is generally seen as one of the main reasons many people in developing economies remain poor (Hermes & Lensink 2007). The popular image of Micro-finance is that of a poverty alleviation tool devised in an innovative and sustainable way to help the undeserved poor in developing countries to develop income generating activities (Milana & Ashta 2012) .While there is a strong ongoing debate on whether microcredit actually lifts people out of poverty (Khandker 2005, Buckley 1997, Morduch 1998) most scholars agree that it offers financial inclusion. Cull et al., (2009) observe that the greatest triumph of microfinance is the demonstration that poor households can be reliable bank customers.

The poor use financial services to meet other basic needs such as health, education as well as food security. Furthermore, it has helped in empowerment of women (Littlefield et al., 2003), who are more likely than men to be credit constrained and have restricted access to wage labor market (Pitt et al.,2006) through an increased ability to plan their futures as well as increased feeling of self-worth. In this way Microfinance has attained a dual purpose; that of poverty reduction and economic growth.

Background of the study

Provision of microcredit in developing countries is based on key assumptions that the loans are the only available financing mechanism that borrowers have a compelling feeling of obligation to repay a loan and that (the) borrowers will eventually graduate to capital markets which offer them access to greater capital for financial development (Pretes 2002).

Nevertheless Wright (1999) warns that poverty is more than just a lack of income and cautions against focusing solely on increased income as a measure of the impact of Microfinance on poverty. Buckley (1997) also notes that given the economic conditions in which some of the recipients live, micro finance usually finds more pressing house hold and consumption needs which is normally prioritized to that of business needs.

Increasing the income of the poor may not necessarily reduce poverty as it depends on what the poor do with this money .As such, focus should be on helping the poor sustain a specified level of well being by offering financial services tailored to their needs (Wright 1999). In their long-term randomized control trial in Bangladesh, Bandiera et al., (2013) found that availability of capital may not be sufficient to start a new business without sufficient skills.

While there are a number of microfinance clients that have created opportunity businesses, most of them end up engaged in subsistence businesses which generate little or any profits (Karnani 2007).

The widely adopted microfinance method of top-down solutions has failed to contribute economically to communities since the recipients of this credit usually have no specialized skills and their businesses compete for a small share of market with other subsistence traders. Khavul (2010) argues that a bottom-up approach that promotes investment allocation based on individual initiative would lead to increase in productivity and innovation that would generate endogenous growth (Aghion & Armendariz deAghion, 2004).

Statement of the problem

If Microfinance is touted as an intervention to reduce poverty and eventually foster economic development, how is it that a large percentage of the businesses it spans are subsistence businesses that have little impact on creating additional employment? This paper investigated *(1)* how borrowers who create well performing micro-businesses are different from those that do not and *(2)* if those so called *opportunity entrepreneurs* contribute to social capital and as a result influences their peers. By so doing the study hoped to shed light on the impact of social capital in groups on entrepreneurial behavior and mentoring.

Rationale of the study

Social economists believe that supporting entrepreneurial ventures is more effective in encouraging development and economic growth than traditional Aid (Yunus 1999). However despite the continued growth of microfinance programs, there is little evidence about the effectiveness of these programs in poverty alleviation. (Buckley 1997)

Recent approaches to microfinance have acknowledged that there are more complementary factors towards making credit more productive and the most important is the borrower´s entrepreneurial skills. Since not everyone can come up with a business idea or perform day to day activities such as book keeping, marketing and management (Bates and Servon 1998), it is important for MFIs and those offering credit to the poor to indentify early on people who lack the propensity to succeed. Furthermore, governments can enact policy to indentify and fund opportunity entrepreneurs.

LITERATURE REVIEW

The world's poorest people lack both capital and skills (Bandiera et al., 2013) and tend to engage in low-skilled labor. Most poor people do not have the basic knowledge or experience in running a business and the subsistence businesses they are financed to start end up failing and leaving them in debt. Karnani (2007) cautions against romanticizing the idea of ´poor as entrepreneurs´ since most microcredit clients are not entrepreneurs by choice. A 2012 study[1] by monitor commissioned by City Bank on the financial capability gap found that 75% of those with access to finance, many do not have the skills and knowledge to make informed financial decisions.

There are documented cases where repayment of microfinance loans left the borrowers in worse of situations. As Karnani (2007) notes, if poor clients cannot earn a greater interest on their investments than the interest they pay to the MFI, then they become poorer as a result of the microcredit. Some borrowers who are heavily indebted turn to relatives or friends to borrow money to repay the microfinance while some may even go without basic necessities so as to make payments. Burton et al., (2013) further highlight this plight by noting that an entrepreneur in settings of poverty not only confronts institutional voids but also faces penalty for failure such as not being able to provide basic necessities for himself and his family.

Microenterprise programs would be more effective in contributing to poverty alleviation by supporting individuals that are more likely to succeed in entrepreneurship and who in turn would create employment and hire people in the community. Skills such as prior business experience and education have been seen to impact positively on business success. Schereiner and Woller (2003) summarize findings from a number of scholars that microenterprise is a good choice for ´a few extraordinary people´, but wage jobs and additional educational are still the most common paths out of poverty. As Pretes (2002) observes, while microenterprises have the potential to

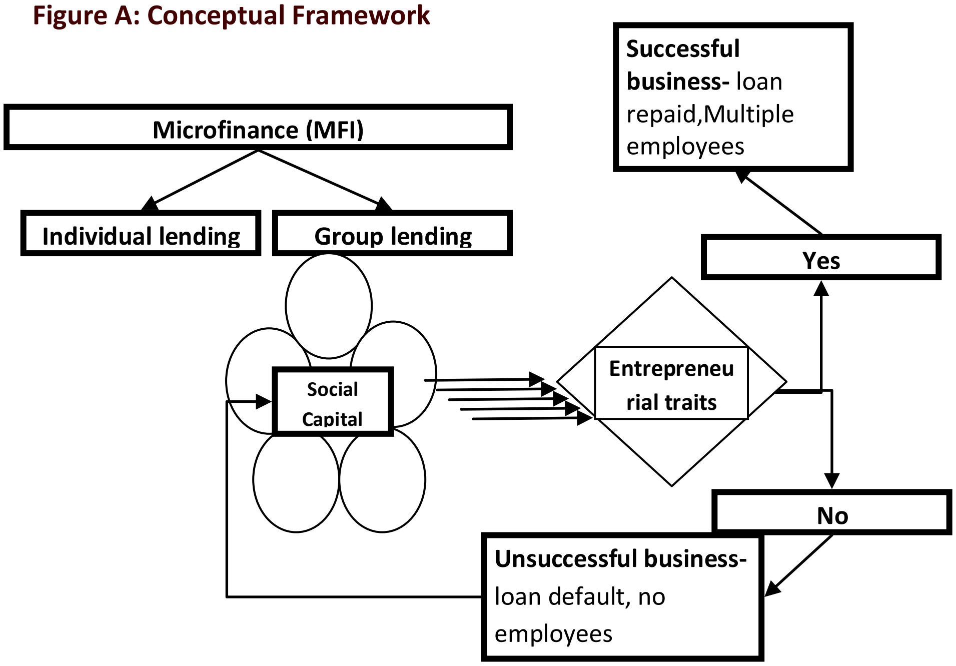
[1] City Bank study on financial capability (2012) http://www.citifoundation.com/citi/foundation/pdf/bridging_the_gap.pdf

create employment, microcredit tends to work best with borrowers who have a genuine ability to repay their loans

Conceptual framework

This study was based on two theories; Schumpeter's Entrepreneurial Theory and the Social Capital Theory (summarized on figure A).

Figure A: Conceptual Framework



Source: authors own

<u>Schumpeter's Entrepreneurial Theory</u>

Opportunity recognition is often viewed as a central aspect of entrepreneurship and entrepreneurial cognition (Baron and Ward 2004). As entrepreneurship is more than just starting a business (Stevenson & Jarillo 1990) successful entrepreneurs are seen to posses certain attributes that enable him/her manage unforeseen factors that may impact on the growth objective of the firm .Individual-level aspects of an entrepreneur come into play during the entrepreneurs' running of the firm and could affect the firm positively or negatively.

Wright & Stigliani (2013), research on entrepreneurial cognition has tried to understand whether entrepreneurs use knowledge structures differently from non-entrepreneurs to access and disseminate information. They further add that successful entrepreneurs think differently from less successful ones since they have a more refined and adaptive behavior which allows them to perform better in their environment. Lee & Tsang (2001) also note that both practitioners and scholars are in agreement that venture success is more dependent on the entrepreneur than on any other factor.

A number of research articles investigated seemed to agree on a set of variables that were classified as entrepreneurial traits leading to successful enterprises. These are innate traits (internal locus of control, need for achievement, risk taking, self-efficacy, and extroversion) and acquired traits (education and industry experience).

Social Capital Theory

A number of scholars (Feigenberg et al., 2010, Nielsen 2012, Woolcock 1998) describe social capital as the expected collective benefit derived from co-operation between individuals or groups. In trying to describe the effect of social capital on microfinance Feigenberg et al., (2010), investigate how increasing a microfinance's client interactions with their group members' builds trust between them. Nielsen (2012), studies social capital at the micro level in the form of horizontal network of individuals and observes values and norms underlying these networks. Basargekar (2010) investigates the impact of social capital on social empowerment of women in India.

Social capital resides in relation between individuals and its impact can be seen on individual as well as community group level (Basargekar 2010; 26). Social capital is normally measured on its impact on achieving mutual benefits in the group or community

It is especially relevant to microfinance given that a large part of lending programs in MFIs is built around ´social assets´ since physical assets are few (Morduch 1999). Hence group loans induce interdependence between borrowers (Besley and Coate 1995).

Yunus credits the social capital model for the success of the Grameen Bank (Zephyr &Yunus 2004). Social capital as noted by Coleman (1988) ensures that local knowledge and social relationships in group lending avoid information asymmetry between the lender and the borrower. Members screen each other before approaching the bank and as Yunus (1994) further notes, the members go through an initial process of understanding and mutual confidence-building. As a result, group loans are more likely to be repaid than individual loans (Armendariz de Aghion & Morduch, 2007).

Recently, studies have shifted attention from repayment rates and towards indentifying effects of microcredit on the profitability of small businesses, investments and household consumption (Banerjee et al., 2009).

Basargekar (2010) notes that social capital is assumed to help group members in their awareness and knowledge about personal issues and their decision making ability in addressing these issues. Interaction of members in credit meetings is especially seen to enhance learning amongst group members as they have an opportunity to observe each other's repayment behavior (Feigenberg et al., 2010) as well as entrepreneurial patterns. If this is the case, the self selection in groups (Nielsen, 2012) and increased interaction through meetings (Feigenberg et al., 2010) serves to further strengthen the bonding in social capital.

RESEARCH METHODOLOGY

The study adopted a descriptive design as to obtain the world view of the entrepreneurs being interviewed. Purposive sampling was used to select groups who were currently borrowing from an existing microfinance institution in Kenya within Nairobi province. This sampling technique was found to be most valuable since the groups were actively engaged in credit meetings and it would be easier to observe the presence of social capital and peer influence. 12 groups from 4

Microfinance Institutions were identified and questionnaires were administered personally to 82 members.

Regression models were used to obtain equations for 2 hypotheses. The first hypothesis tested the relationship between an entrepreneur's education level and prior business experience on microenterprise growth. The regression equation used was as follows: G= $\alpha+\beta 1$ E+ $\beta 2$ P, where G is microenterprise growth, E is education level of entrepreneur and P is previous business experience. $\beta 1$ and $\beta 2$ measure the impact of entrepreneur characteristics on income growth

The second hypothesis tested the relationship between social capital and microenterprise growth. The regression equation used was as follows: G= $\alpha+\beta 1$ Opp+ $\beta 2$ K+ $\beta 3$ C, where G is microenterprise growth , Opp is number of opportunity entrepreneurs in a group, K is the social capital proxy of a group, C is the characteristics of a group. . $\beta 1$ $\beta 2$ and $\beta 3$ determines how much each of the variables tested contribute to microenterprise growth.

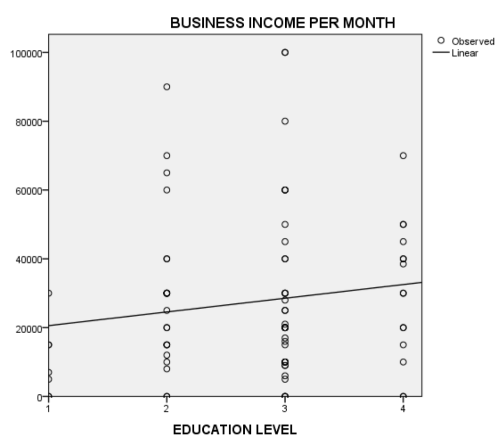
FINDINGS

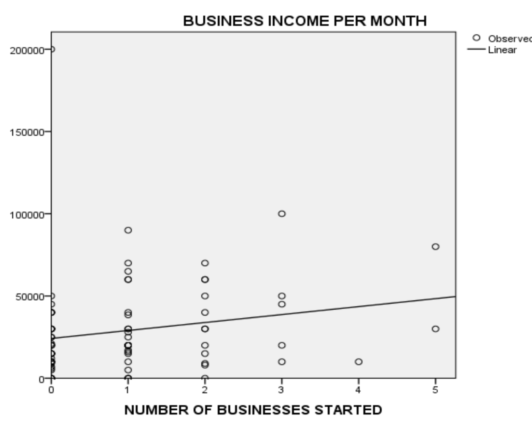
Entrepreneur skills

The study found that there was no significant effect of education level on microenterprise growth. This phenomenon can be explained by the fact that in most developing nations, individuals who cannot afford access to higher education are forced out of school to start necessity enterprises. This result is contrary to what Baringer et al.,(2005) and Copper et al., (2003) find about education being a significant determinant of business income.

However the study found that prior business experience had a significant effect on microenterprise growth.

Figure B. Effect of education and prior business experience on business income





Regression analysis

To test the relationship of the individual determinants on business income, we performed a regression model on education level, type of businesses started and number of business started. According to the F value the global significance of the model is very good. A small F value indicates that all variable are explaining the dependant variables .The model also indicates an R square of .622 which also indicates goodness of fit. The results show that p values of education level and dummies for type of businesses started of VEG (Vegetable sales). DOMBUS (domestic business), ELECTR (Electrical and repairs) as well as TAXI were found to be insignificant. On the contrary P values for number of businesses started and type of businesses started such as FUEL, RENTAL and SUPPIES were found to be significant.

The model shows that for the analyzed sample, entrepreneur's previous business experience is significant while their education level is not significant in determining their business income. Due to restrictions on current sample size, these results are expected to be confirmed with more data.

Model	**R**	**R Square**	**Adjusted R Square**
1	.789	.622	.568

Coefficients

Model 1	**Unstandardized Coefficients**	**Standardized Coefficients**	**Sig.**
	B	Beta	
(Constant)	18987.3		.055
Education level	1728.9	.599	.551
VEG	-8657.3	-.116	.206
DOM.BUS	-646.4	-.009	.924
ELECTR	1769.1	.017	.841
SUPPLIES	175825.8	.714	.000
TAXI	-3814.5	-.022	.788
RENTAL	12790.5	.160	.079
FUEL	24505.6	.195	.021
Number of Businesses started	4517.2	.189	.025

a. Dependent Variable: BUSINESS INCOME PER MONTH

Social capital

Peer influence within groups was measured by number of times members gave or received advice from each other as well as their perception of the same.

To indentify opportunity entrepreneurs within the groups, the study employed a selection criterion; individuals with education levels of secondary School and above, type of business started was either supplies, taxi, rental or fuel, had started more than one business and finally had a monthly business income of above KShs 50,000 (EUR 416). The study observed that the number of opportunity entrepreneurs was found to be 9 in total. A further cross tabulation found that only 6 groups out of 12 were found to have an opportunity entrepreneur, with some groups having two to three opportunity entrepreneurs.

Since the study did not find opportunity entrepreneurs in all groups, a dummy variable **totalopporgrps** was created as a sum of opportunity entrepreneurs per groups in which they appear. The dummy takes into consideration that some groups have no opportunity entrepreneurs while others have two or three. Other dummy variables were created as controls to check group characteristics and effect of social capital.

Regression analysis

According to the P values variables of perception of business advice, Duration in the group and financial status are significant to business income. However the number of entrepreneurs in the groups and the size of the group seem to be not significant to how much an individual in that group would earn. The results show that individuals who are receptive to business advice tend to do better. As such, an opportunity entrepreneur can influence a member in his/her group if this individual is receptive to the advice being offered to them.

Model	**R**	**R Square**	**Adjusted R Square**
1	.588	.346	.284

Coefficients

Model 1	**Unstandardized Coefficients**	**Standardized Coefficients**	**Sig.**
	B	Beta	
(Constant)	-42299.7		.020
totopportgrps	3307.9	.105	.277
Iportance of Meetings	2786.5	.088	.416
Perception of business advice	6,503.0	.246	.015
Quantity in Group	122,395	.012	.910
Duration in Group	316,792	.281	.008
Financial status	25457.8	.402	.000
Mentored	-815 2.1	-.088	.421

a. Dependent Variable: BUSINESS INCOME PER MONTH

DISCUSSIONS

This study found that prior business experience was a significant factor in microenterprise growth for the sample used while education level was not. In addition the study found that there was a positive influence of entrepreneurial behavior in groups where individuals were perceptive to receiving business advice.

CONCLUDING REMARKS

The results of this study bring out an interesting perspective of social capital in groups and further advance the findings of Cassar and Wydick (2010) that microfinance not only benefits from social capital but also creates it.

Factors facilitating successful entrepreneurship in settings of poverty have not been fully investigated; indeed this is an area for further research. Furthermore most of this research will be practical and relevant if offered from the developing countries point of view. As Bruton et al., (2013) note, entrepreneurship scholars who live and experience poverty conditions appreciate and understand accurate interpretation of what occurs within such settings.

POLICY RECOMMENDATIONS

This study has invalidated the assumption that all poor people have the ability to start and run a business once they have access to microcredit. In so doing the study aims to encourage policies from governments and MFIs that identify and fund growth entrepreneurs.

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