Social sanctions or social relations? Microfinance in Mexico

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ARTICLE INFO

Article history:
Received 1 April 2015
Accepted 13 June 2015
Available online 7 July 2015

Keywords:
Microfinance
Social capital
Solidarity
Peer-group pressure
Joint liability
Social sanctions

ABSTRACT

Microfinance is a vital source of funding for micro-entrepreneurs in emerging markets and underdeveloped nations. The emphasis in the literature on social sanctions as a mechanism for ensuring high repayment rates may be misplaced. We propose that the construct of harmonious social relations needs to be added in order to explain repayment rates and that high repayment rates foster increased capital formation for micro-entrepreneurs. Using a sample of 182 respondents drawn from a microfinance institution in Mexico and structural equation modeling, the results support the main hypotheses. Unexpectedly, social sanctions had a negative impact on repayment rates.

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1. Introduction

At a time when the eradication of poverty in the twenty-first century is highlighted as one of the Millennium Development Goals, the ability of micro-entrepreneurs to gain access to credit through microfinance institutions (MFIs) has become a core theme of the entrepreneurship and development literatures (Bruton, 2010; Khavul, 2010). As a result, the explosion in microfinance should be encouraging. As of July 20, 2010, there were over 1834 MFIs with gross loans of over US$43 billion (Mixmarket, 2010). Yet, at the same time, there has been a growing crisis in microfinance repayments in many countries due in part to a relaxing of credit discipline, including less frequent meetings for lending group operations (Besley & Coate, 1995; Hermes & Lensink, 2007). The conventional wisdom in the microfinance literature, related to agency theory, attributes high repayment rates to economic mechanisms for enforcement, especially screening and monitoring, as well as social capital, usually equated with group and community pressure and sanctions (Besley & Coate, 1995; Hermes & Lensink, 2007). Enforcement generally refers to the threat of sanctions through peer-group pressure, whether through verbal admonition or the denial of future cooperation (Besley & Coate, 1995). Screening takes place when group members select new members; and monitoring is the process whereby members decide whether tardiness in payments by a member is justified (Giné & Karlan, 2006; Gomez & Santor, 2003). Where groups belong to highly connected communities, group pressure is magnified by community pressure (Besley & Coate, 1995).

This focus on the negative reinforcement provided by social sanctions ignores the positive effect derived from the role that harmonious group relations play in increasing repayment rates. In fact, social capital is much more than social pressure, but includes harmonious social relations within the micro-lending group, yet this factor has been overlooked in much of the literature. As a consequence, the study of group loans by microfinance institutions has been built on assumptions that have limited our understanding of the antecedents of group-loan repayment rates and may be counterproductive (Hermes & Lensink, 2007). This misunderstanding may be driving inappropriate decisions, such as a lessening emphasis on the importance of group meetings. Building on stewardship theory, we argue that the element of harmonious social relations is an essential key to maintaining high repayment rates.
Mexico provides a particularly appropriate setting for this study for three reasons. First, it is an important country in terms of microfinance with approximately five billion dollars in loans to 6.2 million borrowers, accounting for over ten percent of the microfinance industry worldwide (Mixmarket, 2014). Second, as will be explained later, group-based savings has a long tradition in the Mexican institution of the tanda (Vélez-Ibáñez, 1983). Finally, its relatively high power distance and low individualism make it similar to many of the other leading microfinance countries such as Bangladesh (Hofstede, 1984), birthplace of microfinance, suggesting that lessons from the Mexican experience may be applicable to other regions of the world.

This study of group loans in a Mexican MFI not only evaluates theory in the microfinance and entrepreneurship literatures by testing the impact of peer-group pressure and sanctions on repayment rates, but takes a vital step forward by investigating the influence of harmonious social relations on repayment rates, a factor largely ignored in the literature. In addition, unlike prior research, this study does not simply assume that repayment rates are related to financial capital creation among micro-entrepreneurs, but develops an explanation and tests the impact of repayment rates on financial capital formation. Therefore, this paper follows Bruton, Khavul, and Chavez’s (2011) recommendation that researchers investigate the effect of micro-lending groups on business growth and survival. Overall, this paper makes a contribution to the microfinance and entrepreneurship literatures by testing the influence of social sanctions on group repayment rates; by building theory about the influence of harmonious social relations on repayment rates and testing this relationship; and by developing theory regarding the influence of repayment rates on the financial capital creation of micro-entrepreneurs and also testing this relationship.

The rest of the paper is organized as follows. The next section explores different theories that explain high repayment rates and capital formation and presents a model and hypotheses. The following section describes construct measurement, data collection, and the statistical methods used to analyze the data. The fourth section reports the results of the analysis of the measurement model and the structural equation model. The final section discusses the findings and their implications for research and practice, explains the limitations of this study, and presents the conclusions.

2. Theory and hypothesis development

Prior literature suggests that social sanctions increase repayment rates (Giné & Karlan, 2006; Hermes & Lensink, 2007), which in turn lead to increased capital formation by MFIs and borrowers (Gomez & Santor, 2003). The purpose of this paper is to test these relatively understudied relationships and contribute a new variable to the literature, social relations, which also increases repayment rates (Armendáriz de Aghion & Morduch, 2005; Karlan, 2005). Fig. 1 presents a diagram of this study's conceptual model, based on the key constructs in the literature. It displays the relationship of social sanctions and social relations to repayment rates for group loans, which in turn strengthen capital formation by group members. In the rest of this section, the authors explain these relationships.

Certainly, other factors may affect the environment of microfinance in Mexico, such as the institutional context, corruption, and various cultural variables, like power distance and individualism; however, these factors are excluded from this analysis because they are relatively constant within the Mexican setting. Although the authors do not develop these hypotheses only for the Mexican context, they test them within a single national context. Further work might appropriately consider whether national context strengthens or weakens the relationships between the variables in Fig. 1.

2.1. Social sanctions

Peer-group pressure in the form of potential sanctions is the conventional explanation of high repayment rates for group loans. Barley (2006) refers to peer pressure in work groups as a form of “polic(ing)” other members. This form of policing implies the risk of sanctions if other group members do not follow the rules. In microfinance groups, peers exert social pressure through potential sanctions on group members who may be tardy in their payments. If a member does not pay the weekly payment or the remaining balance of the loan, the other members pay. Therefore, it is in the interests of the group that all members make their payments in a timely manner. The threat of potential sanctions is perceived to be a strong motivating force in ensuring punctual repayment (Giné & Karlan, 2006; Gomez & Santor, 2003; Hermes & Lensink, 2007). Group sanctions can take different forms, such as indirect or direct criticism of an individual by the group, exclusion from social gatherings, financial sanctions related to a loan or future loans (i.e. fines, higher interest rates or denied access to emergency loans) depending on the practices of the MFI, or even expulsion from the group.

Group members can also leverage their relationships with other community members to exert pressure on a delinquent group member in the form of potential community sanctions with the aim of persuading members to repay their loans. Before a loan is approved, microfinance staff may obtain character references from community acquaintances and leaders; and may consult with friends, neighbors, and community figures (Armendáriz de Aghion & Morduch, 2005). Word of mouth can be very influential in traditional societies (Goody & Watt, 1968) and future loans from within the community will no doubt depend on the borrower’s reputation (Ahlin & Townsend, 2007). If default or tardiness in payments by one client contributes to the economic burden of another client’s family, business partners, friends or acquaintances, these community members are likely to exert pressure on the potential defaulter (Besley & Coate, 1995).

Following work on lender–borrower relationships generally (Allen, 1985), one may identify a principal (lender)–agent (borrower) relationship in microfinance groups. Agency theory focuses on extrinsic motivation and views sanctions as a means of punishing or rewarding agents and aligning their interests with those of principals. In microfinance, the lender imposes punishment on the group members who then use social sanctions either directly or indirectly via the community as a concrete means of controlling opportunistic behavior. We argue that, overall, social sanctions motivate clients to be more punctual with their repayments. Thus, we hypothesize:

**Hypothesis 1.** The greater the level of social sanctions among microfinance group members, the higher group repayment rates.

2.2. Social relations

Interestingly, the literature concerned with the success of group loans generally concentrates on the coercive incentives provided by sanctions and avoids the positive relational aspects of groups (Giné &
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