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Does forced solidarity hamper investment in small and micro enterprises?

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ABSTRACT

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Summary: Previous research has shown that small firms in poor countries achieve high marginal returns to capital but show low reinvestment rates. We investigate whether transfers motivated by risk sharing and forced redistribution can explain this pattern and may therefore hamper private sector development. The idea is that the more redistribution distorts the fairness of insurance, the more potentially successful entrepreneurs may be hindered to undertake profitable investments. The empirical results based on a sample of small firms operating in Burkina Faso support the main propositions of this paper. *Journal of Comparative Economics* **000** (2016) 1–20. University of Passau, Department of Economics, Innstrasse 29, 94032 Passau, Germany; University of Namur, Faculty of Economics / CRED, Rempart de la Vierge 8, 5000 Namur, Belgium; GIGA, Neuer Jungfernstieg 21, 20354 Hamburg, Germany; Erasmus University Rotterdam, Burgemeester Oudlaan 50, 3062 PA Rotterdam, Netherlands and IZA, Schaumburg-Lippe-Straße 5-9, 53113 Bonn, Germany.

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1. Introduction

Previous research has shown that micro and small entrepreneurs in poor countries achieve relatively high marginal returns to capital but show very low reinvestment rates (see e.g. McKenzie and Woodruff, 2006; 2008; De Mel et al., 2008; Grimm et al., 2011; Fafchamps et al., 2014). The literature is rather inconclusive on the possible causes of the observed pattern. While capital market imperfections have been shown to be related to high marginal returns (McKenzie and Woodruff, 2006; De Mel et al., 2008), they do not explain why these returns are not retained and reinvested. Banerjee and Duflo (2011) argue that an overall low profitability may prevent many entrepreneurs to further increase the size of their firm. Risk, as another factor, has also been associated with high returns, whereby low reinvestment rates are explained by households being required to hold on to cash if investments are largely irreversible (see e.g. Fafchamps and Pender, 1997, Rijkers

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and Söderbom, 2013). One aspect which has received less attention so far is whether obligations to share constitute an important cause of low reinvestment rates.

In a context where people are frequently exposed to severe shocks but where the possibilities to smooth consumption through formal insurance, savings and credit are limited, sharing might be necessary to secure subsistence at all times (see, for example, Townsend, 1994; Kocherlakota, 1996). At the same time if social norms are in place that try to overcome participation constraints (Stark and Lucas, 1988; Coate and Ravallion, 1993; Attanasio and Rios-Rull, 2000; Foster and Rosenzweig, 2001; Ligon et al., 2002; Genicot and Ray, 2003) and add a redistributive role to transfers (Gubert, 2002; Fafchamps, 2003; Azam and Gubert, 2006) transfers may become excessive. In this case, it may be difficult to save and invest in which case sharing obligations can become an important deterrent to economic growth and development.

The idea that family and kinship ties may be an obstacle to economic activity is relatively old in particular in the context of Africa. It is, for example, often mentioned in the anthropological literature (see e.g. Barth, 1967) and was emphasized by modernisation theorists but with very different nuances and clearly distinguished conclusions (see e.g. Lewis, 1955; Meier and Baldwin, 1957; Bauer and Yamey, 1957; Hirschman, 1958; Rostow, 1960). Such negative effects are also discussed in the field of economic sociology and social network analysis as the downside of 'strong ties', which are often also referred to as 'bonding ties' (Granovetter, 1973; 1983; 1985; Barr, 2002).

More recently, the topic has been taken up again by economists (see, for example, Platteau, 2000; 2014; Hoff and Sen, 2006; Alger and Weibull, 2008; 2010; Haagsma and Mouche, 2013). While acknowledging that family and kinship ties can be a vehicle for mutual insurance in contexts where formal insurance markets do not exist, these authors also argue that these ties may become an important obstacle in the process of economic transition when economically successful members within the kin may be confronted with sharing obligations by less successful ones. These obligations may require successful members to remit money, find jobs or host relatives in the city home (see e.g. Hoff and Sen, 2006). The main hypothesis that can be derived from these considerations is that these demands can adversely affect the ability of otherwise successful relatives to pursue and develop their economic activity. While opting out of the kinship network and refusing to comply with sharing obligations is possible, it may result in sanctions and high psychological costs, such as guilt, shame or ridicule or the fear of witchcraft (Platteau, 2000).

To date, there has been very little empirical backup for the existence of negative effects associated with family and kinship ties though there is some evidence that successful individuals do indeed tend to use various strategies to hide their income. Di Falco and Bulte (2011), for instance, find evidence that kinship size is associated with higher budget shares for non-shareable goods. In another paper both authors find that compulsory sharing invites free riding and attenuates incentives for self-protection against weather shocks (Di Falco and Bulte, 2013). Baland et al. (2011) analyze borrowing behaviour and find that some people take up credits even when they don't suffer from a liquidity constraint just to signal to their kin that they are unable to provide financial assistance. Brune et al. (2011) arrive at similar conclusions concerning saving, whereby commitment saving arrangements are found to lead to larger savings than ordinary saving arrangements (see also Anderson and Baland, 2002). The authors explain the positive impact of commitment saving also with the desire to keep funds from being shared with one's kin. Adverse incentive effects due to redistributive pressure are also identified by Jakiela and Ozier (2012). They conducted lab-experiments in rural Kenyan villages in which they randomly vary the observability of investment returns to test whether subjects decide to hide income under certain conditions and indeed find that at least female participants who know that the outcome of their investment will be made public, make decisions that are expected to be less profitable. Baland et al. (2014) reveal a system of reciprocal credit within extended families in Cameroon and find some evidence that this has negative effects on labour market outcomes. Duflo et al. (2011) point to sharing obligations as one explanation why impatient Kenyan farmers forgo highly profitable investments in fertilizer. They argue that the impatience is partly rooted in the difficulty of protecting savings from consumption demands. Finally, Fafchamps (2002) also finds a negative association between perceived 'fear of predation by relatives' and value added among agricultural traders in Madagascar.

Against this background, the purpose of this paper is to empirically investigate whether family and kinship ties used for redistribution and mutual assistance reduce the ability to invest in enterprise capital. To guide the empirical analysis, we start from a theoretical model in which entrepreneurs have to decide whether they want to invest and rely on themselves or whether they share their income with their family and kin, hence forgo investment opportunities, but are insured against business and household-related shocks. A sanction that is imposed if sharing is refused, may force entrepreneurs to comply even if from their individual perspective investing would be the better alternative. In other words, sharing becomes the norm and can be interpreted as compulsory informal insurance; non-compliance with which is costly. Predictions derived from that model are then tested empirically using data from small and micro entrepreneurs in Burkina Faso. Sharing norms are generally strong in the Burkinabè context, in particular within the dominant ethnic group of the Mossi (Fiske, 1990; Englebert, 1996).

We find empirical support for our theoretical model. Redistributive pressure and risk aversion increase the probability of staying in the risk sharing network and this is associated with significantly lower investment as pressure increases. In contrast less risk averse entrepreneurs that step out of such networks show clearly higher investment levels and have substantially larger stocks of capital. Family pressure does not affect their investment decisions.

It is important to note that in this paper we focus on family and kinship ties as opposed to social networks. The main difference between family and kinship ties, on the one hand, and the social network as a generic set of individuals who interact, on the other, is that family and kinship ties can be seen as largely exogenous and cannot be changed freely or

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