How Cash Transfers Create Businesses?

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The creation of small, but formal, enterprises is one of the engines for the process of economic growth with poverty reduction. Among all kinds of policy thought to foster entrepreneurial activity, access to financial services, particularly credit and insurance, usually receives the most attention. The common presumption is that microloans and cash transfers provide the liquidity to poor individuals who want to start a business but cannot afford the start-up costs and potential losses with their own savings.

This presumption, however, ignores the role of risk-sharing strategies and mutual assistance between households in investment decisions. Indeed, informal financial arrangements, such as interpersonal lending and mutual insurance, are often reported as a form of poor households sharing idiosyncratic risks. Accordingly, small entrepreneurs may also lean on friends and relatives as a source of credit and insurance. In this case, they are not financially constrained, but their investments are more responsive to the liquidity in the informal system than in the formal market.

Social transfers may increase liquidity in the informal market because their recipients might use them to invest or just help another household's business, instead of saving or spending them. In Brazil participants in the Bolsa Família programme are found to be 40 per cent more likely to make private transfers to other households than non-participants with the same level of income. Despite their low income, by receiving a steady transfer every month, programme participants have enough room to become a crucial source of liquidity in their communities. Then the programme produces spill-overs that indirectly affect the decision of both recipients and non-recipients to be an entrepreneur.

In a recent study (Ribas, 2014), I found that the proportion of small entrepreneurs has grown by at least 10 per cent (or 7 percentage points) because of the liquidity provided by Bolsa Família in urban areas. Nevertheless, after decomposing this impact into direct and indirect effects, I observe that they go in opposite directions. While the rise in entrepreneurial activity is entirely driven by spill-overs within villages, the direct response of participants reduces the overall impact by 40 per cent.

My results, on the one hand, confirm that the indirect impact of cash transfers is associated with an increase in private transfers between households. Then the liquidity shock delivered by the programme appears to reduce the opportunity cost of risk-sharing among poor households, rather than lessen individual financial constraints. Furthermore, the indirect effect of Bolsa Família on entrepreneurship is at least as high as the effect of other similar cash transfer programmes and microfinance policies. This finding is consistent with the fact that in a risk-sharing network the transfers made to any household will eventually end up in the hands of potential entrepreneurs.

On the other hand, an eligibility rule tends to encourage recipients to either reduce their labour supply or move to the informal sector so that they continue receiving their benefit. In fact, the negative direct response of participants in Bolsa Família is followed by an increasing participation in the informal sector. It is worth noting that informal workers do not have their earnings tracked by the government, unlike formal workers and entrepreneurs.

Given those two opposite gradients, the net growth of entrepreneurship depends on the initial level of liquidity in the local economy. As a result, the program is not effective in creating businesses in large cities, because the negative direct response offsets the small spillover. The program's impact is rather concentrated in small villages. This result reveals the importance of combining geographic targeting with household targeting for the programme to be more cost-effective.

Reference: