

Returns to Capital in Microenterprises

Small amounts of capital have big payoffs in microfirms—at least for those owned by men. It's a different story for those owned by women

Small, informal firms provide employment for half or more of the labor force in most developing countries. A central question for policy makers is whether these firms hold the potential for income growth for their owners—or whether they merely represent a source of subsistence income for low-productivity workers unable to find alternative employment.

Assessing the extent to which lack of capital is a constraint on business profitability is complicated by the fact that firms that have more capital stock or greater access to credit are likely to also differ in many other ways from firms with less capital stock. Firms with more capital may earn higher profits simply because their owners have better entrepreneurial skills than those owning firms with less capital or because they have increased their capital investments in response to growing demand for their products.

A recent randomized experiment in Sri Lanka provides a way to resolve this problem and credibly identify the return to capital. Grants of \$100–200 were given to randomly selected microenterprises, making it possible to compare the profits of these firms with those of similar firms that did not receive this additional capital. The research finds real returns of 5 percent a month, much higher than market interest rates. But while returns to male-owned businesses are high, the average return to female-owned businesses is close to zero.

The results imply that, on average, microenterprises do have the ability to pay the high interest rates charged by some microfinance organizations—and that firms can start small, reinvest profits earned, and grow. The high returns to male-owned microenterprises suggest a need for the microfinance industry to develop

products to better serve these enterprises. But the low average returns earned by female-owned enterprises are a puzzle, one that ongoing research is attempting to understand.

Suresh de Mel, David McKenzie, and Christopher Woodruff. Forthcoming. "Returns to Capital in Microenterprises: Evidence from a Field Experiment." *Quarterly Journal of Economics*.

New Global Poverty Estimates

Poverty rates are higher than previously thought. But there is also evidence of continual decline in poverty since the early 1980s

The last issue of the *Research Digest* (vol. 2, no. 4) reported on the new data on the cost of living in developing countries from the International Comparison Program. This new set of consumption purchasing power parities (PPPs), estimated from the 2005 round of price surveys, has been used by Chen and Ravallion to undertake a major overhaul of the World Bank's past estimates of global poverty.

Extreme poverty—as judged by what poverty means in the world's poorest countries—is found to be more pervasive than previously thought. Yet the data also provide robust evidence of continual decline in the incidence and depth of poverty since the early 1980s. In 2005, 1.4 billion people, or a quarter of the population of the developing world, lived below an international line of \$1.25 a day in 2005 prices; 25 years earlier there were 1.9 billion poor, or half the population (figure 1).

Progress was uneven across regions. The poverty rate in East Asia fell from 80 percent to less than 20 percent in 1981–2005. By contrast, the rate in Sub-Saharan Africa stayed at around 50 percent, though with signs of progress since the mid-1990s.

Because of lags in the availability of survey data, these estimates do not yet reflect the sharp rise in food prices since 2005.

Shaohua Chen and Martin Ravallion. 2008. "The Developing World Is Poorer Than We Thought, But No Less Successful in the Fight against Poverty." *Policy Research Working Paper 4703*, World Bank, Washington, DC.

Figure 1. People Living on Less Than \$1.25 a Day, 1981–2005

