

Behavioral Foundations of Microcredit: Experimental & Survey Evidence from Rural India

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Orthodox economic theory is based on the assumption that people make decisions rationally, by weighing expected costs against expected benefits. Behavioral economics departs from this assumption to make room for theories of decision-making that better match the way people actually behave. One such theory is “hyperbolic discounting,” or the idea that people think differently about choices that matter today compared to choices that will bear out in the future. The theory accounts for why, in general, people tend to under-save and over-borrow. In order to understand how hyperbolic preferences relate to the success of microcredit contracts, Michal Bauer, Julie Chytilová, and FAI managing director Jonathan Morduch examine survey data from rural India. They ask villagers about their preferences for receiving a sum of money today or a larger sum in the future and find that preferences are inconsistent, varying with the amount of time they would have to wait for the future payout. They also find that women with present-biased preferences are particularly likely to be microcredit borrowers. This finding aligns with the idea that microcredit borrowing offers specific structure and support for people with self-discipline problems.

Time-Inconsistent Preferences

A common feature of microcredit contracts is repayment in small, frequent installments. Since clients typically have yet to reap returns from the investment of their loan when they begin making repayments, these repayments must come from other sources of income. In this way, microcredit contracts resemble a savings mechanism, or a way of setting aside a little money at a time in order to access a lump sum. Given that clients must pay interest on loans, however, it seems puzzling that they would choose to access lump sums in this way instead of simply saving. An insight from behavioral economics, hyperbolic discounting, makes sense of this puzzle. It explains that some people are present-biased—they are more impatient with regard to current trade-offs than with regard to future tradeoffs. Hyperbolic discounting creates a tension between future plans and current actions. People who understand this inconsistency, even intuitively, value ways to commit themselves to future plans. Microcredit contracts are one way of doing so. To examine the relationship between hyperbolic preferences and the success of microcredit contracts, Bauer, Chytilová, and Morduch survey 573 villagers in rural India who match the profile of microcredit clients.

Results

The authors find that roughly one-third of the people they surveyed are present-biased. Women in this group tend to keep a smaller share of their savings at home and are more likely to borrow from microcredit organizations. Patient people, on the other hand, save more and have more “future-oriented” saving goals. These findings are consistent with the notion that microcredit borrowing offers structure for people with self-discipline problems who want to accumulate capital but lack convenient savings mechanisms.

Policy Implications

This study makes a link between hyperbolic discounting and use of microcredit borrowing. Borrowing to save is one way microcredit can be useful beyond allowing borrowers to invest in microenterprises. The findings suggest that creating more convenient and reliable savings mechanisms could help people who value microcredit as a commitment device better manage their money.