Does Selection Matter in Credit Markets?
Survey Evidence from Uganda

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Abstract

In this paper, I study how modifications to the standard credit contract affect loan demand and selection into borrowing, using a random sample of micro enterprises in urban Uganda. Despite widespread enthusiasm about microfinance as a tool in alleviating poverty, recent evaluations of microfinance initiatives have found the long run impact on firm growth and the welfare of borrower-households to be limited. Existing studies of microfinance focus on present or previous borrowers, and can therefore provide only limited insight into how effectiveness of micro loans is affected by se-lection into the borrower pool. I study loan attitudes among a random sample of entrepreneurs, most with no experience of borrowing, in core sectors within both retail and manufacturing. Hypothetical loan demand questions are used to test whether firm owners respond to changes in loans' contractual terms and whether take-up varies by firms' risk type and firm owner characteristics. The results indicate that contracts with lower interest rates and less stringent collateral requirements are likely to attract less risky borrowers. This is especially true among manufacturing sectors. The findings suggest that there is scope for improvement of standard financial contract terms.

Keywords: Loan contract structure, Microfinance, Business growth, SMEs.