Microfinancing for Informal Enterprises: Perspectives in Colombia

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Abstract

Informal economy is a phenomenon present in all Latin American countries. It causes lower level of productivity and social problems given the fact that informal workers do not have social benefits neither the possibility of having a retirement fund if they keep in the informal market. Reducing the size of the informal sector of the economy is a step that must be taken in order to improve the economic and social situation. One important factor of a policy to reduce the size of informal economy is the access to credit to entrepreneurs. This paper summarizes briefly the situation of informal economy in Bogotá, Colombia and proposes microfinancing as a realistic and inclusive way to include informal enterprises into the formal sector of the economy.

Keywords
Microfinancing, Informal enterprises, micro and small enterprises

1. Introduction

Access to financial funds is one a key issue for any enterprise, even more for micro, small and medium enterprises. Nitescu (2015), stated that the problem of access to funds has increased due to the financial crisis and the economic downturn. In Latin America, thirty-one percent SMEs identify access to financing as an important obstacle (ECLAC and EU-LAC, 2015).

Salcedo-Pérez and Carvajal-Contreras (2018) state that insufficient access to financing may lead entrepreneurs to get funds from informal lenders, who ease the requirements for lending but charge higher interest rates compared to formal lending. This high interest rates can become a problem for the survival of entrepreneurs, especially when they are starting their business operations. Therefore, to increase access to formal sources of credit to small and medium entrepreneurs becomes a must in order to improve the situation of business and the economy of a country. However, micro and SMEs do not necessarily use or have access to formal credit. Ferraro (2011) includes high interest rates, lack of collaterals, and excessive requirements (paperwork) as factors that restrain micro, small and medium enterprises from asking formal credit institutions for financial funds. In the specific case of Colombia, only 27% of all loans were granted to SMEs, while in Europe 46% of all loans were given to SMEs (ECLAC & EU-LAC, 2015).
The previous numbers provide an idea of a challenge that is important to address in order to increase economic development and strengthen competitiveness.

This paper concentrates on access to financing for micro and small enterprises in Colombia, considering especially informal business, given the importance of this enterprises in the Colombian economy and the fact that informal enterprises usually operate at micro and small sizes. The authors emphasize on and propose microfinancing as a possible, realistic, applicable way to increase access to formal credit to enterprises.

2. Informal Economy

According to Kalmanovitz (2015) informal activities are those that are not regulated by law, by which workers earn less than minimum wage and do not have access to social security, do not join unions and employ less than 10 workers. Even when not all informal enterprises may employ less than 10 workers, it is clear that when studying informal economies, their micro or small size is a characteristic considered usual. Actually, the first definitions provided by the ILO considered also the small size as a characteristic of informal activities. Since informal economies operate outside the formal business environment, it could be considered obvious their small size, since bigger numbers will make it difficult to hide activities. However, Salcedo-Perez (2012) states that the fact that an enterprise is created following the requirements established by Law, such enterprise may not meet the legal requirements for its workers, therefore having a formal enterprise with informal workers operating in it.

The definition by Kalmanovitz, a Colombian economist, encompasses two characteristics of the informal sector different to size: lack of fulfilment of formal regulations and informal jobs. It is important to keep this in mind since estimations of the size of the informal economy in Colombia performed by the DANE (National Administrative Department of Statistics, official entity in charge of statistics) emphasize on the percentage of workers who work in the informality (who may or may not work in an informal enterprise).

Different authors provide different explanations for informality. De Soto (1987) was the first person who tried to provide an explanation to find an explanation about why entrepreneurs decided to start their business outside the formal regulatory environment, finding that excessive bureaucracy (paperwork and regulations) and costs were in the root of informality; therefore, informality became a response to these obstacles. These ideas have been at the core of measures to reduce informal economy in many countries. Thus, many initiatives have been aimed at reducing costs, procedures and time at the moment of creating an enterprise. Another explanation to informal activities comes from Pollack and Jusidman (1997) who state that informal jobs exist because the formal sector of the economy does not provide enough jobs. Therefore, a change in the economic structure and an environment that strengths formal enterprises can be a factor to help reduce the size of the informal sector of the economy.

2.1. Informal Economy in Colombia

According to the Asociación Nacional de Instituciones Financieras (National Association of Financial Institutions of Colombia, which groups all formal financial institutions of the country) ANIF (2018), the informal economy in Colombia accounts for 39,8% of GDP, of which 33,5% deals with legal activities, 54% of all enterprises and 25% of tax evasion. It is important to clarify that the authors of this paper consider the informal sector only legal activities (not illegal activities) though they are performed not following the regulations established for their creation and operation in terms of registration, taxation and labor requirements. The Departamento Nacional de Planeación (National Department of Planning, government organization in charge of planning issues in the country) DNP (2018) over 75% of micro enterprises in Colombia are not registered, and the percentage of not complaining with taxation and labor regulatory norms is even higher. It is estimated that there are 2,5 million micro, small and medium enterprises in Colombia which account for 67% of jobs and 28% of GDP (Dinero, 2016).

The most common used and cited statistics to estimate the size of the informal sector in Colombia are those official statistics provided by the DANE. The DANE, estimates the size of the informal sector in terms of the percentage of workers operating in it. Figure 1. Percentage of informal workers in Colombia, 2016-2019 shows the percentage of workers who work in the informality in Colombia in the period 2016-2019. The numbers show the percentage estimated for the mobile quarters of April to June of each year.

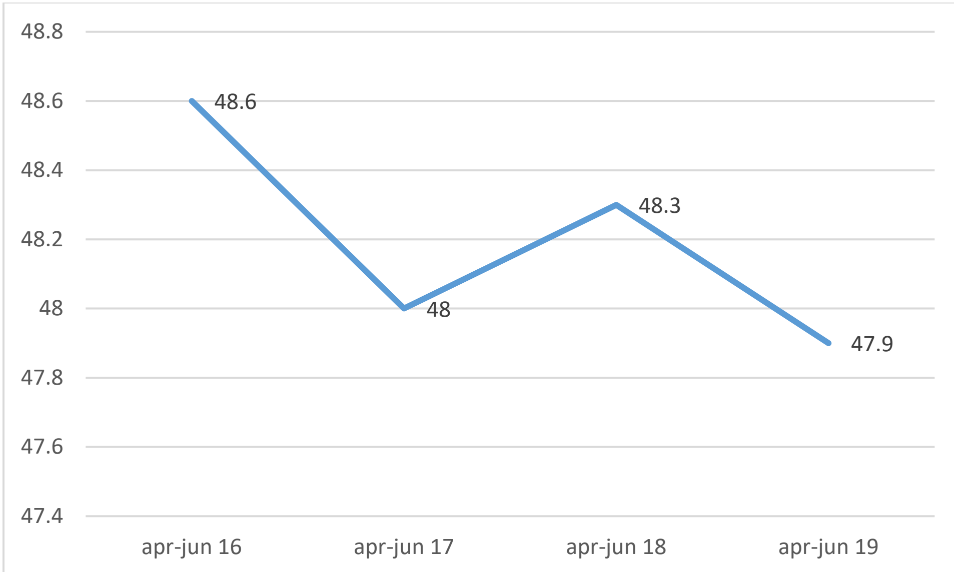

Figure 1. Percentage of informal workers in Colombia, 2016-2019
Source: the authors using information from DANE (2016), DANE (2017), DANE (2018) and DANE (2019)

As Figure 1 shows, the percentage of informal workers has been on a decreasing trend, even though it grew slightly in the 2017-2018 period. In the last three years, the percentage of informal workers decreased 0.7%, good but not enough.

Since the authors have developed their research on entrepreneurs from Bogota, data for informal workers of the city is shown. Figure 2. Percentage of informal workers in Bogota, 2016-2019 shows the percentage of workers who work in the informality in Bogota in the period 2016-2019. The numbers show the percentage estimated for the mobile quarters of April to June of each year.

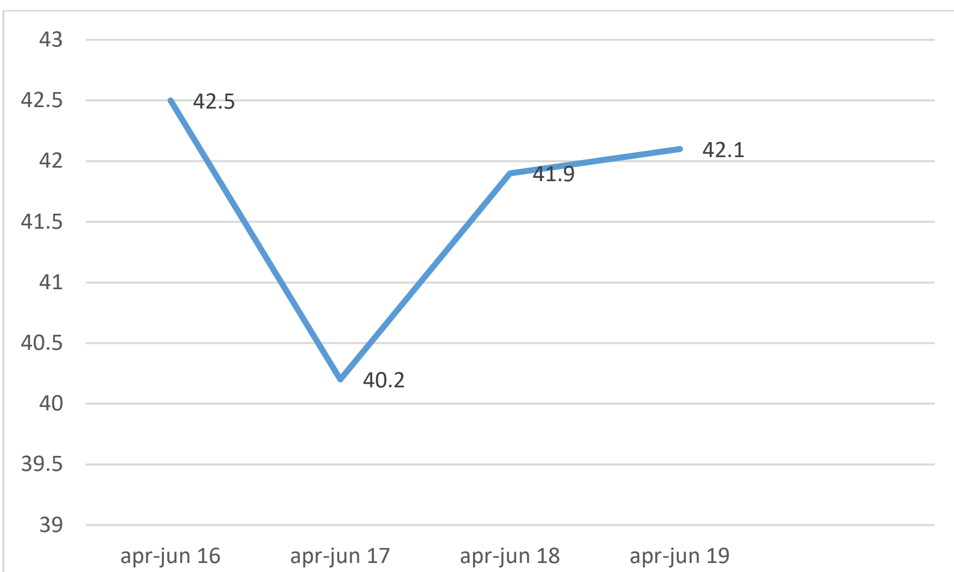

Figure 2. Percentage of informal workers in Bogotá, 2016-2019
Source: the authors using information from DANE (2016), DANE (2017), DANE (2018) and DANE (2019)

Data shows that as at national levels, the percentage of informal workers in the las three years decreased but on a smaller percentage (0.4%). However, in the last two years the percentage of informal workers has shown a constant increase, from 40.2% in 2017 to 42.1% in 2019, (1,9%). The strong reduction of 2,3% that occurred in the period 2016-2017 has been almost completely regained in the last 2 years.

In Colombia, there have been studies to find causes that explain the occurrence of informal economy. Ochoa and Ordoñez (2004) stated that unemployment has an effect on the number of informal workers. High non salary costs and minimum wage were found to have an effect on the size of informal economy (Mondragon, et al, 2009). Gordo (2002) cited the DANE, stating that 56.95% of informal entrepreneurs do not register their enterprises because they think registration is not mandatory; 18.64% are not sure that whether or not registration is mandatory; 11.75% do not do it because of registration costs, 8.73% because of paperwork and requisites and 3.93% because of time.
The first two causes find factors that explain the percentage of informal workers, while the last two deal more with the creation of informal enterprises (that will have at least one informal worker). It is important to point that lack of knowledge about regulation was a cause mentioned by most entrepreneurs, instead of the traditional view of cost, time and regulatory obstacles, mentioned only by 24.41% as a reason for not formalizing their businesses. Colombia has made improvements in terms of facilitating formal registration of enterprises, which may lead to such numbers.

Related not to causes to be informal but to alternatives to formalize, in a study directed towards informal footwear manufacturers in Bogota, Salcedo-Pérez (2012) found access to formal credit as the most mentioned factor by informal entrepreneurs when asked about possible motivators for formalizing their businesses. Entrepreneurs mentioned access to such credit not only as a factor that motivate them to formalize their business, but also as the most important advantage perceived of being formal. There are other factors that may motivate formalization (professional training in managerial aspects among them), and other advantages perceived of being formal (such as access to markets and possibilities to increase the size of their business). Regardless other aspects, access to credit was found to be the most important. The authors then will concentrate on this aspect, considering microfinancing as one way to provide such formal financing that entrepreneurs are looking for in order to become more competitive, get the resources they need to grow and to become formal in the case of informal enterprises.

3. Microfinancing

Since the late decades of the XX Century, microcredit has been considered a financing mechanism that could help to reduce poverty and extreme poverty, a condition suffered by a big share of world population. Consequently, the United Nations, in its Millennium Declaration, declared that Microcredit should play an important role when it comes to improving living conditions of the population and in order to boost such idea, it named 2005 as the International Year of Microcredit (Patiño, 2010).

Since then, microcredit acquired its current importance, and it has helped financing economic growth, being one of the elements that facilitate the development of more solid and stable financing conditions, which as a consequence increase the GDP (King and Levine, 1993). However, findings are contradictory since Larrain (2009) proved that countries with higher economic development are those in which there is lower development of microfinancing.
Just as it happened in the rest of the world, microcredit operations in Colombia started as private initiatives, specifically from NGOs, which primarily tried to satisfy the financial needs of population in conditions of extreme poverty (Junus, 2009; Navajas and Tejerina, 2007).

The decrease in the social divide, especially evident in extreme poverty conditions, reduce inequality, therefore, this causes the creation of an inclusive financial system that includes the poor but without generating distortions to incentives to productive activities as consequence of the creation of subsidies and tax benefits (Dermiguc-Kunt et.al., 2007).

Therefore, it is not only about being part of a financial system; challenges for microcredit institutions are deeper, their persistence in time is linked to their understanding of the conditions inherent to their service. In such sense, an institution must fully know its target market, differentiating their legal nature, place, industry, product, recognition in the market, among other characteristics (Ledgerwood, 1999).

Considering the specific characteristics and social function of microcredit and its social functions, there must be limits regarding the amounts that institutions can lend. Thus, the first regulatory measures about microfinancing in Colombia were established by the Law 590 issued in 2000. Such Law established that to be considered microfinancing operations they must comply with: do not be over 25 current minimum legal monthly salaries (approximately USD 6,500.00 by May 2019) and with consolidated amounts that do not have balances over 120 current minimum legal monthly salaries (approximately USD 31,000.00 by May 2019).

Due to its nature, microfinancing is a credit form that must focus on programs directed towards microenterprises, which, according to Colombian Law, must not have over 10 workers; in addition, their total assets cannot surpass an amount of 500 current minimum legal monthly salaries (approximately USD 130,000.00 by May 2019) (Congress of the Republic of Colombia).

Lagos (2018) presented some facts that show the development of microfinancing in Colombia lately. Specialized microfinancing institutions have improved their participation in the market with an stable growth in the number of new clients in the system, which favors their consolidation as a financial alternative; on the contrary, non-specialized institutions have seen their participation in the market go down, with less loans, a reduction of their balances and an increase in defaults. Regarding coverage, new loans have been made in regions of the country with higher levels of economic activity, especially in sectors such as retail trade, food products retailers, clothing and apparel and street vendors. Besides, Lagos (2018) states that private microfinancing institutions are those that most favor processes of financial inclusiveness, and that the amounts lent are considerably lower than those given by public organizations.

One of the aspects that favors microfinancing the most is historically the low level of defaults. Thus, Clavijo (2016) states that the frequency of a credit payment is one of the most important factors of defaulting, also stating that higher rates of default occur when credits have bigger payment intervals; therefore, the higher the frequency of the payment, the lower the possibility of entering into default.
The previous affirmation goes along well with the reality of the financing of Colombian microenterprises, in which the informal lending market offers different payment methods, even including daily payments. This is one of the product lines in which microfinancing institutions must develop alternative financial products, since it is the only way to take borrowers from informal lenders and include them in the formal financial system, also taking them out of the circle of extreme poverty that high interest rates have caused.

Given the conditions in which informal credit operates, statistics about this phenomenon are almost nonexistent, however, estimations calculate that amounts lent are higher to 5 trillion COP (approximately USD 1.55 billion by May 2019).

One of the biggest challenges for microfinancing institutions, that becomes a big opportunity for informal lenders, is the inability to react quickly to market conditions. The alternative financial market, that permanently rethinks its own options, has developed lending mechanisms through online platforms that fully facilitate access to credit in financial conditions that keep the excessive costs attributed to traditional informal lending. There are credits that can be asked for in just a few minutes, whose financial study takes also a few minutes, and whose funds are provided to the borrower in no more than 24 hours; these types of credits are just few of many that can be found online. Even though the interest rates offered are not as high as those charged by informal lenders, there are other associated costs, such as the use of the online platform or warranties, raising the final cost of the credits even to 40% for a 20-day lending period, which means an APR of 42,588%. This alternative market can charge such types or rates, absurd for an economy that looks for better conditions for its micro entrepreneurs (Salcedo-Pérez and Patiño, 2017).

Along with this situation, the formal microfinancing market had high growth expectations in 2018, regarding the fact that there are still many obstacles to grant credits such as borrowers' low repayment capacity, over debt, bad credit history and long geographic distances to get to bank offices (Banco de la República de Colombia, et al, 2018).

4. Microfinancing: An Alternative to Informal, Micro and Small Enterprises

An exploratory study performed by the authors in 2014 showed low levels of microfinancing use by informal footwear manufacturers in Bogota (Patiño and Salcedo-Pérez, 2016). In another study in 2016, the same authors found that over

40% of micro and small entrepreneurs in Bogota did not know what microfinancing was or did not know that there were institutions that offered microfinancing (Salcedo-Pérez and Patiño, 2017).

This data called the attention of the authors, considering the limited financial alternatives available for informal, micro and small entrepreneurs in Colombia, where entrepreneurs many times use informal lenders that charge high interest rates. Microfinancing institutions offer lower interest rates than informal lenders, accept informal entrepreneurs as customers to provide financial funds. However, the fact that high percentages of entrepreneurs do not even know about their existence (therefore do not consider them as an available formal source of income) leads to two issues: 1) microfinancing institutions are losing a target market they could serve and that instead is usually recurring to informal sources of financing, and 2) entrepreneurs are turning to informal lenders, missing the opportunity to get cheaper credit that will allow them the opportunity to grow and become more competitive, by reducing the cost of their financing and having more resources available for their short and long term needs.

Microfinancing could play the role of incorporating entrepreneurs to the formal financing system, allowing informal, micro and small entrepreneurs/enterprises to start creating a credit history. If credit history records are good, they can ask for higher amounts of money in the formal financing industry. A person who repays at higher interest rates to informal lenders may find easier paying lower interest rates to a formal institution, creating a history that makes it appealing to formal financing institutions. One problem that many entrepreneurs have is that they need small amounts of money that the formal system do not provide as formal loans, so if they want to finance small operations with formal financing they use credit cards, which are the most expensive formal financing available. Since microfinancing institutions have a limit in the amount lent, this reduces the risk of default, while providing the resources that informal, micro, and formal entrepreneurs need for their operations.

The authors want to highlight that regardless its clear advantages, microfinancing is not the panacea to informal, micro and small entrepreneurs. It is definitely a financing method that can help formalizing enterprises and providing cheaper resources, but other additional measures are necessary to help entrepreneurs. Most informal entrepreneurs, or micro and small entrepreneurs do not have a clear knowledge about financing options, financial institutions or the correct use of financing in a business. Financial education, at least at a basic level, is necessary to increase the possibility of success of any mass credit policy directed to small entrepreneurs. The latter is not a topic intended to be covered in this paper, however the authors consider important to mention it for future investigations.

5. Conclusions

Credit is an important factor for any enterprise. Credit allows enterprises to have the resources needed to survive, grow, and consolidate their position in the market. Informal, micro and small enterprises usually lack access to formal financing, then recurring to informal lenders to obtain resources that have to be repaid at high interest rates, even though the process to acquiring such resources is easy given the low requirements needed. This factor becomes then crucial for enterprises, since recurring to informal lenders is an obstacle to their growth and competitiveness, which in turn affects the economy as a whole.

Microfinancing represents a formal, cheaper alternative that informal, micro, and small enterprises have to finance their operations. In the case of Colombian informal enterprises, this financing method can represent that access to formal, cheaper credit they find appealing in order to become formal. Micro and small enterprises, due to their size and limited amount of resources find a similar situation than informal enterprises when needing credit, recurring also to the same lenders.

Microfinancing is a realistic, available alternative since microfinancing institutions already exist in Colombia, the amounts lent and requirements necessary are at reach of what informal, micro and small enterprises can meet. As mentioned, microfinancing is not a panacea but an alternative to find resources in the formal financing industry. However, microfinancing institutions must make themselves more visible to informal, micro and small entrepreneurs, so it is necessary that they try to get closer to their customers. Microfinancing is not a panacea to solve all entrepreneurial problems, but definitely can help a very important one as it is facilitating access to resources to enterprises that have found hard to get them. Financial education is necessary so entrepreneurs will not only have resources but also know about financial choices and the correct use of them.

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