

THE DESIGN OF MICRO CREDIT CONTRACTS AND COSTS OF CREDIT:
A CASE STUDY OF MICRO ENTERPRISE FINANCE IN UGANDA.

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Abstract

Several factors affect the efficient performance of credit markets. Uganda, like any other least developed country, has a credit market characterized by what economists call “market imperfections” that affect access to credit. These imperfections can broadly be summarized as information asymmetry and moral hazard. Their effects on the functioning of credit markets vary from one jurisdiction to another. In most developing countries, efforts to improve access to credit have largely focused on lending techniques in which contracts are structured in such a way as to overcome the credit market frictions ordinarily faced by lending institutions. Microfinance has been heralded for its use of innovative lending methods to improve access to credit. The last decade has witnessed an unprecedented increase in the outreach of micro lending institutions and the development of financial products suited to the needs of the economically active poor who often are unable to obtain credit from traditional lenders such as commercial banks.

This research seeks to examine why, despite measures aimed at improving access to micro credit, micro enterprises in Uganda prefer to finance their businesses using informal sources of credit. I present the results of an empirical investigation involving 602 micro enterprises located in various parts of Uganda and 105 lending institutions. The findings show that while the majority of micro enterprises need credit, they opt for other forms of finance, particularly informal credit, for various reasons.

I argue that although the design of micro credit contracts attempts to eliminate the problems of adverse selection and moral hazard, there are price and non-price costs associated with the design of these contractual arrangements that affect demand for micro credit. Factors such as the evolving nature of micro credit lenders, the lack of flexibility in structuring

micro loans, the negative perceptions about loan applicant screening processes, the harsh expected consequences of default, the disincentives of contingent credit and the blind sanctioning of default, increase the costs of credit for micro enterprises. Therefore, unless addressed, informal credit will continue to play a more significant financing role than formal credit.