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Abstract

Governments are trying to alleviate the widespread liquidity problems caused by the COVID-19 crisis by facilitating access to loans and guaranteeing debt. However, entrepreneurs frequently do not apply for a loan, even if the company would be in need of financing (Nguyen et al., 2020). In the context of an economic downturn, this self-rationing behavior is expected to become more pronounced, and can generate large economic problems. Research suggests self-rationing can be related to burdensome application procedures and the anticipation of being refused a loan, but is often also motivated by inherent debt aversion that is likely grounded in cultural factors. To reduce the risk of widespread underuse, effective credit support programs should therefore not only be designed with streamlined application procedures and simple-to-understand features, but should also be accompanied by a communication effort targeted at reducing debt aversion and other forms of borrower discouragement.

Keywords: Borrower discouragement, Debt aversion, Education, Financial constraints, SMEs

* This short paper summarizes the results of Nguyen, T. H., Nguyen, M. H., Troege, M. & Nguyen, T. H. A. 2020. "Debt aversion, education and credit self-rationing in SMEs." Small Business Economics, 1-19. in light of the current economic crisis.

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Now is not the time to be afraid of debt

Governments and organizations around the world have reacted to the liquidity crisis triggered by the COVID-19 by providing different types of financial support. However, almost all of the proposed tools rely on the supply of subsidized or guaranteed debt. This is not only problematic because new debt adds to the already high debt level of many companies, but also because many SMEs will be reluctant to apply for loans in the first place, even if their companies are in dire need of financing (Kon and Storey, 2003). This type of credit self-rationing has been found to be particularly severe during an economic crisis with serious consequences (Cowling et al., 2016).

We know that even in normal times many SMEs do not invest enough. The traditional explanation for this underinvestment relies on supply-side financial constraints. A large literature builds on Stiglitz and Weiss (1981)'s seminal insight that asymmetric information can lead to credit rationing and thus a sub-optimal level of investment. These findings provide the rationale for a large variety of policies aiming at improving access to finance around the world and also serve as underlying motivation for the large effort that is currently underway to prevent widespread liquidation of companies affected by the COVID-19 crisis.

Credit self-rationing

Recently, however, researchers have begun to understand the importance of demand side credit rationing rather than the supply side rationing. In other words, often it is not the lenders who refuse to provide credit, but entrepreneurs who self-ration loans, i.e. knowingly restrict the firm’s use of debt to a suboptimal level. This phenomenon, often called borrower discouragement in the literature, is widespread in both developed markets as well as emerging markets, and has been documented in several European countries (Bhaird et al., 2016, Brown et al., 2011). Empirically, the percentage of discouraged borrowers has been found to range from less than 10% to as high as 44.36%.

Cowling et al. (2016) study the UK's SMEs and show that borrower discouragement rises during the 2008's global financial crisis. They also find that discouraged borrowers overestimate the extent of contraction in credit availability due to the economic downturn, and 55.6% of them would have got loans had they applied. Consequently, they estimate that under-investment resulting from borrower discouragement is in the billions of pounds during that crisis.

Designing debt-based support programs

This has important consequences for the design of the tools to stabilize companies in the current crisis. Credit self-rationing will limit the effects of efforts targeted at improving the supply of finance through loan subsidies and monetary expansion. Moreover, self-rationing SMEs will lower their economic activity which, thought network externalities, will create negative spillovers on other firms. The resulting multiplier effect can reduce long term economic growth. In extreme cases, underfinanced companies will fail during or after the crisis, and then cause the failure of firms to which they are connected in the supply chain.

These risk externalities can cause the interruption of the entire supply chains and result in severe economic distress.

It is therefore essential to identify the reasons for self-rationing and address the causes with appropriate policy measures. The literature essentially provides two types of explanations. Kon and Storey (2003) argue that self-rationing is a rational behavior if firms anticipate high loan application costs and low loan acceptance rates. These views are corroborated by the fact that discouraged borrowers have been found to be riskier and less creditworthy (Han et al., 2009). Self-rationing may therefore be a rational strategy to avoid wasting resources on a costly application with little chance of success.

Nguyen et al. (2020) show, however, that this type of rational borrower discouragement is not the only reason for self-rationing. They identify irrational debt aversion or fear of debt as another reason for self-rationing. In their data base of Vietnamese SMEs, debt-averse entrepreneurs are defined as those who indicate that they did not apply for formal loans specifically because they do not want to incur debt. In other words, they avoid bank loans not because they are discouraged by application costs or a low probability of success, but because they think that debt is per se undesirable. In their sample, 6.9% of all firm-years are discouraged from applying for loans due to the apprehension of a difficult application process, whereas, 11.6% do not apply because they are debt-averse. This suggests that self-rationing due to irrational debt aversion or inability to deal with loan application process is no less a problem than rational borrower discouragement.

Reducing self-rationing

How can this kind of irrational self-rationing be addressed? Nguyen et al. (2020) show that credit self-rationing is related to the educational background of the entrepreneur: Entrepreneurs with university degrees are less likely to be discouraged from applying for formal loans due to perceived difficulties in loan application process, and are less likely to exhibit debt aversion. These mentality has concrete consequences: Entrepreneurs with lower educational levels more frequently report administrative difficulties during the application process. They also actually use less debt, especially less bank loans, and at the same time are more likely to perceive their firms to be financially constrained.

Nguyen et al. (2020) argue that education reduces debt aversion and borrower discouragement through three channels. Most straightforwardly, education will be correlated with greater cognitive ability and a better ability to deal with ambiguity and complexity and (Dollinger, 1984). Debt financing requires the entrepreneur to evaluate expected returns on investments to the borrowing costs and increased risk. This is a complex task, especially in an economic recession when risk and asymmetric information are particularly high. Preparing a loan application is also a time-consuming that requires human resources. More educated entrepreneurs are better able to deal with such complex process and thus more welcoming of debt financing in general and bank loans in particular. A second important potential channel for the relationship between education and debt aversion is risk-aversion. The literature has documented a negative relationship between education and risk-aversion (Riley Jr and Chow, 1992). This channel will be particularly important in the current environment. The current crisis already provides massive economic risk and many entrepreneurs will hesitate to add further risk by increasing their firms' leverage. Finally, cultural aspects might contribute to debt aversion. Debt is viewed negatively in many cultures. For example, many religions impose a ban on debt or interest and these cultural aspects may contribute to the debt aversion of less educated entrepreneurs. Parker (2006) suggests that education can alleviate a bias toward former beliefs and information. Thus, more educated entrepreneurs may be less affected by this culturally rooted bias against debt.

While advocating for better formal education can alleviate these problems in long term, it is an unlikely solution for the imminent economic downturn due to the COVID-19. Rather, the banks and governmental agencies should aim at streamlining application process to reduce subjective application costs for entrepreneurs. However, there must be a balance between the qualities of being rigorous and being borrower-friendly. Moreover, as the application procedure is very structured, the extent to which it can be simplified may be limited. Despite these constraints, the bank can empower its own staff with the ability to advice, counsel and even educate the borrowers throughout this burdensome process, alleviating their apprehensions and discouragement.

Additionally, a clear and far-reaching communication of credit availability and the credit-supporting policies is also essential. As pointed out by Cowling et al. (2016), entrepreneurs can over-estimate the extent of credit rationing in an economic downturn. In such a time of high uncertainty and asymmetric information, proactive communication from lenders and supervisory agencies are needed to keep borrowers informed and to ease their discouragement.

Conclusion

The success of government sponsored support programs for companies relies on the large scale-adoption of subsidized debt by entrepreneurs. Existing research on the use of debt by SMEs suggests that achieving this will not be an easy task. Even if banks are willing to lend, entrepreneurs are often reluctant to contract the debt that their companies would require. This is not only because they want to avoid burdensome application procedures, but also because they are risk averse, have limited information processing capacities and are averse to debt for various reasons. A strategy of counseling, educating and keeping borrowers informed is necessary to brace entrepreneurs for the imminent economic impact of the COVID-19.

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