Has the development community over-invested in microfinance?

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A micro-enterprise course led this Chilean woman to small business success selling empañadas. But can microfinance alone help people to break out of poverty?

MILLIONS OF PEOPLE RELY on micro-enterprises for a large part of family income yet have little access to finance. I have long advocated microfinance as one strategy for development and poverty alleviation that can be effective, and continue to do so. Microfinance is a powerful tool, but in some circles microfinance has become practically synonymous with grassroots poverty alleviation emphasising women. Yet our menu of effective strategies is much broader, and the limitations of microfinance as a poverty and development strategy must also be appreciated.

I start with the perspective that what matters is improving the well-being of people, and that a given improvement in income, health, education, and empowerment for the most disadvantaged in society has a much larger impact on social welfare than such improvements for the more advantaged would have.

Microfinance will continue to play a significant role. Even without regular, formal sector jobs, if the poor are well nourished and have other keys to capability, they frequently use their creativity to earn a basic living in micro-enterprises. Many hard working women have been caught in working capital **poverty traps**, struggling with an inventory too small to be productive – too few sales per hour at the market or per door knocked. This means they will have too little net income to maintain a larger inventory in the future. In response, the number of microfinance institutions (MFIs) in the world lending in support of micro-enterprise activity has grown to over 2500, many supported by developed-country donors. Over 67 million borrowers have taken part.[2] For-profit banks are joining the market – an encouraging sign. Even so, the reach has been limited. MFIs commonly lend to the richest of the poor. A 2002 study estimated that only 11% of the world's 240 million poorest families have so far gained access to microfinance.[3]

Factors often overlooked

But a large flow of funds from both public and private donors have recently poured into microfinance. Given limited resources, could donors, funding agencies and NGOs have overemphasised microfinance and underemphasised viable solutions to other poverty traps? The question cannot be answered in a general or categorical way, but there are some important considerations that NGOs should take into account. Despite great attention and resources to microfinance its relative impact remains unclear. We need to better understand what does and does not work, through rigorous programme evaluation, and experimental testing of ideas behind microfinance designs. Even when indicators of success are agreed upon and impact is assessed carefully, genuine cost-effectiveness comparisons **between alternative approaches** to poverty reduction are rarely achieved. Each NGO must decide based on local needs and its own comparative advantage.

In the meantime, there are at least 10 sometimes-overlooked limitations to MFIs' claim to address poverty that funding agencies and NGOs should consider as they balance their activities to assist the poorest.

1. Cost of subsidising MFIs. It is important to understand that – as Jonathan Morduch has documented – significant donor grants have been put into MFIs; not just the sometimes substantial start-up funding but in many cases ongoing financial subsidies such as staff time and expenses. Thus, the argument that MFIs should get priority funding because they are or become self-sustaining needs close scrutiny. Subsidy costs are real, so hard decisions about funding priorities cannot be side-stepped. I worry that one reason for the predominance of microfinance-based strategies may be that programme selection is distorted when donors respond to microfinance's "hand up rather than hand-out" image. Hand-outs are not a bad thing when they genuinely assist people in extreme poverty; and given microfinance's image among small donors it is ironic that it generally involves hand-outs as well as "hand-ups". Investments in education, health and nutrition, environmental protection, market access, agricultural extension for women, and genuine empowerment can also provide "hand-ups", but all programmes cost something. Donors should be educated as to the issues and trade-offs.

2. Parallel interventions. In *Ending Global Poverty* I review 16 poverty traps,[4] of which working capital traps are one. Others include child labour traps, undernutrition and poor health traps, farm erosion traps, uninsurable risk traps, low skill traps, and subsistence traps. The poor often need programmes that address other traps. When these traps interlock, it may make sense to combine microfinance with other programmes. Business education is the most common service packaged with microfinance, but health care and other capabilities are increasingly included.[5] BRAC's "Microcredit plus" programme in Bangladesh integrates village health, business education and legal training with microfinance. Even "minimalist" MFIs usually include non-financial activities. These strategies deserve rigorous evaluation; and funding agencies and NGOs need to identify how much of the benefits come from microcredit and how much from the parallel interventions.

We need to better understand which approaches are the most cost-effective in reducing poverty

3. Bigger-picture solutions. As my colleague Shahe Emran and co-authors argue, while failures in credit markets are pervasive and important, the reason microfinance can reach so many **even with such high interest rates** is often due to gender inequality in labour markets.[6] Women who are constrained from working outside the home may benefit from microcredit particularly because it lets them work at home, but a bigger benefit to women and their children might come from social changes that enable women to work outside the home. If NGOs such as the Self-Employed Women's Association (SEWA) in India can successfully campaign for changes that make the labour market more accessible to women, then that has implications for the relative weight we should place on micro-enterprise support activities. Microfinance is oriented toward individual activities, or at most a few individuals in a cooperative undertaking, but community-wide development initiatives (from education or health to community empowerment) can help solve other poverty traps and magnify the benefits of individual credit.

4. The group factor. As a microfinance innovation, joint liability among groups of borrowers offers clear benefits, especially for lending to poor borrowers without collateral. But when participation in microfinance groups leads to improvements in the lives of poor women, the key reasons may be the value of group solidarity, and even the raised self-esteem simply from success in repaying loans, rather than the microcredit itself. Some practitioners observe that the biggest impact is on raised self-esteem simply from success in repaying loans. Many women with individual liability loans still opt to participate in borrower groups (such is the experience of the Association for Social Advancement (ASA) in Bangladesh). Social capital is clearly important. Groups offer the chance to share ideas, address feelings of powerlessness, and find friends and comrades who stand with you in difficult times. To the degree that social solidarity (or improved self-esteem) drives success, perhaps funding agencies and NGOs should address these goals differently. Certainly, it costs less to facilitate solidarity groups than to create and operate small banks.

5. Access for the poorest. Most of the poorest still do not join microfinance programmes or, if they do join, there is growing concern that they cannot use the loans productively. We cannot assume that simply because the poor participate in a microfinance borrowing group or other MFI programme, they must be better off by "revealed preference", because the poor rely on NGOs' advice on how to escape poverty. Many borrowers could be turning over loans without realising they are not benefiting much. Working capital is never sufficient for business success: if the poorest lack capabilities such as recognising and adding numbers, and minimal health and nutrition, they cannot be expected to borrow, spend, and sell productively. The poorest have often been unable to start any enterprise, however meagre. To be successful, even micro-enterprises must reach a minimum size that can be beyond the reach of the poor, and microcredit can add to costly but unproductive debt. The

Grameen beggars' programme offers hope, but successful programmes for the poorest commonly introduce microcredit only near the end of interventions for overcoming other poverty traps.[8]

6. Regular vs "micro" employment. Even MFI borrowers often seem to view their micro-enterprises as a stop-gap solution. Former micro-entrepreneurs sometimes abandon these activities when presented with the opportunity for a steady and reliable job at a small or medium-sized enterprise (SME), even if it is rather low-paying.[9] Indeed, a steady job can be the most important asset for escaping poverty traps. Most people are willing to pay for insurance, and a predictable wage offers insurance against the vagaries of micro-enterprise proceeds. Even many laid-off professionals in rich countries go into self-employment only and until they can find a suitable replacement job.

7. Few micro-enterprises become SMEs. In principle, the poor might find employment in a neighbour's micro-enterprise that has expanded as a result of access to credit. In practice, there is little evidence of micro-enterprises growing into SMEs. SMEs are usually started by entrepreneurs from a different demographic: less poor, more educated, more able to accept risks. This came as a surprise to BRAC, which found that its SME programme was rarely utilised by its micro borrowers.

8. Possible short-term harm. Sometimes micro-entreprenurs who gain access to microfinance do sufficiently well to out-compete those who do not; and those with MFI access are less likely to be among the poorest. Given that few micro-enterprises grow to the point where they hire outside employees, and that there is no evidence that microfinance facilitates sustained general economic growth, in the short run some MFI activities could even **hurt** the poorest if safety nets are not available or counter-measures are not taken. Funding agencies and NGOs should be attuned to this possibility in local activities.

9. MFI "gluts". MFIs may have been established in settings (such as Bangladesh) where they are most likely to be successful; and in those settings the most viable borrowers may already be served. As a result, a larger share of increments to funding might be better placed in other programmatic areas, even when the money spent thus far on MFIs has been a good investment. Beyond a certain point, if MFI competition becomes large, MFIs may be tempted to make poor loans, as observers have noted in some cases in Bolivia. Or clients may find themselves borrowing from one MFI to repay another, while trapped in a hidden cycle of losing precious income to unproductive interest payments. Credit-scoring bureaus can help, but it is difficult to ensure that they function effectively and extend broadly to the microfinance market.

10. What improves financial systems? Some practitioners argue that poverty reduction is not realistic for MFIs; rather, their purpose is to stimulate a better financial system. This is a worthy goal,[10] but microfinance development is not necessarily the best way to achieve it. Improved systems for regulation and oversight, upgrading the financial system safety net, training of government financial officials, better tax collection to lower fiscal deficits, focusing financial services on the SME sector, and facilitating participation by foreign banks all can make plausible claims as more cost-effective strategies for improving the functioning of the financial system *per se*. Micro-enterprises, and the MFIs that lend to them, may turn out to be "transitional institutions", as are often encountered in the process of economic development.[11] For example, "township and village enterprises" (TVEs) appear to have been a transitional institution in China: they played an important role in Chinese development, particularly given the institutional constraints in the 1980s and 1990s when these firms grew most rapidly. Small MFIs and the micro-enterprises they serve are playing important roles in many developing countries, and support for them must continue. But pending better research we should be careful not to overly rely on MFIs as a solution for poverty alleviation and economic growth. With anticipated increases in poverty programme funding, such a shift would require no decrease in planned support for microfinance, but funding agencies and NGOs must continually reconsider how to allocate new resources on the margin. ■

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[1] The keys to capability, defined in S C Smith, *Ending Global Poverty: A guide to what works*, New York: Palgrave Macmillan, 2005, are health and nutrition, basic education, credit and basic insurance, access to functioning markets, access to the benefits of new technologies, a non-degraded and stable environment, social inclusion and human rights, and community empowerment and development. Thus, credit and insurance will not be the limiting factor (binding constraint) in all cases. [2] B Armendriz de Aghion & J Morduch, *The Economics of Microfinance*, Cambridge, MA: MIT Press, 2005 [3] S Daley-Harris, *et al.*, "State of the Microcredit Summit Campaign Report", 2002, www.microcreditsummit.org/pubs/reports/socr/2002/socr02_en.pdf [4] S C Smith, *Ending Global Poverty* (see note 1), ch. 1 [5] See S C Smith "Village Banking and Maternal and Child Health: Evidence from Ecuador and Honduras", *World Development*, 30 (4): 707–723, April 2002; and C Dunford, "Building Better Lives: Sustainable integration of microfinance and education in health, family planning and HIV/AIDS prevention for the poorest entrepreneurs", Microcredit Summit Campaign, 2001 [6] S Emran, M Morshed & J Stiglitz, "Microfinance and Missing Markets", draft, George Washington University, Oct. 2005. I would like to thank Shahe Emran for helpful discussions. [7] See Armendriz de Aghion & Morduch, chs. 4 and 5; and M Ghatak & T Guinnane, "The Economics of Lending with Joint Liability: Theory and practice", *Journal of Development Economics*, Oct 1999, 60(1), 195–228 [8] D Adams & J D von Pischke (1992), "Microenterprise credit programs: déjà vu", *World Development* 20 (10): 1463–70. But see Armendriz de Aghion & Morduch, The Economics of Microfinance, ch. 6 [9] For example, some employees of SMEs that I interviewed in Lima reported that they were former micro-entrepreneurs. This is anecdotal evidence, and it needs more systematic study. [10] M P Todaro and S C Smith, *Economic Development*, Ninth Edition, Reading, MA: Addison Wesley and Essex, England: Pearson, 2005, ch. 16 [11] Y Qian, "How Reform Worked in China", in D Rodrik (ed.), *In Search of Prosperity: Analytic narratives on economic growth*, Princeton University Press, 2003, pp. 297–333