

## Microfinance as a development and poverty reduction policy: is it everything it's cracked up to be?

By Milford Bateman

For more than 30 years microfinance has been portrayed as a key policy and programme intervention for poverty reduction and 'bottom-up' local economic and social development. Microfinance (more accurately microcredit, but in practice the terms are interchangeable) is the provision of tiny loans to the poor to help them establish or expand an income-generating activity, and thereby escape from poverty.

The microfinance movement began with the work of Dr Muhammad Yunus in Bangladesh in the late 1970s, spreading rapidly to other developing countries. Most early microfinance institutions (MFIs), including Yunus's own iconic Grameen Bank, relied on funding from government and international donors, justified by MFI claims that they were reducing poverty, unemployment and deprivation.

In the 1980s, however, the expanding microfinance model operated in a transformed political and ideological environment. Market principles were in the ascendant, with growing emphasis on financial sustainability and the need to wean microfinance programmes off long-term donor support. It was felt that the poor should pay the full cost of any support received, rather than impose an additional tax burden on others.

This led to a push for MFIs to cover their own costs through greater commercialisation, private ownership and profit-driven incentives with market-based interest rates. It was thought that market forces and profits would ensure financial self-sustainability, generating a cost-free increase in the supply of microfinance to the poor.

To some extent this proved correct, with some MFIs making profits without subsidies. By the early 2000s, a number of developing countries – such as Bangladesh – had achieved the microfinance movement's 'holy grail': virtually every poor person had easy access to a microloan if they wanted one. Table 1 ranks the most microfinance-friendly countries in terms of microfinance penetration.

With so many of the poor now able to establish or expand simple income-generating projects, there were hopes that poor communities the world over would soon escape poverty on an unprecedented scale. But, is microfinance really having a positive impact?

**Table 1: Microfinance penetration by 2009**

Global ranking	Country	Borrower accounts/ population
1	Bangladesh	25%
	(Andhra Pradesh State, India)	17%*
2	Bosnia and Herzegovina	15%
3	Mongolia	15%
4	Cambodia	13%
5	Nicaragua	11%
6	Sri Lanka	10%
7	Montenegro	10%
8	Viet Nam	10%
9	Peru	10%
10	Armenia	9%
11	Bolivia	9%
12	Thailand	8%
13	India	7%
14	Paraguay	6%
15	El Salvador	6%

Source: Gonzalez (2010); \*Rozas and Sinha (2010).

## What do impact evaluations tell us?

Individual microfinance programmes have most often been judged on the basis of impact evaluations. Most of the early impact evaluations were positive, but very thin in terms of robust evidence. Very often, the ‘evidence’ consisted of anecdotes from successful MFI clients, while less successful clients were ignored. As microfinance became more popular in the 1990s, displacing other interventions from the policy agenda, notably small and medium business development, there was growing pressure for more meaningful evaluations.

A widely cited study by Khandker (1998) on three major MFIs in Bangladesh – BRAC, Grameen Bank and RD-12 – found that up to 5% of participants were able to lift their families out of poverty every year by borrowing from one of these MFIs. Littlefield et al. (2003), summarising the literature available at the time, cited evaluation findings of higher incomes among microfinance programme participants than among non-participants. Goldberg (2005) found that most early impact evaluation studies reported a positive impact on poverty and income.

Most of these evaluations were undertaken by MFIs, microfinance advocacy groups, or international development agencies promoting and funding microfinance. Naturally, this raised concerns about potential bias, especially under-research on the downsides.

As a result, a growing number of impact evaluations were commissioned from independent researchers, mainly university-based academics. Many of these independent studies (e.g. Morduch, 1998; Coleman, 1999) questioned the rigour and validity of earlier evaluations, highlighting data and methodological problems.

There was a shift to more rigorous forms of impact evaluation, such as the randomised control trial (RCT) methodology. This aims to avoid the selection bias in the choice of treatment and control groups that might occur if, for example, those receiving a microloan were already more entrepreneurial than those in the control group. Any impact here would have to be attributed to this characteristic, rather than to a microloan. RCT methodology ensures that both groups studied are as identical as possible, aside from the receipt of microcredit.

In 2007 researchers using RCTs began to publish major impact evaluations. The evidence, while mixed, suggested that microfinance had little or no impact.

Esther Duflo and colleagues analysed 5,000 households in rural Morocco over two years. Their initial findings (reported in Straus, 2010) found the effect of microfinance on consumption to be negative and insignificant, with no impact on new business creation, education or women’s empowerment. Karlan and Zinman (2009) and Banerjee et al. (2009) found almost no impact from a number of large-scale microfinance programmes. Roodman and Morduch (2009) took a different tack, revisiting the work by Pitt and

Khandker cited as the most robust evidence supporting microfinance (Khandker, 1998; Pitt and Khandker, 1998). Reworking the original data, they came to a new conclusion: there was little to confirm that microfinance was having any real role in poverty reduction. Their conclusion (2009: 4) was that, ‘Strikingly, 30 years into the microfinance movement we have little solid evidence that (microfinance) improves the lives of clients in measurable ways’.

In 2010, the six leading microfinance advocacy bodies responded that it is difficult for studies to demonstrate the impact of microfinance quantitatively for methodological reasons (implicitly conceding the lack of robust quantitative evidence), and fell back on anecdotal evidence, citing carefully selected anecdotes and uplifting case studies from individuals (ACCION International et al., 2010).

## Why has microfinance not worked as hoped?

### Impact on household debt

Dichter (2006) finds that microfinance has often been used to cover basic consumption needs rather than fuel enterprise. In the face of such evidence, the microfinance sector now portrays consumption ‘smoothing’ as a new argument for microfinance (see Collins et al., 2009). Consumption smoothing can certainly reduce risk and vulnerability, but it can lead poor individuals to substitute microcredit for non-existent income in an unsustainable way. Growing dependency upon microcredit, coupled with high interest rates, means that a growing proportion of the unstable income of the poor is siphoned off to cover interest charges. As Srinivasan (2010) suggests, this is the dynamic behind the current microfinance crisis in Andhra Pradesh, India.

A key claim for microfinance was that it would help to detach the poor from local loan sharks charging higher interest rates – a claim made by Muhammad Yunus when promoting microfinance to international donors. In fact, by conferring social legitimacy upon microfinance, rather than loan sharks, the stage was set for the poor to become open to the idea of going into debt.

Today, unsustainable microcredit indebtedness is commonplace across developing countries: in India; in Bangladesh (Banking with the Poor, 2009); and in Peru (Kevany, 2010); and also in transition countries, notably in the Balkans (Bateman, 2011) and especially in Bosnia and Herzegovina (Cain, 2010). Microfinance can also encourage further engagement with the local loan shark. In Andhra Pradesh, for example, the poorest households have increased their engagement with local loan sharks to pay off microloans they obtained all too easily from their local MFIs (Ghokale, 2009).

While MFIs charge lower interest rates than local loan sharks, they are still seen as imposing high rates on poor clients. In the early days, many MFIs said this

was necessary to cover the high operational costs of providing tiny loans to the poor, but that interest rates would fall through competition. This argument had some validity initially. But interest rates have not fallen as much as predicted, and in some countries (notably Mexico) have remained very high. In part, this is because of the emphasis on the commercial model, with MFIs now required to generate high financial rewards for their managers (salaries, bonuses) and owners/shareholders (dividends and capital gains).

In the case of *Compartamos* in Mexico, the personal rewards have run to tens of millions of dollars for key managers, while the interest rates for its mainly poor women clients have remained very high, with an APR of 129% in 2008 (Waterfield, 2008).

The fear is that significant financial flows are flowing out of the poorest communities, rather than being retained and recycled within them to underpin productive investment as the precursor to an escape from poverty.

### Market saturation and displacement

Do new or expanded microenterprises in poor communities find sufficient local demand to absorb their products and services? Muhammad Yunus founded the Grameen Bank on the basis that this would not be an issue, believing that ‘A Grameen-type credit programme opens up the door for limitless self-employment, and it can effectively do it in a pocket of poverty amidst prosperity, or in a massive poverty situation’ (Yunus, 1989: 156).

Hasluck (1990), however, showed that poor communities in developed countries routinely experience very significant ‘displacement’ effects. His work in the UK showed that local demand for the simple products and services of most microenterprises is generally finite (at least in the short term), with new microenterprises doing little more than displace existing microenterprises. The net result is few additional jobs or income. It seems the same is true for developing countries. Back in 1984, Ahmad and Hossain (1984) suggested that displacement would seriously undermine Bangladesh’s microfinance model in practice. Osmani (1989) and Quasem (1991) provided evidence to support that claim, and Bateman (2010) demonstrated that displacement is an important downside in developing countries.

### Does microfinance promote growth and development?

The key question is whether microfinance promotes sustainable ‘bottom-up’ development. Robinson (2001) is one of many arguing that microfinance helps to build thriving hubs of entrepreneurial activity, with many clients escaping poverty by growing their informal microenterprises into small and medium enterprises. La Porta and Schliefer (2008), however, show that this is rare.

Storey (1994) notes that policy-makers should consider the dangers associated with the very high failure rates for microenterprises, particularly new start-ups. For example, in Tamil Nadu state in India, one programme study found less than 2% of microenterprises still operating three years after their establishment (George, 2005). In Bosnia and Herzegovina, World Bank researchers found that up to 50% of microenterprises failed within one year of their establishment (Demirgüç-Kunt et al., 2007). As Davis (2007) notes from his work on Bangladesh, such failure can lead to irretrievable poverty. The social necessity to repay microloans attached to failed microenterprises can strip the poor of all their remaining assets.

Institutional economics helps to clarify the issue of development through microfinance. A major claim long made of microfinance is that it can reduce the credit constraints that often face potential entrepreneurs in poor communities, and that preclude enterprise development (Stiglitz, 1998). A contrasting viewpoint is that credit constraints affecting tiny individual enterprises are not the core problem. It is the overall lack of access to credit for small and medium enterprises that prevents microenterprises growing into anything more substantive.

The essential problem is the lack of *institutions* that can promote productive ‘Baumolian’ entrepreneurship (see Baumol, 1990) – institutions that can quickly scale-up small business projects into those capable of productivity growth via innovation, technology transfer, subcontracting, skills-upgrading and serving non-local demand. Ha-Joon Chang is a high-profile proponent of this view, pointing out that developing countries have been awash with entrepreneurs for years, with a higher proportion of individual entrepreneurs than in developed countries (Chang, 2010). They, and their countries, remain in poverty, however, because they lack the institutional vehicles and mechanisms of *collective entrepreneurship* that can facilitate organisational upgrading and learning.

### Recommendations

Even some long-standing supporters of microfinance now accept that the evidence of its positive impact in the community is very weak. Evidence to the contrary now needs to be weighed against the hyperbole surrounding microfinance. More focus is needed on other interventions that may better promote growth and poverty reduction, such as local financial systems and poverty reduction models with a good track record. Five steps are suggested:

- More use of simple cash grants and Conditional Cash Transfers (CCTs), which have been shown to reduce the worst excesses of income poverty.
- An urgent refocus on the promotion of local micro-

savings, rather than microcredit, as the first step in the local accumulation of capital.

- Robust financial sector regulations to ensure that local financial institutions act in a manner conducive to sustainable local economic development and to building and retaining local social capital.
- The promotion of genuine community-owned and controlled financial institutions, such as credit unions, building societies and savings banks, to

underpin local capital accumulation.

- Pro-active local financial institutions and local industrial policies that can provide ‘patient capital’ and promote sustainable growth-oriented businesses, rather than ‘survivalist’ no-growth/high failure rate microenterprises.

Written by Milford Bateman, ODI Research Fellow ([m.bateman@odi.org.uk](mailto:m.bateman@odi.org.uk)).

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