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Evaluating development policy at IFS

Microfinance research at the Institute for Fiscal Studies

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Growth
Research
Programme

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ISBN: 978-1-909463-92-9

For a long time, microfinance – the extension of very small loans to poor people – was cheered as an excellent policy to spur entrepreneurship and alleviate poverty. Microloans, in particular, were often portrayed – typically backed by inspiring individual success stories – as a successful means for the poor to engage in profitable, income-generating activities that would lift them out of poverty. Through this economic improvement, changes in other dimensions of well-being, such as healthier consumption patterns, lower stress levels and the ability to send children to school, were assumed. The focus on women in addition spurred hope for greater empowerment. However, over the last few years, controversies in India and Bangladesh have led to a much more cautious view of such schemes. In the absence of solid evidence on the impacts of microfinance, the debate continued.

At the beginning of this year, however, a collection of randomised evaluations (large field experiments) that rigorously measure the impact of access to microcredit on borrowers and their households, in a wide range of settings, was published in one of the top economic journals, the *American Economic Journal: Applied Economics*. These studies span microfinance programmes in Bosnia and Herzegovina, Ethiopia, India, Mexico, Mongolia, Morocco and the Philippines, covering urban as well as rural areas and evaluating both individual-liability and joint-liability (group) loans. Some of the participating microfinance institutions were for-profit organisations whereas others were non-profit organisations. Nominal annual interest rates varied between 12% (Ethiopia) and 110% (Mexico). The main lessons that were drawn from this gathered evidence are as follows.

- While microcredit induced greater borrowing in all countries, it did not lead to substantial increases in borrowers' income and their overall economic well-

¹ The author gratefully acknowledges funding from the European Bank for Reconstruction and Development (EBRD) and from the ESRC-DFID Grant ES/J009253/1.

being, neither within the typical loan period of 18 months, nor in the longer run of three to six years.

- Positive impacts on other measures of well-being (consumption, empowerment, etc.) were also not observed in any of the studied settings.
- However, the evidence suggests that households with access to microcredit enjoyed greater freedom in deciding how they earned and spent money (e.g. reducing earnings from wage labour and increasing income from self-employment activities), and were more able to deal with income shocks.
- Importantly, there is no evidence of systematic harmful impacts of access to microcredit.

This is sobering evidence for a multi-billion dollar industry,² which still today enjoys unprecedented growth in emerging markets (Chen, Rasmussen and Reille, 2010),³ and is expected to achieve also in 2015 a growth rate of 15–20%.⁴ What do these findings – that microfinance seems, on average, to have done neither good nor bad – imply?

Is it time to write off microfinance?

As usual, the devil is likely to be in the details.

Researchers at EDePo have been tackling the question of how effective microfinance is as a poverty reduction tool since 2008. Two of the studies published in the Special Issue on microfinance were a result of this effort, jointly conducted with the European Bank for Reconstruction and Development (EBRD).

² The International Finance Cooperation (IFC) of the World Bank Group, for example, stated this year that their cumulative investment portfolio in microfinance exceeded US\$3.5 billion (http://www.ifc.org/wps/wcm/connect/545892004f36e7ed9c32de032730e94e/SM2015_IFCIssueBrief_Microfinance+.pdf?MOD=AJPERES).

³ G. Chen, S. Rasmussen and X. Reille, 'Growth and vulnerabilities in microfinance', Focus Note 61, Consultative Group to Assist the Poor (CGAP), Washington, DC, 2010 (<https://www.cgap.org/sites/default/files/CGAP-Focus-Note-Growth-and-Vulnerabilities-in-Microfinance-Feb-2010.pdf>).

⁴ C. Etzensperger, 'Microfinance Market Outlook 2015', responsAbility Investments AG, 2015 (<http://www.responsability.com/funding/data/docs/es/10427/Microfinance-Market-Outlook-2015-DE.pdf>).

While the studies addressed the overarching question of the poverty impact of microfinance, they went beyond this research question. The study conducted in Bosnia and Herzegovina focuses on whether microfinance can be extended to poorer, previously excluded parts of the population, and the one in Mongolia analyses the effectiveness of group lending – where liability for repayment is shared among a group of borrowers – compared to individual lending.

We find that Mongolian women who receive access to a group liability product are more likely to make investments for productive purposes (such as setting up a business) – a strategy that leads these types of borrowers to experience an increase in their consumption (particularly food consumption). However, those offered an individual lending product do not increase entrepreneurial activity, and the availability of such loans has no impact on consumption or other measures of well-being.

We also find that group lending boosts loan uptake by poorer, less-skilled individuals, and we postulate that this is because such individuals particularly value intra-group cooperation and support, and the scope for risk diversification. Group loans also seem particularly popular in villages with higher levels of reported income risk, perhaps for similar reasons. Despite the fact that this might be expected to increase the risk to the lender of group loans, we do not find any differences in their repayment performance.

The impact on poverty of loosening lending criteria a little in Bosnia and Herzegovina to offer individual loans to poorer and less-skilled clients (who are generally deemed at higher risk of repayment problems) was mixed. We find evidence of lower employment but higher self-employment, and increases in business inventory, as well as some evidence of increases in profits, among those operating businesses. At the same time, however, we find an increase in the labour supply of 16–19 year olds in households' businesses, accompanied by a drop in school attendance, a reduction in consumption and saving, and no evidence that the programme increased overall household income.

Thinking about design and targeting

What these more nuanced findings suggest is that targeting of microfinance is important and that this targeting can be done through a variety of means. Small changes to product design may have a big influence on who is attracted to the

product and how people use and benefit from microcredit, as our differential impacts of varied loan liability structures in Mongolia suggest.

If the wrong group is targeted, or if the right group is targeted with the inappropriate product, then impacts are likely to be absent and could even be negative, as suggested by some of our findings in Bosnia and Herzegovina. For example, the reduction in schooling of 16–19 year olds due to the microfinance loans could lead to negative impacts in the long run, if this behaviour is inefficient from the perspective of the teenagers and no corrective policies are put in place.

It is conceivable that a change in the design of the product could have avoided such unintended consequences. Such product design is not constrained to the features of the financial product itself, as liquidity constraints may not be the only impediment to impacts. An increase in productivity, through for example skills training, might be crucial in achieving positive changes in the well-being of particular client groups; see, for example, Bruhn, Karlan and Schoar (2010)⁵ for a discussion.

An interesting new loan product in the microfinance sphere applies a loan use conditionality, which aims at improving the health of the client and its family, possibly also of the entire community, ensuring loan repayment and social impacts, simultaneously.

This loan product is a sanitation loan, providing poor households with the opportunity to access funds for the construction of a toilet. As discussed in more detail in EDePo's policy brief on sanitation, in addition to its importance for public and private health, safe sanitation benefits individual households on a wide range of other aspects as well, including time savings, comfort, increased productivity, greater safety and a higher social status.

The effectiveness of this type of loan product in increasing uptake of sanitation is analysed in two evaluation studies undertaken by EDePo in India. The results of the first evaluation indicate that, despite demand for the loan product, alleviating the liquidity constraint for this investment is not sufficient in inducing uptake. The second evaluation study therefore analyses the importance of providing more information and mobilisation alongside the provision of credit for sanitation. In

⁵ M. Bruhn, D. Karlan and A. Schoar, 'What capital is missing in developing countries?', *American Economic Review* 100 (2), 629–633, 2010.

collaboration with the Water and Sanitation Program (WSP) and the Financial INclusion Improves Sanitation and Health (FINISH) programme, EDePo researchers look at the differential uptake of private household sanitation in Maharashtra when sanitation microcredit is provided and when this credit is combined with a sequence of 'soft activities', including information provision through meetings, flyers and theatre plays, as well as a training of masons.⁶

The results on non-impacts of the sanitation loans, although provided, raise further questions on the effectiveness of the conditionality on the loan use. EDePo researchers are currently delving deeper into this topic.

Take-away thought and suggestion

Recent new evidence on microfinance has suggested that the impact of microfinance is, at best, modestly positive, but not transformative for the lives of the poor, as often suggested. Rather than abandoning this development tool however, the sector needs to think of innovations in loan products and features to make microfinance a more powerful tool to contribute to poverty reduction. The poor need finance, as do the non-poor. However, the current approach does not seem to be sufficient. We need to think of and test innovations and to be bold in being creative and making significant changes to the sector, while at the same time we should be willing to fail and to find and acknowledge non-impacts.

⁶ The programme evaluated in the first study, implemented in Tamil Nadu, had a small awareness creation component, which was, however, not very intense.