ON COMBATING POVERTY

Microcredit has been a triumph of rhetoric over reality,
argues **Jens Schroeder**

It has long been thought that if poor people in developing countries could access bank loans at reasonable rates they could break out of the cycle of poverty. For almost four decades the answer to this lack of access has been microcredit. However, microcredit is based on a misguided model of poverty reduction and bottom-up development that has not only diverted attention and resources away from proven (if more mundane) development strategies that combat poverty, but also has failed to address some basic institutions of a market economy that support economic growth and could help make the poor's aspirations a reality.

The evolution of microcredit

Microcredit involves providing unsecured small loans to poor people with no assets to use as collateral in order to facilitate income-generating activities that are expected to lift them out of poverty. For instance, a woman uses a micro loan to buy a sewing machine to make more clothes than she could sewing by hand, thereby generating greater income and rising out of poverty. Conventional banks would turn such people away.

Enter economist Muhammad Yunus, who first experimented with the provision of microcredit in the Bangladeshi village of Jobra in the mid-1970s. Based on these early experiments, Yunus founded the Grameen Bank in 1983 and, with the help of subsidies, pioneered several innovations.

The first was a group lending model that relied on peer pressure to ensure repayment. This new practice was credited with high repayment rates of over 95%,[1] suggesting the poor made good use of the money they borrowed. Second, the Bank targeted women for loans because when they control money they tend to spend more on their family's welfare. Third, the Bank mainly focused on supporting micro businesses at the village level to help build social ties and strong local economies. Finally, the Bank was based on a 'social business' model and operated to meet social goals that served the poor's needs. Profits were re-invested to fund expansion.

By the late 1990s Yunus famously claimed that 5% of Grameen borrowers exit poverty every year.[2] Based on such declarations of success the model was copied in Bangladesh and then all over the world. Microcredit became the darling of aid donors who rushed in to subsidise the new anti-poverty approach through generous grants and soft loans.[3]

The sector expanded rapidly. Between December 1997 and December 2005 the number of microcredit providers increased from 618 to 3,133. The number of poor customers rose from 13.5 million in December 1997[4] to 133 million (mostly women) by the end of 2006.[5] If one multiplies this number by five to get a rough total of the people affected through family members' access to microcredit, the model reached over half a billion people worldwide.[6] The United Nations declared 2005 the Year of Microcredit, and in 2006 Yunus received the Nobel Peace Prize for his 'efforts to create economic and social development from below'. In his acceptance speech, he expressed the hope that, thanks to microcredit, the next generation would only find poverty in a museum.

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It seemed like a win-win solution. The left loved the 'bottom-up' aspects, attention to community, empowerment of the poor, and focus on women. As pop star turned political activist, U2's Bono, said: 'Give a man a fish, [and] he'll eat for a day. Give a woman microcredit, [and] she, her husband, her children, and her extended family will eat for a lifetime'.[7] The right loved the prospect of reducing poverty by encouraging individual entrepreneurship, the private sector approach, and the use of mechanisms disciplined by market forces.[8]

This excitement, however, was short-lived as the oft-claimed impact of microcredit on poverty came under greater scrutiny.

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How microcredit missed its mark

Some studies have backed up claims about the social benefits of microcredit such as the enhancement of women's economic status and the creation of social ties.[9] Microcredit was also found to have some positive short-term effects in alleviating poverty by increasing the poor's ability to cope with emergencies and smoothing out gaps in cash flow (although production—micro business activity—not consumption was claimed to be the aim).[10] The situation becomes more complex, however, in the context of opportunity costs and a shift from subsidies towards financial sustainability.

Providing microcredit can be an expensive business due to high transaction and information costs. To meet these costs, a large number of microcredit programs relied on subsidies to stay in business.[11] In 2008, 53% of the funds flowing into the microcredit industry came from aid agencies, multilateral banks and other donors.[12] The previous year 'social investors'—individual and institutional investors not seeking maximum financial returns—sank some $4 billion into microcredit.[13] This, then, raises the issue of the opportunity cost of subsidies, especially after it became apparent that there were surprisingly few credible estimates of the extent to which microcredit actually reduces poverty.[14]

Evidence on the outreach of microcredit was often anecdotal, biased, incomplete and/or based on flawed research methodologies[15]—despite microcredit becoming increasingly celebrated simply on the extent of outreach.[16] A 2011 study funded by the UK government found that while inspiring stories claimed 'to show that microfinance can make a real difference in the lives of those served, rigorous quantitative evidence on the nature, magnitude and balance of microfinance impact [was] . . . scarce and inconclusive'.[17] Longtime microcredit sceptic Thomas Richter argues that the industry instead relied on impressive rates of loan repayment as a proxy for impact on poverty: If the loans weren't beneficial poor people would not take them on. But this did not prove that repayments came from micro business activity.[18]

More rigorous estimates of the average impact of microcredit on the poverty of borrowers have since ranged from negligible or zero.[19] Yet as early as 1999 US economist Jonathan Morduch warned that 'microcredit's greatest promise is so far unmet, and the boldest claims do not withstand close scrutiny'.[20] Even in the best of circumstances, he found that microcredit neither drove fundamental shifts in employment patterns for borrowers—it merely helped fund self-employment activities that supplemented income—nor did it generate new jobs for others.[21] Making real and long-lasting inroads into poverty, he concluded, requires increasing overall levels of economic growth and formal sector job creation.

Further problems arose with the commercialisation and deregulation of the microcredit model to reduce reliance on subsidies, promote financial sustainability and attract private capital to fund expansion. This led to the rapid rise of for-profit models, which raised interest rates to around 30%-60% (or more).[22] In the rush to find new clients, loans at exhorbitant interest were often made to people who were unlikely to be able to repay them. A microcredit bubble developed in some countries, bursting with tragic consequences in the Indian state of Andhra Pradesh where 'unethical collections, illegal operational practice . . . poor governance, high interest rates, and profiteering'[23] resulted in over-indebtedness and entire village defaults. The press even cited links between group lending practices and suicides amongst borrowers.[24]

In the context of very high interest rates, development consultant Milford Bateman argues that microcredit even disadvantages the poor.[25] Microcredit by definition produces microenterprises that operate below minimum efficient scale.[26] Bateman cites examples in Africa where a boom in microcredit-funded businesses swamped the informal sector, creating an oversupply of largely unnecessary simple goods and services sold by the poor to their equally poor neighbours. Examples include grocery stores, farmers, street sellers, basket-makers, bakeries, shoe repairers, and personal transport suppliers. As a result, they did not provide meaningful additional source of income; instead they took business from their competitors, who in turn saw reduced spending power. Oversupply led to hyper competition which further softened prices.[27] The direction of finance towards simple, petty trade-based microenterprises and away from formal sector small and medium enterprises (that create jobs) essentially *further* de-industrialised and infantilised local economies. In short, microcredit did not create its own demand.

From microcredit to social business models

As seen, microcredit attracted subsidies for a construct of dubious efficiency. Although well-intentioned, Yunus ignored concerns that microcredit would be difficult to scale up because of a fundamental misunderstanding of supply and demand. The goal of financial sustainability and subsequent advent of for-profit models also laid bare a trade-off between social and commercial objectives to which he never admitted. In 2011 he resigned from Grameen Bank and, as chair of the Yunus Centre and co-founder of Yunus Social Business (YSB), reinvented microcredit as 'social business models.'

One difference is that YSB offers loans to social entrepreneurs too big for microcredit. However, the rhetoric is similar. Social business models are based on the 'selflessness that is in all of us'. The principles of venture capital investment are applied to the sourcing, selection and financing of social businesses and profits are reinvested to generate sustainable social impact (such as better and cheaper products and services for the poor). In return, financial partners are offered transparent reporting and 'unique experiences' such as the 'unforgettable event' of meeting social entrepreneurs on the ground.[28] While Yunus has distanced himself from claims that microcredit eradicates poverty, equally ambitious claims are made for social business models as the 'missing piece of the capitalist system' that 'may save the system altogether, by empowering it to address the overwhelming global concerns that currently remain outside mainstream business thinking'.[29]

Social business models are not constructed against market reform but, like microcredit, they risk ignoring basic principles of economic development and neglecting deeper structural issues that prevent prosperity in developing countries.

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For instance, one approach that has been tried, tested and proven to combat poverty is the support of formal sector, small and medium sized enterprises that operate at efficiency, drive innovation, are integrated through clusters and networks, and help to create jobs and increase worker productivity (through adoption of new technology and management methods). This, in turn, leads to rising wages. Economist Aneel Karnani has illustrated this point by offering alternative scenarios:

> (1) A microfinancier lends $200 to each of 500 women so that each can buy a sewing machine and set up her own sewing microenterprise, or (2) a traditional financier lends $100,000 to one savvy entrepreneur and helps her set up a garment manufacturing business that employs 500 people.[30]

While the women have to contend with usurious interest rates and compete with each other in a niche market, he points out that the 'garment manufacturing business can exploit economies of scale and use modern manufacturing processes and organisational techniques to enrich not only its owners, but also its workers'.[31] Examples of this successful model include China and Vietnam, both of which have alleviated poverty with relatively little microcredit. While it is possible to invest in both micro and larger enterprises, limited resources require prioritising policies that have the bigger impact.

Most importantly, these countries demonstrate that the biggest poverty-reduction measure of all is liberalising markets to let poor people get richer. It was globalisation, free trade between countries and within them, and increases in economic freedom that enabled economies and incomes to grow. It is this growth, principally, that has eased destitution.[32]

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As the *Economist* reported in 2013: 'poverty rates started to collapse towards the end of the 20th century largely because developing-country growth accelerated, from an average annual rate of 4.3% in 1960-2000 to 6% in 2000-2010. Around two-thirds of poverty reduction within a country comes from growth'.[33] China alone managed to lift 680 million people out of misery in less than 30 years and reduced its absolute poverty rate from 84% to 10%[34] despite growing inequality.

The importance of institutions

Free trade in goods and services directly stimulates economic growth, helps disseminate new technologies, and creates pressures to invent and innovate. But its full benefits are often squandered by the lack, or inefficiency of, the web of institutions that underpin economic growth. These include 'fair, equitable and transparent rules to govern markets and to enforce contracts as well as secure and enforceable property rights to both physical and intellectual products'.[35]

Security of property rights (based on risk of expropriation, risk of contract violation, and presence of rule of law) has long been strongly correlated with growth. In developed countries it not only guarantees legal protection via enforceable rights but also provides a critical stimulus to invention, innovation, and diffusion of new and improved technologies, which, in turn, stimulates further economic growth by being embedded in legally protected patents and copyrights.

In the context of developing countries, a simple example is how poor farmers' opportunities for land titling can facilitate greater success. Legal title gives households some semblance of food security and permanence, and opens doors to other opportunities including access to credit because the titles can be used as collateral for loans. The association between land titling and strength of a local economy is revealing. A 2009 World Bank report found that '[i]n communities with strong or very strong local economies . . . nearly 86 percent of households reported holding legal title to land'.[36]

More recently, Peruvian economist Hernando de Soto has argued there is evidence 'that the Arab Spring revolution was rooted in a desire for the economic security that comes with property rights and other rights' associated with a market-based economy.[37] The catalyst for the Arab Spring was the self-immolation in January 2011 of a Tunisian fruit vendor, Mohamed Bouazizi, protesting the expropriation of his merchandise. Bouazizi's ability to conduct business depended on the goodwill of local authorities, not on enforceable rights. As de Soto pointed out: 'Once these authorities withdrew their protection and seized his goods, Bouazizi was ruined. There was no legal system in place by which he could hope to recover from bankruptcy'.[38] His subsequent research estimated that more than 200 million people throughout the Middle East and North Africa depend on income from operating businesses or occupying property in the informal economy, none of whom are protected by the rule of law.

While capitalism has lessened the severity of poverty over time, another problem in many nations is that it has too many elements of cronyism.[39] In a landmark 2009 World Bank report on how and why poor people move out of poverty, authors Deepra Narayan, Lant Pritchett and Soumya Kapoor found that elite collusion has created rigged markets where the better-off and well-connected use their power to tilt both prices and scales in their favour, often supported by government intrusion.[40] Rather than being guided by Adam Smith's invisible hand, markets are distorted by visible hands in ways that disadvantage poor producers and consumers.

Narayan, Pritchett and Kapoor found three main factors that distort free markets: 'rules and regulations, especially those governing micro and small businesses; corruption; and elite capture of resources and power by particular ethnic or religious groups'.[41] In their research, they repeatedly encountered regulations discriminating against the poor who, despite economic liberalisation at the national level, 'remain subject to complex rules around licensing, ownership of assets, and livelihoods. Across contexts, local government officials have devised informal regulations that sometimes appear to have no purpose other than to create a hidden or not-so-hidden flow of private revenue'.[42] They cite examples of huge fines, enforced by violence, on fishing in public waters as well as arbitrary levies on micro businesses that not only curtail livelihoods but also are designed to favour certain local government officials who themselves own businesses in the community.

The ease with which local governments make services, licenses and registration available can play an important role in the success or failure of such micro businesses. For instance, Bangladesh's ease of doing business ranking is 174 out of 189 according to the World Bank's 2016 *Doing Business* report. It takes an average of 429 days to get electrical services at a cost of 3140% of per capita income and 244 days to register property.[43] Bangladesh also ranks low on the Heritage Foundation's annual Index of Economic Freedom. In 2016 it ranked 136 out of 178 listed countries and was classed as 'mostly unfree.' The worst areas out of the ten economic freedoms the index measures were under the rule of law category: property rights and freedom from corruption.[44] Poorer governance in South Asia, and elsewhere, therefore suggests that the experience of countries like China in reducing poverty may not be as swiftly replicated in these regions.

Conclusion

In 2010, the World Bank estimated that by the end of 2015 less than 10% of the world's population will be living under a poverty line of US $1.90 a day. While that still leaves 700 million people in destitute conditions, this is a remarkable achievement. As recently as 1980, the World Bank estimated that 50% of the global population lived in absolute poverty.

Expanding trade, integrating countries in the world economy, increasing economic growth and generating jobs will be key to combating this remaining poverty. They need to be supported by the closely associated institutions of property rights, the rule of law, and fair and equitable rules to govern markets—especially if the transition from informal to formal sector is to be made. Governments have an important function in facilitating a favourable institutional climate for the kind of growth to occur that will lead to a permanent reduction in poverty.

Social business models come with equally ambitious claims as microcredit but arguably share the same flawed premise. While microcredit proved that the poor are creditworthy, it was overhyped as a deceptively simple solution to ending poverty in lieu of the long and complex process of development. Too much money poured in too quickly, a classic case of good intentions gone wrong. It may have lightened the burden of poverty for some destitute people, but short-term poverty alleviation is not sustainable economic development. As Thomas Richter rightly notes:

> Time and time again [the development] industry ignores complex and contextual approaches to development (institutional, legal, governance, and other reforms) in favour of feel-good solutions that produce at best marginal changes but satisfy the need to be perceived to be 'doing something for the poor'. The tough question needs to be asked: is the goal to ease the pain or cure the disease?[45]

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