



STANFORD
GRADUATE SCHOOL OF BUSINESS

STANFORD SOCIAL INNOVATION *review*

Microfinance Misses its Mark

By Aneel Karnani

Stanford Social Innovation Review
Summer 2007

Copyright © 2007 by Leland Stanford Jr. University
All Rights Reserved

A man in Malawi sews on a microloan-financed machine, while (far right) rows of women work in the Minh Phung 7 factory of Ho Chi Minh City, Vietnam. Although microenterprises may be more picturesque, large factories more effectively lift people out of poverty.



Microfinance

Despite the hoopla over microfinance, it doesn't cure poverty. But stable jobs do. If societies are serious about helping the poorest of the poor, they should stop investing in microfinance and start supporting large, labor-intensive industries. At the same time, governments must hold up their end of the deal, for market-based solutions will never be enough.

by ANEEL KARNANI



misses its mark

MICROCREDIT IS THE NEWEST silver bullet for alleviating poverty. Wealthy philanthropists such as financier George Soros and eBay co-founder Pierre Omidyar are pledging hundreds of millions of dollars to the microcredit movement. Global commercial banks, such as Citigroup Inc. and Deutsche Bank AG, are establishing microfinance funds. Even people with just a few dollars to spare are going to microcredit Web sites and, with a click of the mouse, lending money to rice farmers in Ecuador and auto mechanics in Togo.

Wealthy philanthropists, banks, and online donors aren't the only ones fascinated with microcredit. The United Nations designated 2005 as the International Year of Microcredit, explaining on its Web site that microen-

trepreneurs can use their small loans to “grow thriving business and, in turn, provide for their families, leading to strong and flourishing local economies.” The Nobel Committee awarded the 2006 Nobel Peace Prize to Muhammad Yunus and Grameen Bank, declaring that microcredit is “an ever more important instrument in the fight against poverty.”

All this enthusiasm for microcredit has attracted untold billions of dollars.¹ Grameen Bank alone disbursed \$4 billion in microloans over the last 10 years, and it now has 7 million borrowers in Bangladesh. In India, about 1,000 microcredit organizations and 300 commercial banks lent \$1.3 billion to 17.5 million people in 2006, says Sanjay Sinha, managing director of Micro-Credit Ratings International

Although some microcredit clients have created visionary businesses, the vast majority have no specialized skills and are caught in subsistence activities.

in India.² Worldwide, 3,133 microcredit institutions provided loans to 113.3 million clients, finds the *State of the Microcredit Summit Campaign Report 2006*.³

This fervor suggests that microcredit really must help the poor. And many have made grand claims to this effect, including Yunus, who said, “We will make Bangladesh free from poverty by 2030.”⁴ Somewhat less ambitiously, the *State of the Microcredit Summit Campaign Report 2006* states that “microcredit is one of the most powerful tools to address global poverty.”

Yet my analysis of the macroeconomic data suggests that although microcredit yields some noneconomic benefits, it does not significantly alleviate poverty. Indeed, in some instances microcredit makes life at the bottom of the pyramid worse. Contrary to the hype about microcredit, the best way to eradicate poverty is to create jobs and to increase worker productivity.

To understand why creating jobs, not offering microcredit, is the better solution to alleviating poverty, consider these two 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. In the first case, the women must make enough money to pay off their usually high-interest loans while competing with each other in exactly the same market niche. Meanwhile the garment manufacturing business can exploit economies of scale and use modern manufacturing processes and organizational techniques to enrich not only its owners, but also its workers.

As these scenarios illustrate, a surer way to ending poverty is to create jobs and to increase worker productivity, rather than investing in microfinance. But before going into detail about why it is better for an underdeveloped country to promote large enterprises, not microenterprises, let’s examine the theory behind microcredit.

Microcredit 101

The microfinance movement addresses a basic yet devastating glitch in the formal banking system: Poor households cannot get capital from traditional banks because they do not have collateral to secure loans, and traditional banks do not want to take on the risks and costs of making small, uncollateralized loans. Without this capital, impoverished people cannot rise above subsistence. For example, a seamstress cannot buy the sewing

ANEEL KARNANI is an associate professor of strategy at the University of Michigan’s Ross School of Business. Karnani’s research focuses on competitive advantage, strategies for growth, global competition, and emerging economies. He works with several companies to design and deliver executive development programs, and he is also actively involved in consulting to businesses.

machine that would allow her to sew more clothes than she could by hand, and thereby pull herself out of poverty.

Microfinanciers use innovative contractual practices and organizational forms to reduce the risks and costs of making loans, such as lending to groups, rather than just to one person. Some microcredit organizations give their clients more than loans, offering education, training, healthcare, and other social services. Typically, these organizations are not-for-profit or are owned by customers or investors who are more concerned about the economic and social development of the poor than they are with profits. The largest of these social purpose microfinanciers include Opportunity International, Finca International, Accion International, Oikocredit, and Grameen Bank.

In contrast to nonprofit organizations, commercial banks that make microloans typically provide only financial services. Indonesia’s Bank Rakyat, Ecuador’s Bank Pichincha, and Brazil’s Unibanco all directly target poor customers. Some large commercial banks, such as the Indian bank ICICI, do not lend directly to individual microcredit clients, but instead work through small microfinance organizations.

Another innovation that many nonprofit microfinance organizations have adopted is targeting women. At Grameen Bank, for example, 97 percent of clients are women because “women have longer vision [and] want to change their lives much more intensively,” says Yunus.⁵ On the other hand, “men are more callous with money.”⁶ Evidence indeed suggests that when women retain control of microloans, they spend more on the health, security, and welfare of their families.⁷

A major selling point of microfinance is its alleged ability to empower women. Research shows that microcredit increases women’s bargaining power within the home, centrality to the community, awareness of social and political issues, and mobility. It also increases their self-esteem and self-worth.⁸ Yet microcredit alone cannot overcome ingrained patriarchal systems of control. In spite of having *access* to credit, some female microcredit clients do not have *control* over the loans contracted or the income generated by the microenterprises.⁹ Overall, microcredit does empower women, but only in noneconomic ways.

Failures of Microfinance

Despite the hoopla surrounding microcredit, few have studied its impact.¹⁰ One of the most comprehensive studies reaches a surprising conclusion: Microloans are more beneficial to borrowers living above the poverty line than to borrowers living below the poverty line.¹¹ This is because clients with more income are willing to take the risks, such as investing in new technologies, that will most likely increase income flows. Poor borrowers, on the other hand, tend to take out conservative loans that protect their subsistence, and rarely invest in new technology, fixed capital, or the hiring of labor.



A woman in Bariali, Bangladesh, collects eggs from chickens at a poultry operation started with money borrowed from Grameen Bank, a leading microfinance lender. Grameen Bank's founder, Muhammad Yunus, won the 2006 Nobel Peace Prize.

Microloans sometimes even reduce cash flow to the poorest of the poor, observes Vijay Mahajan, the chief executive of Basix, an Indian rural finance institution. He concludes that microcredit “seems to do more harm than good to the poorest.”¹² One reason could be the high interest rates charged by microcredit organizations. Acleda, a Cambodian commercial bank specializing in microcredit, charges interest rates of about 2 percent to 4.5 percent each month. Some other microlenders charge more, pushing most annual rates to between 30 percent and 60 percent.¹³ Microcredit proponents argue that these rates, although high, are still well below those charged by informal moneylenders. But if poor clients cannot earn a greater return on their investment than the interest they must pay, they will become poorer as a result of microcredit, not wealthier.

Another problem with microcredit is the businesses it is intended to fund. A microcredit client is an entrepreneur in the literal sense: She raises the capital, manages the business, and takes home the earnings. But the “entrepreneurs” who have become heroes in the developed world are usually visionaries who convert new ideas into successful business models. Although some microcredit clients have created visionary businesses, the vast majority are caught in subsistence activities. They usually have no specialized skills, and so must compete with all the other self-employed poor people in entry-level trades.¹⁴ Most have no paid staff, own few assets, and operate at too small a scale to achieve efficiencies, and so make very meager earnings. In other words, most microenterprises are small and many fail – contrary to the United Nations’ hype that microentrepreneurs will grow thriving businesses that lead to flourishing economies.

This should not be too surprising. Most people do not have the skills, vision, creativity, and persistence to be entrepreneurial. Even in developed countries with high levels of education and access to financial services, about 90 percent of the labor force is employees, not entrepreneurs.¹⁵

The reality of microcredit is less attractive than the promise.¹⁶ Even a stalwart proponent of neoliberal policies like *The Economist* is beginning to conclude that “the few studies that have been done suggest that small loans are beneficial, but not dramatically so.”¹⁷

Jobs, Not Microcredit

Microcredit is certainly a noble idea and a genuine innovation that has provided some positive impact to its clients, particularly to women’s noneconomic empowerment. It also helps the poor during cyclical or unexpected crises, and thus reduces their vulnerability.¹⁸ But the critical issue is whether microcredit helps eradicate poverty. And on that front, it falls short.

China, Vietnam, and South Korea have significantly reduced poverty in recent years with little microfinance activity. On the other hand, Bangladesh, Bolivia, and Indonesia haven’t been as successful at reducing poverty despite the influx of microcredit.

The fact is, most microcredit clients are not microentrepreneurs by choice. They would gladly take a factory job at reasonable wages if it were available. We should not romanticize the idea of the “poor as entrepreneurs.” The International Labour Organization (ILO) uses a more appropriate term for these people: “own-account workers.”

Creating opportunities for steady employment at reasonable

Consider the patterns of poverty and employment over time in China, India, and Africa, whose populations make up about three-quarters of the world’s poor (see graphs on p. 39). Each region has pursued a different path to economic development, and the results so far have been markedly different.

In China, a large and growing percentage of the population is employed in a job. At the same time, the percentage of peo-



Workers shelling shrimp at a Kim Anh Co. factory, located in southern Vietnam’s Mekong Delta. Vietnam has become one of the world’s largest shrimp exporters by using large-scale production, modern technology, and inexpensive labor.

wages is the best way to take people out of poverty. “Nothing is more fundamental to poverty reduction than employment,” states the ILO. And the United Nations Development Programme agrees: “Employment is a key link between economic growth and poverty reduction. Productive and remunerative employment can help ensure that poor people share in the benefits of economic growth.”

ple living in poverty has declined significantly in recent decades. In Africa, a small and shrinking fraction of the population is employed, and the incidence of poverty has remained unchanged during the same period. India’s performance lies somewhere between the two: The number of people in jobs has grown some, and the number of people in poverty has shrunk a little.

Many people who have jobs in these regions are still stuck below the poverty line – the working poor. Whether an employee is “poor” depends on her wages, the size of her household, and the income of other household members. Increased productivity leads to higher wages, which in turn lead to employees earning enough to rise above poverty. That is why it is not enough to create jobs; regions must also increase labor

PHOTOGRAPH BY REUTERS/CORBIS

productivity through the use of new technology, management techniques, specialization, and the like.

When it comes to increasing labor productivity, India's performance is mediocre and the situation in Africa is dismal. One reason for India's poor productivity growth is that its enterprises are often too small. The average firm size in India is less than one-tenth the size of comparable firms in other emerging economies.¹⁹ The emphasis on microcredit and the creation of microenterprises will only make this problem worse.²⁰

It is possible for an economy to invest in both microenterprises and larger enterprises. But governments need to prioritize development approaches that have a higher payoff. As Amar Bhidé and Carl Schramm wrote in *The Wall Street Journal*: "Governments in fragile states have only so much political capital and capacity. So it is crucial to proceed in a disciplined sequence."²¹

The State's Responsibilities

Poverty alleviation cannot be defined only in economic terms; it is also about addressing a much broader set of needs. Amartya Sen, the Nobel Prize-winning economist, eloquently argues that development can be seen as a "process of expanding the real freedoms that people enjoy."²² Social, cultural, and political freedoms are desirable in and of themselves, and they also enable individual income growth. Services such as public safety, basic education, public health, and infrastructure nurture these freedoms and increase the productivity and employability of the poor, and thus their income and well-being.

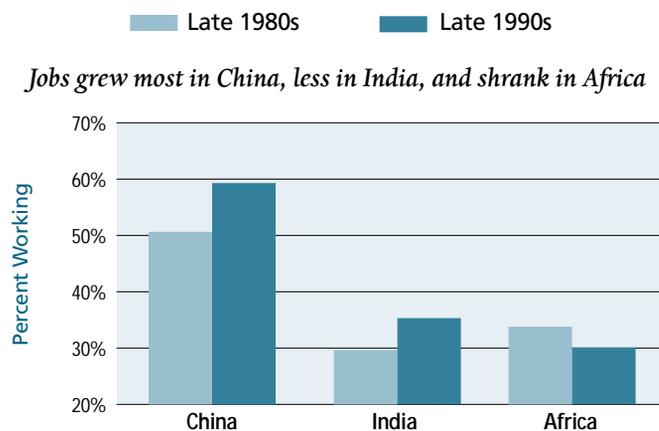
The governments of all developing countries claim to accept responsibility for these functions. Yet they have failed dismally to deliver on their promises. Consider the case of India: The economy is growing rapidly, the stock market is at an all-time high, Indian companies are expanding abroad, and a large middle class is emerging. It is, for many, the best of times.

Contrast this image with that of another India, where 79 percent of the population still lives on less than \$2 per day, 39 percent of adults are illiterate, 31 percent of rural households and 9 percent of urban households do not have safe drinking water, 81 percent of rural households and 19 percent of urban households do not have a toilet, 10 percent of boys and 25 percent of girls do not attend primary school, 49 percent of children are underweight, 9 percent of children die in the first five years of their lives, and 400,000 children die of diarrhea every year.

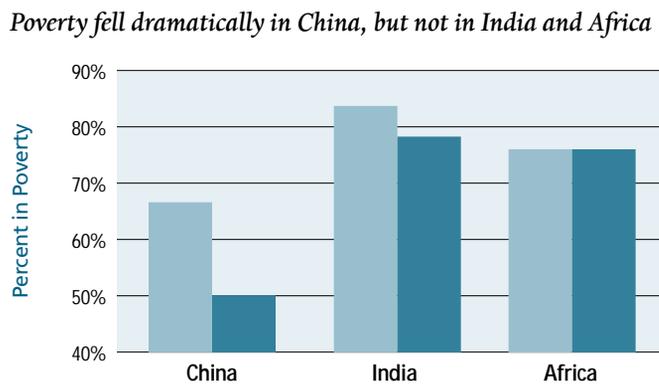
The boom in India's private sector has been accompanied by an outright failure of the state, and the poor have borne the brunt of this failure. The rich can purchase services from private enterprises, and the middle class are the main beneficiaries of limited public services. But the poor have little or no access to public services and cannot pay the high prices for private services. For instance, children of the rich go to exclusive private

schools, children of the middle class use a mix of private and public schools, and children of the poor often do not go to school at all or go to low-quality public schools.

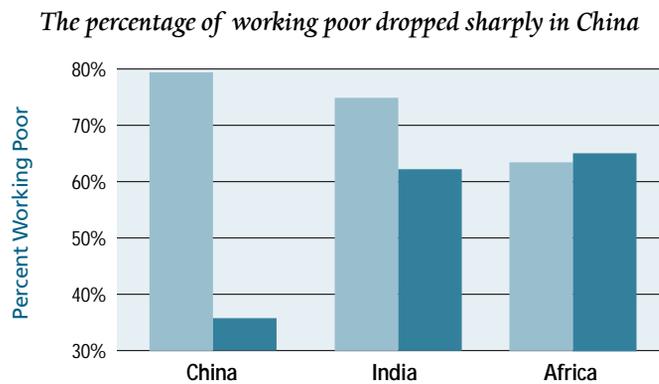
JOBS GET PEOPLE OUT OF POVERTY



Jobs grew most in China, less in India, and shrank in Africa



Poverty fell dramatically in China, but not in India and Africa



The percentage of working poor dropped sharply in China

NOTES: Poverty means earning less than \$2 per day, converting at purchasing power parity rates in 1990 prices. Working poor means that a person has a job, but still earns less than \$2 per day.

SOURCE: Nomaan Majid, "On the Evolution of Employment Structure in Developing Countries," *Employment Strategy Papers*, International Labour Organization (2005).

Markets Aren't Enough

India isn't the only country whose government is failing to meet its responsibilities. Much of the developing world is likewise missing a vibrant public sector. In response to these shortcomings, a growing number of people believe that markets would do a better job of providing these same services. That is one of the reasons why microcredit has such widespread appeal: It's a market-based approach to eliminating poverty.²³

Even those who advocate a market-based approach to providing basic services don't argue that the state can totally abdicate its responsibilities. The late economist Milton Friedman, who advocated a school voucher system, did not want the state to withdraw totally from the field of education. The state must provide basic education for the sake of intergenerational equity. The state must also be responsible for providing services when there is a market failure. Free markets do not work well when economies of scale are very large and there is a natural monopoly, as in the case of piped water, and when the commodity is a "common good," as in the case of public health. In such cases, the market might be a partial complement to the state, but it cannot be a total substitute. For example, if a region has a private water supply, the government must still regulate rates and ensure that the poor have enough purchasing power to buy water.

The business guru C.K. Prahalad says, "If people have no sewage and drinking water, should we also deny them televisions and cell phones?"²⁴ Writing about the slums of Mumbai, he argues that the poor accept that access to running water is not a "realistic option" and therefore spend their income on things that they can get now and that will improve the quality of their lives.²⁵ This opens up a market, and he urges private companies to make significant profits by selling to the "bottom of the pyramid" (BOP).

Yet the BOP proposition glosses over the real issue: Why do poor people accept that they cannot expect running water? Even if they do accept this bleak view, why should we? Instead, we should emphasize the failure of government and attempt to correct it. Giving a voice to the poor is a central aspect of the development process.

The business community, bureaucrats, politicians, and the media are very busy congratulating themselves on the booming private sector in India. Sure, more Indians have cell phones. But what many remember about India is not all the people using cell phones. It's all the people defecating in public because they do not have toilets. Even in Mumbai, the business capital of India, about 50 percent of the people defecate outside. The current celebration of private sector successes should be met, and perhaps chastened, with anger at the failure of the state to provide basic services.

Overall, governments, businesses, and civil society would be well advised to reallocate their resources and energies away from

microfinance and into supporting larger enterprises in labor-intensive industries. This is what is alleviating poverty in China, Korea, Taiwan, and other developing countries. At the same time, they should also provide basic services that improve the employability and productivity of the poor. Otherwise, they will miss the mark of lifting people out of poverty. □

1 Tom Easton, "Hidden Wealth of the Poor," *The Economist* (Nov. 3, 2005).

2 Claire Cane Miller, "Microcredit: Why India Is Failing," *Forbes* (Nov. 10, 2006).

3 Sam Daley-Harris, "State of the Microcredit Summit Campaign Report 2006." Available at <http://www.microcreditsummit.org/pubs/reports/socr/2006.htm>.

4 "Bangladesh Will Send Poverty to Museum by 2030: Yunus," *Financial Express* (Feb. 18, 2007).

5 George Negus, "Foreign Correspondent – Interview With Prof. Muhammad Yunus," ABC Online (March 25, 1997).

6 Manfred Ertel and Padma Rao, "Women Are Better With Money," *Spiegel* (Dec. 7, 2006).

7 Aminur Rahman, "Micro-credit Initiatives for Equitable and Sustainable Development: Who Pays?" *World Development* (1999); Naila Kabeer, "Money Can't Buy Me Love? Re-evaluating Gender, Credit and Empowerment in Rural Bangladesh," IDS Discussion Paper No. 363 (1998); Mark Pitt and Shahidur Khandker, "Household and Intrahousehold Impact of the Grameen Bank and Similar Credit Targeted Programs in Bangladesh" (Washington, D.C.: World Bank Publications, 1995).

8 Gita Sabharwal, "From the Margin to the Mainstream. Micro-Finance Programmes and Women's Empowerment: The Bangladesh Experience," University of Wales, Swansea (2000).

Available at <http://www.gdrc.org/icm/wind/geeta.pdf>.

9 Jennefer Sebstad and Gregory Chen, "Overview of Studies on the Impact of Microenterprise Credit" (Washington, D.C.: USAID, 1996).

10 Aliya Khawari, "Microfinance: Does It Hold Its Promises?" Discussion Paper, Hamburg Institute of International Economics (2004).

11 David Hulme and Paul Mosley, *Finance Against Poverty* (London: Routledge, 1996).

12 Salil Tripathi, "Microcredit Won't Make Poverty History," *Guardian Unlimited* (Oct. 17, 2006).

13 Daniel Ten Kate and Van Rouen, "The Cycle of Debt – As Microcredit Institutions Grow, Some Question Their Effect on Poverty," *The Cambodia Daily* (Feb. 21-22, 2004).

14 Abhijit V. Banerjee and Esther Duflo, "The Economic Lives of the Poor," *Journal of Economic Perspectives* (2006).

15 LABORSTA Internet database, available at <http://laborsta.ilo.org/>, International Labour Organization.

16 Thomas W. Dichter, "Hype and Hope: The Worrisome State of the Microcredit Movement" (2006). Available at <http://www.microfinancegateway.org/content/article/detail/31747>.

17 "Macro credit," *The Economist* (Oct. 21, 2006).

18 Jonathan Morduch, "Does Microfinance Really Help the Poor? New Evidence From Flagship Programs in Bangladesh," Harvard Institute for International Development and Hoover Institution, Stanford University (1998). Available at http://www.wws.princeton.edu/~rpds/downloads/morduch_microfinance_or.pdf.

19 Kalpana Kochhar et al., "India's Pattern of Development: What Happened, What Follows?" *Journal of Monetary Economics* (2006).

20 Milford Bateman and David Ellerman, "Micro-Finance: Poverty Reduction Breakthrough or Neoliberal Dead-End?" Paper presented at UNDP Bosnia and Herzegovina and the BiH Economic Policy Planning Unit (EPPU), "Poverty Roundtable: Achieving MDG 1 (sustainable poverty reduction) in BiH" (June 16-17, 2005).

21 Amar Bhidé and Carl Schramm, "Phelps's Prize," *The Wall Street Journal* (Jan. 29, 2007).

22 Amartya Sen, *Development as Freedom* (New York: Anchor Books, 2000).

23 Bateman and Ellerman.

24 "Selling to the Poor," *Time* (April 17, 2005).

25 C.K. Prahalad and Allen Hammond, "Serving the World's Poor Profitably," *Harvard Business Review* (2002).