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## **The Record of Microfinance: The Effectiveness/Ineffectiveness of Microfinance Programs as a Means of Alleviating Poverty**

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### **Abstract**

With the Muhammad Yunus being recently awarded the Nobel Peace Prize for his pioneering approach and sustained effort in addressing the problem of poverty, microfinance programs have continued to grow in usage and popularity. There are numerous studies that demonstrate the tremendous successes of such programs throughout much of the underdeveloped world. However, the universal effectiveness of microfinance institutions in alleviating poverty is still in question, and not free from debate. Much of the evidence cited for the successes of microfinance and microcredit are merely anecdotal or involve in-depth case-study approaches, which provide vivid examples and rich details of the impact and effectiveness of specific programs in specific locations at a specific time, but generally fail to achieve a more rigorous standard that would allow for research findings to be widely generalized. Some more rigorous studies have been conducted and more are surely to follow, but in the meantime, NGO leaders and government policy makers must exercise caution and restraint in applying the microfinance approach universally as a means of alleviating poverty. This article reviews some of the recent research into the effectiveness of microfinance programs and proposes areas for future directions in the continued research of microfinance programs.

## Introduction

Poverty has different meanings to different people and is the source of much debate in the public arena. This is largely due to the fact there are many potential causes of poverty, ranging from those that could be categorized as causes stemming from one's personal choices and actions, causes stemming from structural constraints and inequalities in society, and causes that arise from government welfare entitlement programs. As a result of such a wide and diverse array of potential poverty causes, there are an equally large number of proposed policy interventions and solutions designed to eradicate the problem of poverty, some addressing each of the different areas mentioned above. One potential solution that has been increasing in popularity, and controversy, in recent years is the area of microfinance. However, despite the increased popularity, what is the record of such programs? Furthermore, what is the effectiveness/ ineffectiveness of such programs on reducing poverty? Finally, what are the predominant methodological approaches in the microfinance literature? As with any intervention strategy, as the number of microfinance programs instituted throughout the world continues to increase, formal investigation into the effectiveness of such programs is important.

In this paper I will provide evidence from the existing literature on microfinance to show the current performance record of such programs and the effectiveness/ineffectiveness of such programs on reducing poverty. Furthermore, I will discuss some criticisms of the microfinance approach to eradicating poverty and provide a critique of the methodological foundation of microfinance as a whole, as well as the increased number of impact studies that have been conducted in recent years. Finally, I will draw several conclusions on the appropriateness and effectiveness of microfinance programs in addressing the problem of world poverty, while providing several suggestions for future research directions in this developing field.

## Review of Literature

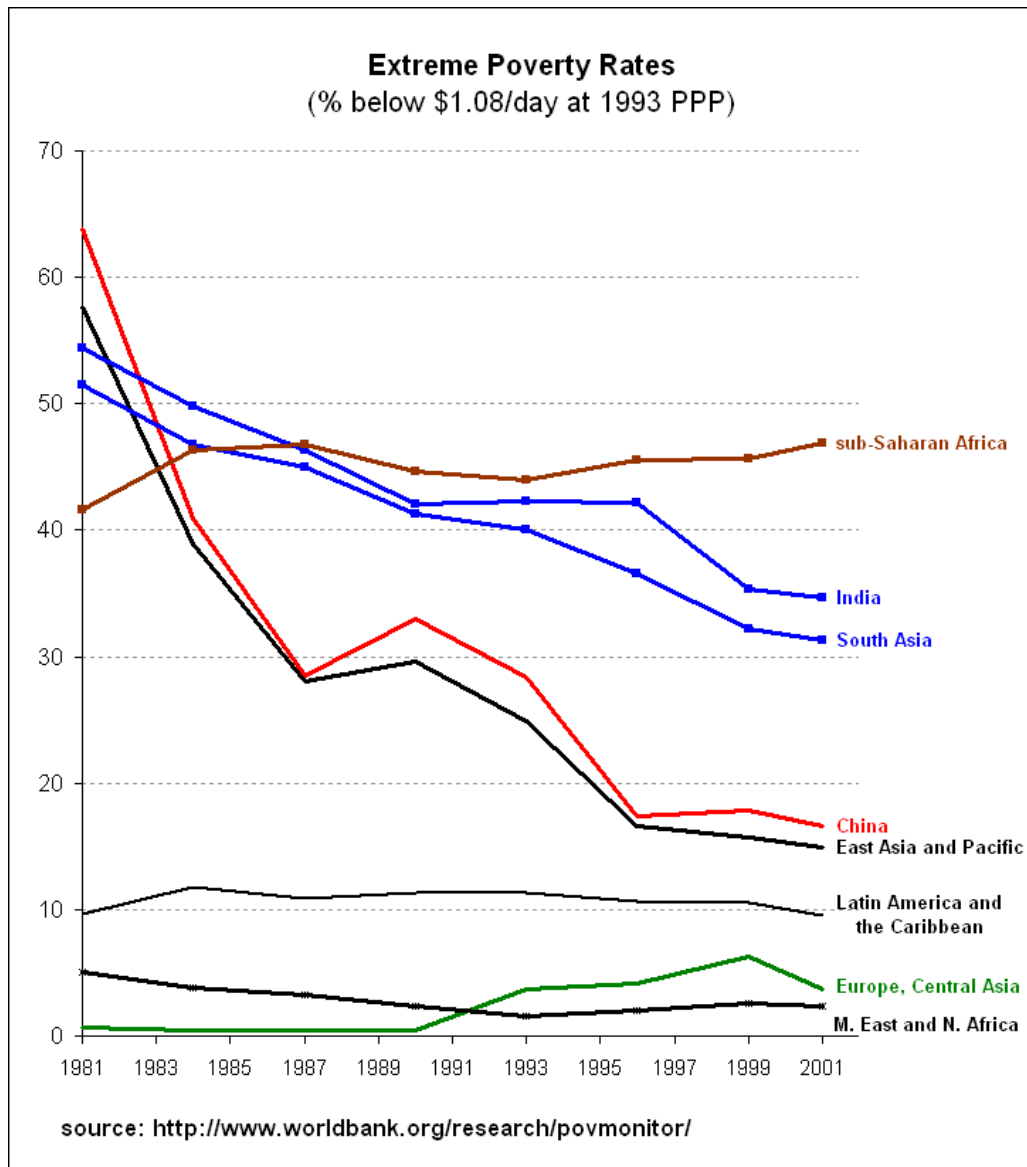
### *Article Selection Method*

For this literature review, I conducted an EBSCO Host database search of peer-reviewed academic journal articles between the years of 1996-2006, using the search terms, "microfinance and poverty," and "microcredit and poverty." This search produced over 100 article abstracts, which I read to determine which articles I would include in the review for this paper. While reading through the abstracts as skimming through the methods and findings sections of these articles, I quickly find that there is a large body of less "rigorous" research in this area, including microfinance institutions program impact studies and a large number of studies that used qualitative or more of a case studies approach. I therefore decided to focus my review on those articles that utilized some form of quantitative data and analysis, and where possible, a broader study scope (rather than focusing on just one program or one town). This reduced the number of articles dramatically, yielding the final six studies to be reviewed in this paper. In addition to the peer-reviewed journal articles, I also used some references to popular media sources and visited a few microfinance practitioner-based websites to provide what may be viewed as the popular mainstream perspective.

*Background to Microfinance*

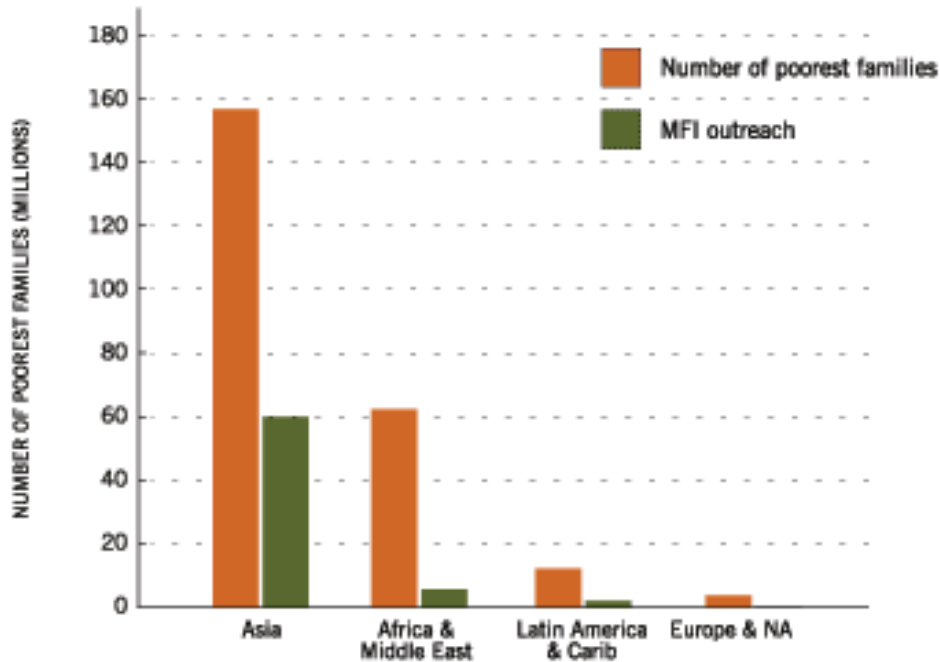
Poverty is a worldwide epidemic. Figure 1 below illustrates that though extreme poverty rates have been declining across many regions of the world in recent decades, high rates still persist. Furthermore, it is estimated that about one-sixth (500 million of an estimated 3 billion) of poor people throughout the world have access to formal financial services (World Bank, 2005). This represents a large gap in access to such services.

**Figure 1: Extreme Poverty Rates in World Regions**



One approach to reducing this gap that has increased in popularity in recent years has been the formation of microfinance institutions (an estimated 7,000 microfinance institutions serving approximately 16 million poor individuals in developing countries) (World Bank, 2005). However, Figure 2 illustrates the large gap that still persists between need and the access of microfinance services available to the world's poorest families.

**Figure 2: Access to Microfinance Services**



Source: [www.unitus.com/wwd\\_whatismf.asp](http://www.unitus.com/wwd_whatismf.asp)

The idea of microfinance started in Bangladesh around 1976 with Muhammad Yunus and Grameen Bank (recently awarded the Nobel Peace Prize for his work). Microfinance refers to financial services offered to low SES individuals that are excluded from the traditional financial system (considered “unbankable”—lacking collateral, steady employment, and a verifiable credit history). Aspects of microfinance, such as microcredit, are designed to help lift individuals, families, and communities out of poverty by providing small amounts of start-up capital for entrepreneurial projects, which will then presumably help individuals to generate income, build wealth, and exit poverty.

One aspect of microfinance that distinguishes it from the traditional financial system is the “joint liability concept,” where groups of individuals, usually women, group together to apply for loans, and hold joint accountability for repayment of the loan. The premise is that providing low SES individuals access to financial services will better enable poor households to move away from subsistence living, to a future oriented outlook on life and an increased investment in nutrition, education, and living expenses. Furthermore, microfinance is unique as a development tool because of its potential to be self-sustaining (both reducing poverty and maintaining a profitable business) (Business Week, 2005).

#### *Reported Strengths/Positive Impacts of Microfinance Programs*

A variety of studies have found a few key strengths and positive impacts produced by the implementation of microfinance programs in poor and impoverished areas of the world. First, microfinance programs can be an effective way to provide low-cost financial services to poor individuals and families (Miller and Martinez, 2006; Stephens and Tazi 2006). Second, such

programs have been shown to help in the development and growth of the local economy as individuals and families are able to move past subsistence living and increase disposable income levels (Khandker, 2005).

In addition, many studies (primarily microfinance institution impact studies and academic researcher qualitative or case studies) have shown that microfinance programs were able to reduce poverty through increasing individual and household income levels, as well as improving healthcare, nutrition, education, and helping to empower women. For example, standard of living increases, which help to eradicate extreme poverty and hunger, have occurred at both the individual and household levels as a result of microfinance programs (Khandker, 2005). Furthermore, it has been demonstrated by some research that microfinance programs increase access to healthcare, making preventative healthcare measures more affordable to the poor. In addition, more children are being sent to school and staying enrolled longer (Morduch, 1998). Finally, it has been shown that such programs can help borrowers to develop dignity and self-confidence in conjunction with loan repayment, and self-sufficiency as a means for sustainable income becomes available. Since microfinance services are primarily focused on women, it is argued that this leads to the empowerment of women and the breaking down of gender inequalities, through providing opportunities for women to take on leadership roles and responsibilities (Goetz and Gupta, 1995).

#### *Reported Problems/Negative Impacts of Microfinance Programs*

In contrast to the various positive impacts and strengths of microfinance programs listed above, other studies (more quantitative, with appropriate treatment/control frameworks and comparisons made across larger samples) have found several key problems and negative impacts produced by the implementation of microfinance programs in poor and impoverished areas of the world. First, some studies have shown that microfinance programs benefit the moderately poor more than the destitute, and thus impact can vary by income group (better-off benefit more from micro-credit) (Copestake et al., 2001; Morduch, 1998; Dugger, 2004). Second, most microfinance programs target women (due to higher repayment rates), which may result in men requiring wife to get loans for them (Goetz and Gupta, 1995). Third, examples exist of a vicious cycle of debt, microcredit dependency, increased workloads, and domestic violence associated with participation in microfinance programs (Copestake et al., 2001; Morduch, 1998). Fourth, studies have shown that there are low repayment rates in comparison with traditional financial institutions (Miller and Martinez, 2006; Stephens and Tazi, 2006), thus possibly contradicting one of the key strengths listed above, that such programs can lead to empowerment and increased self-confidence through responsible loan repayment. Fifth, there have been reports of the use of harsh and coercive methods to push for repayment and excessive interest rates (Business Week, 2005; The Financial Express, 2005). Finally, concerns have been raised that the reliance on microfinance programs to aid the poor may result in a reduction of government and charitable assistance (“privatization of public safety-net programs”) (Neff, 1996).

#### *Microfinance as a Means to Alleviate Poverty?*

Based on the findings reported above, there are mixed conclusions as to the overall impact of microfinance institutions. This leads us to the key question of this paper: What is the effectiveness/ineffectiveness of microfinance programs on reducing poverty? Some studies have found marked decreases in overall poverty levels, including declining levels of extreme poverty (Khandker, 2005), while other studies do not find the same direct effect (Morris and Barnes, 2005; Kan, Olds, and Kah, 2005; Goetz and Gupta, 1996). Still, other studies provide mixed results (Copestake, Bhalotra, and Johnson, 2001; Morduch, 1998). Thus, the academic literature is mixed in regards to the specific impact that microfinance has on alleviating poverty. In what follows, I will review these studies,

briefly discussing the study designs and key findings.

#### *Microfinance Helps to Alleviate Poverty*

The only study, among those selected for review in this paper, that was both more rigorous in design and reported very clear and direct effects of microfinance programs on poverty was Khandker's 2005 article, "Microfinance and Poverty: Evidence Using Panel Data from Bangladesh." This research examined 1,638 households that participated in two waves of the BIDS—World Bank 1991/92 and 1998/99 survey in Bangladesh. Khandker found that moderate poverty in the sample villages declined 17% between the two waves of the survey, and extreme poverty declined 13%. Among those households that participated in the microfinance programs, the poverty rate declined 20% in the same period, with more than half of the nearly 3% annual moderate poverty decline among participants attributed to the microfinance programs alone. He further found that access to microfinance programs contributed to the reduction of both moderate and extreme poverty of individuals (particularly women) as well as for the village as a whole—where inflow of microfinance funds to rural areas impacted the local economy— and raised per capita household consumption for both participants and nonparticipants.

#### *Microfinance Does not Help to Alleviate Poverty*

Despite the very positive results reported by Khandker, other studies reported more findings that were much muddier. Kan, Olds, and Kah (2005) studied the evolution, sustainability, and management of ten microcredit institutions in Gossas, Senegal, using a mixed-methods approach to study design, utilizing socioeconomic surveys, semi-structured interviews, and ethnographic research over a period of three years. They found that microcredit institutions have helped to create some positive change, but that there was no clear and marked evidence of poverty reduction that was attributable to the microfinance programs studied and stated that the expectations of what microcredit can do to help lift communities out of poverty is "a bit too optimistic" (p. 146).

Morris and Barnes (2005) attempted to provide an overall assessment of the impact of microfinance, and examined the impacts of three microfinance programs in Uganda (FINCA, FOCCAS, and PRIDE). Utilizing survey data collected via random sample from each of the three program areas (for both program clients and non-clients), baseline data was first collected in the winter of 1997, and then the survey was repeated in the winter of 1999 to assess impact. The researchers did not find that microfinance programs help to alleviate poverty in program areas, though results from these impact studies indicated positive impacts of these microfinance programs on both program participants' entrepreneurial business endeavors and within their own households. The authors further found that microfinance programs help to reduce financial vulnerability of poor individuals through the diversification of available income sources and the accumulation of assets.

#### *Mixed Results*

Though most of the studies already previously cited found some mixed results of the role that microfinance programs play in alleviating poverty, a few other studies clearly did not come down on one side or the other. Copestake, Bhalotra, and Johnson (2001) also attempted to provide an overall assessment of microfinance programs and used a mixed-methods approach, utilizing a questionnaire-based sample survey of PULSE participants, a secondary survey on drawn on a larger population of businesses and households, and qualitative focus-group discussion and key informant interviews. The researchers noted that "expectations are high, but evidence of the impact of microcredit remains in short supply" (abstract) and that the number of rigorous studies still remains small (p. 82). However, 57% of program participants reported feeling better off overall, though some borrowers are made worse off financially through involvement with the microcredit

programs. Further, the researchers found that the microfinance programs benefited the moderately poor more than the destitute.

Morduch (1998) attempted to look specifically at the role microfinance plays in helping the poor, and reported mixed results, including some positive and some negative impacts of microfinance in alleviating poverty and helping the poor. Morduch used survey data collected in 1991/92 by the Bangladesh Institute for Development Studies, in collaboration with the World Bank, covering 87 villages and nearly 1800 households. Survey data was collected at three points during the collection period to capture seasonal variations in household circumstances. Morduch found that the microfinance programs benefited the moderately poor more than the destitute. Further, he found that households that are eligible to borrow and have access to the programs do not have notably higher consumption levels than control households. Additionally, he found that households eligible for programs have substantially lower variation in consumption and labor supply across seasons, thus the most important potential impacts of microfinance programs are with reducing one's financial vulnerability, and not necessarily poverty.

## Critique of Existing Literature

As demonstrated in the review section of this paper, the findings in the literature on the effectiveness and impact of microfinance programs vary. Many impact studies and other similar assessments find great strengths and positive impacts of such programs on reducing poverty, while other studies report that such positive impacts may be over-reported and even inaccurate, while pointing out some fundamental flaws with such study designs. The question is, which group of studies is correct, and to what extent? In what follows I will briefly provide some methodological critiques of the current body of research in trying to address this question.

At this point in the literature, there are few stringent evaluations of microcredit programs generally viewed as credible by experts. Much of the literature reporting positive results of the impact of microfinance programs in reducing poverty fails to meet a rigorous level of study design and statistical analysis, using qualitative methods, looking at single cases or specific areas or regions, using cross-sectional data, analyzing self-reported measures, and using non-random sampling procedures, resulting in findings that cannot be easily replicated nor generalized to all programs. In contrast to the common qualitative and case-study approaches in the less rigorous body of research, only a handful of studies use sizeable samples and appropriate treatment/control frameworks to answer the questions of real impact and effectiveness. As Morduch said in his critique of the existing literature methodology, "While strong claims are made for the ability of microfinance to reduce poverty, only a handful of studies use sizable samples and appropriate treatment/control frameworks to answer the question" (1998, p. 1). Until more such studies are conducted and findings reported, we must take the findings of less rigorous impact studies with a grain of salt and not be too quick to generalize findings of the impact and effectiveness of a specific program, in specific location, at a specific time, to other cases.

## Future Directions

I am encouraged by the increasing popularity of the growing microfinance movement and recognize it as a pioneering approach to addressing the problem of poverty. There are numerous studies that demonstrate the tremendous successes of such programs throughout much of the underdeveloped world. However, despite the increase in the popularity of microfinance programs and the vast amount of research conducted to date, there are two key areas for future research into the effectiveness of microfinance programs.

First and foremost, more stringent evaluations of microcredit programs are needed. Various feasibility and impact studies have shown the financial viability of such programs in being self-sustainable institutions, but the question of the effectiveness and impact on the poor of such programs is still highly in question. Many studies use a case-study approach to looking at the effectiveness of a given program in a given region at a given time, but few effectively measure the impact of multiple programs. To be able to say once and for all that these programs are or are not effective at reduce poverty will require a large sample of programs with data that can be rigorously analyzed, with replicable methods and generalizable findings.

Second, there are considerable practical debates surrounding the implementation of microfinance programs that have yet to be answered. These debates include a fundamental theoretical debate between large-scale, top-down funding of major development projects versus small-scale, bottom-up funding to individuals and households as a means of alleviating poverty. Additionally, there are questions surrounding the potential of microfinance programs to cannibalize other programs, including government assistance and aid. Furthermore, there are still questions as to the potential of microcredit hurting the poor and creating a kind of microcredit dependency. Finally, as microfinance programs are geared almost exclusively to woman, there is a debate about the appropriateness of such a policy and the possible exploitation of women. Therefore further research needs to be conducted to examine these facets of microfinance programs.

## Conclusion

Despite the popularization of microfinance in the mass media and the many positive findings that are reported in some feasibility and impact studies, there are also many studies that report some negative impacts of such programs and fail to find a direct link between microfinance program involvement and poverty reduction. Thus, at this point, NGO leaders and government policy makers must exercise caution and restraint in applying the microfinance approach universally as a means of alleviating poverty and continue to conduct rigorous research that will better answer the questions addressed in this paper.



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