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The Microfinance Schism

JONATHAN MORDUCH*
Princeton University, New Jersy, USA

Summary. — Leading advocates for microfinance have put forward an enticing "win-win" proposition: microfinance institutions that follow the principles of good banking will also be those that alleviate the most poverty. This vision forms the core of widely-circulated "best practices," but as a general proposition the vision is fully supported neither by logic nor by the available empirical evidence. Recognizing the limits to the win-win proposition is an important step toward reaching a more constructive dialogue between microfinance advocates that privilege financial development and those that privilege social impacts. © 2000 Elsevier Science Ltd. All rights reserved.

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1. INTRODUCTION

Few recent ideas have generated as much hope for alleviating poverty in low-income countries as the idea of microfinance. Microfinance promises both to combat poverty and to develop the institutional capacity of financial systems through finding ways to cost-effectively lend money to poor households.[1] Poor households are typically excluded from the formal banking system for lack of collateral, but the microfinance movement exploits new contractual structures and organizational forms that reduce the riskiness and costs of making small, uncollateralized loans. Microfinance programs have also demonstrated that even poor households can save in substantial quantities. Success stories are being written around the world, from Jakarta to Dhaka to Nairobi to La Paz. Advocates have broadcast these successes widely, and donors have been quick to pledge billions of dollars to support the expansion of programs in the next decade.

Much of the enthusiasm rests on an enticing "win-win" proposition: microfinance institutions that follow the principles of good banking will also be those that alleviate the most poverty. By eventually eschewing subsidies and achieving financial sustainability, microfinance institutions will be able to grow without the constraints imposed by donor budgets. In the process, according to the argument, these institutions will be able to serve more poor people than can be served by programs fueled by subsidies. A key tenet is that poor households demand *access* to credit, not "cheap" credit. Thus, programs can charge high interest rates without compromising outreach.

If the argument is right, much poverty alleviation can be achieved at no cost to governments and donors–or perhaps even at a small profit. The vision has been translated into a series of "best practices" circulated widely by the Consultative Group to Assist the Poorest (CGAP; a donor consortium housed within the World Bank), the US Agency for International

* The paper was initially prompted by a meeting with representatives of the Consultative Group to Assist the Poorest, the US Agency for International Development, ACCION International, and the Harvard Institute for International Development, convened in Cambridge in Spring 1997. My views have evolved through conversations with Abhijit Banerjee, Gregory Chen, Monique Cohen, Peter Fidler, Mike Goldberg, Claudio Gonzalez-Vega, Albert Park, Marguerite Robinson, Richard Rosenberg, Jay Rosengard, J. D. von Pischke, Jacob Yaron, and participants at lively seminars at Ohio State and the World Bank. I have particularly benefited from input from practitioners in Bangladesh, Indonesia, and China, and from Christopher Dunford and his colleagues at Freedom From Hunger. Throughout, Mark Schreiner has provided particularly comprehensive and thoughtful criticisms. The paper was completed during a year as a National Fellow at the Hoover Institution, Stanford University. The views expressed here are mine solely. Final revision accepted: 30 June 1999.

Development, the United Nations Development Program, and other key donors.

While some find the win-win argument to be self-evident, most practitioners appear to be convinced by only part of the message. Despite keen awareness of "best practices," nearly all programs remain substantially subsidized. This is especially so for those with explicitly social objectives. For example, the most careful and comprehensive recent survey shows that the programs that target the poorest borrowers generate revenues sufficient to cover just 70% of their full costs (MicroBanking Bulletin, 1998).[2] While subsidy rates will surely fall as more programs gain age and scale, even many older, larger programs are far from being able to make ends meet with their own revenues. Some donors believe that little more than 5% of all programs today will be financially sustainable ever.[3]

Why are programs not raising interest rates and moving over to "best practices" more quickly? Much of the answer is that the win-win proposition turns out to be far more complicated than it would seem at first. It rests on a series of empirical assumptions and logical connections that do not generalize easily and which have yet to be demonstrated through careful empirical studies. Almost no studies provide comparable and reliable evidence on attributes as basic as the incomes, occupations, or loan uses of clients—and of comparable nonparticipants (the Hulme & Mosley, 1996, studies are an important exception). So while advocates continually trumpet the advantages and successes of one program or another, practitioners concerned with *who* they serve have inevitably discounted the success stories for fear that someone else's oranges are being compared to their apples.

By far, loan size has been the predominant metric for comparison of outreach. But loan size is a rough and indirect measure (Hatch & Frederick, 1998). A poverty-focused nongovernmental organization (NGO) in Nepal or Malawi will be understandably reluctant to assume that lessons can be learned directly from the experience of say, the Badan Kredit Desa of Indonesia—a series of village-based financial facilities that are financially self-sufficient despite serving clients with an average loan balance of just $38 (relative to $101 for the Grameen Bank; Christen, Rhyne, Vogel & McKean, 1995). The practitioners are probably right. The main clients of the BKD system are petty traders or owners of small service enterprises like restaurants and tailor shops, typically making high margin, quick turnaround investments. As a result, the clients are capable of paying real interest rates approaching 50% per year on 3–4 month loans (as is true for clients of Bolivia's well-known BancoSol).[4] Elsewhere, in contrast, the best available investments of many microfinance clients involve longer term loans for moderate-return activities like livestock raising, handicrafts, and agricultural processing. Programs fear that increasing the costs of borrowing will put these investment opportunities beyond the reach of their target clients. Not surprisingly, donor exhortations to follow the full slate of "best practices" have frustrated many NGOs. Until recently, consideration of *who* is being served has been almost entirely absent from the "best practices" conversation.

Instead, socially-minded practitioners have had to contend with the assertion that those clients that cannot pay the kinds of charges required for programs to break-even then certainly must be destitute, in need of direct health and education programs (or simple charity) rather than credit (e.g., Gonzalez-Vega, 1998). But socially-minded practitioners argue that their target group of clients is somewhere between destitute households and richer households. These target households (termed here the "core" poor) can potentially benefit from microfinance services, even if average loan sizes are too small to allow the kinds of economies of scale that have delivered financial sustainability for well-known programs such as BancoSol and Bank Rakyat Indonesia's *unit desa* system.[5]

Confronting the schism between rhetoric and action—and between financially-minded donors and socially-minded programs—will first require that both donors and practitioners pay greater attention to who is being served (Woller, Dunford & Woodworth, 1999; Rhyne, 1998). Constructing profiles of clients by occupation, loan use, and income level is an important first step. The call to best practices will only be convincing if backed by a series of well-documented examples of institution that are (truly) breaking even financially while serving clients with profiles very close to those served by socially-minded NGOs. Bangladesh's Association for Social Advancement (ASA) provides one promising example, as do some programs built on the village banking model. But these cases need to be expanded upon and more carefully documented with an eye to crosscountry comparisons.[6]