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Microfinance: Its Impact, Outreach, and Sustainability

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Summary. — This symposium brings together recent empirical contributions with respect to a number of related and highly relevant issues on the economics of microfinance. In particular, the contributions provide answers to the following two main questions: (1) does microfinance have an impact on the social and economic situation of the poor in developing nations; and (2) are microfinance institutions sustainable in the long term and is there a trade-off between sustainability and outreach?

Key words — microfinance, impact, outreach, sustainability

1. INTRODUCTION

The role of microfinance has attracted significant interest in recent years, both from policy makers as well as in academic circles. However, as has been pointed out in a recent special issue on microfinance in *The Economic Journal* (Hermes & Lensink, 2007), many questions regarding microfinance remain unanswered. In particular, the following two pressing issues should receive more attention: (1) does microfinance have an impact on the social and economic situation of the poor in developing nations? This question is very relevant since a lot of effort and resources have been put into developing microfinance, especially since the beginning of the new millennium, as an instrument to combat poverty. (2) Are microfinance institutions sustainable in the long term; is there a trade-off between sustainability and outreach? Again, this is a very relevant question, since putting emphasis on poverty reduction comes at a price, which may reduce the scope for financial sustainability and *vice versa*.

This symposium contains eight original contributions that provide new empirical evidence on these two issues. First of all, four of the eight contributions address the question of the impact of microfinance on the well-being of the poor in developing nations. Does microfinance have a measurable impact on the social and economic situation of the poor in developing nations? The other four contributions focus on the trade-off between reducing poverty and being financially sustainable at the same time, that is, can MFIs finance their own operations without compromising their mission to reach out to the poor?

The current symposium for *World Development* elaborates on the special issue in *The Economic Journal* (Hermes & Lensink, 2007) in a number of ways. In the 2007 special issue we primarily dealt with joint liability group lending, providing new insights with respect to why and how this type of lending works in enhancing repayment rates. We also touched upon the issue of the trade-off between the financial sustainability and outreach of microfinance programs. In this symposium, we provide much more evidence on the trade-off between sustainability and outreach. Moreover, the analyses in this symposium do not explicitly focus on group lending; instead they include different types of lending.

The remainder of this introduction consists of brief reviews of the existing literature on the two issues the papers in this symposium deal with. Section 2 deals with the impact of microfinance on the well-being of the poor; Section 3 discusses the tradeoff between sustainability and outreach.

2. THE IMPACT OF MICROFINANCE

The advocates of microfinance argue that access to finance can help to substantially reduce poverty (Dunford, 2006; Littlefield, Morduch, & Hashemi, 2003). Access to finance may contribute to a long-lasting increase in income by means of a rise in investments in income generating activities and to a possible diversification of sources of income; it may contribute to an accumulation of assets; it may smooth consumption; it may reduce the vulnerability due to illness, drought and crop failures, and it may contribute to better education, health and housing of the borrower. In addition, access to finance may contribute to an improvement of the social and economic situation of women. Finally, microfinance may have positive spill-over effects such that its impact surpasses the economic and social improvement of the borrower. The positive assessment of the contribution microfinance can make to reducing poverty has convinced many governments, NGOs, and individuals to put efforts in supporting MFIs and their activities.

Yet, microfinance has also received criticism. In particular, the critics of microfinance doubt whether access to finance may contribute to a substantial reduction in poverty. They claim that microfinance does not reach the poorest of the poor (Scully, 2004), or that the poorest are deliberately excluded from microfinance programs (Simanowitz, 2002). First, the extreme poor often decide not to participate in microfinance

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programs since they lack confidence or they value the loans to be too risky (Ciravegna, 2005). The poorest of the poor, the so-called core poor, are generally too risk averse to borrow for investment in the future. They will, therefore, benefit only to a very limited extent from microfinance schemes. Second, the core poor are often not accepted in group lending programs by other group members because they are seen as a bad credit risk (Hulme & Mosley, 1996; Marr, 2004). Third, staff members of microfinance institutions may prefer excluding the core poor since lending to them is seen as extremely risky (Hulme & Mosley, 1996). Fourth, the way microfinance programs are organized and set up may lead to the exclusion of the core poor. Examples for this exclusion are the requirement to save before a loan can be granted, the minimum amount of the loan that needs to be accepted and the requirement that a firm is registered before the loan can be granted (Kirkpatrick & Maimbo, 2002; Mosley, 2001).

Finally, critics of microfinance doubt whether it has a positive impact on women. Many microfinance schemes have a clear focus on women. Research shows that women are more reliable and have higher pay-back ratios. Moreover, women use a more substantial part of their income for health and education of their children (Pitt & Khandker, 1998). Thus, women play a very important role in reducing poverty within households. However, the critics argue that often women are forced to hand over the loan to men, who subsequently use the loan for their own purposes. This may lead to an additional burden for women if they are held responsible for the repayment (Goetz & Gupta, 1996).

The disagreement about the contribution microfinance can make to reduce poverty impact of microfinance has triggered a large number of empirical assessments. In this respect, research has tried to address one or more of the three following questions: (1) does microfinance reach the core of the poor or does it predominantly improve well-being of the better-off poor; (2); which contribution is seen as the most important (improvement of income, accumulation of assets, empowerment of women, *etc.*); and (3) do the benefits outweigh the costs of microfinance schemes? (Chemin, 2008; Dunford, 2006). The latter issue deals with the question to what extent subsidies to microfinance organizations are justified. Most studies aiming at evaluating the impact of microfinance address the first of the above three issues.

Even though several assessments of the impact of microfinance on poverty reduction have been made, there is surprisingly little solid empirical evidence on this issue. [1] One major problem with respect to investigating the impact of microfinance is how to measure its contribution to poverty reduction. Several studies measure the impact of microfinance by comparing recipients of microfinance with a control group that has no access to microfinance. In most cases, these studies apply non-randomized approaches. These approaches may be problematic, however. First, changes of the social and/or economic situation of the recipients of microfinance may not be the result of microfinance. For instance, it is well-known that relatively rich agents are less risk averse than relatively poor agents. This may induce rich agents to apply for microfinance whereas poor agents do not apply, that is, there may be a self-selection bias. In this situation, an *ex post* comparison of income of the two groups may lead to the incorrect conclusion that microfinance has stimulated income. Second, in order to improve the probability of microfinance being successful, MFIs may decide to develop their activities in relatively more wealthy regions (i.e., non-random program placement). Obviously, this biases any comparison between recipients of microfinance and the control group (Armendáriz de Aghion & Morduch, 2005; Karlan, 2001).

The evidence from available published non-randomized microfinance impact evaluations is mixed. One of the most influential studies in this field is by Pitt and Khandker (1998) on the impact of microfinance in Bangladesh, using household survey data for 1991–92. They find that access to microfinance increases consumption expenditure, especially if loans are taken by women. Khandker (2005), in a follow-up study using panel data for 1991–92 and 1999, concludes that the extremely poor benefit more from microfinance than the moderately poor. The results of both these studies have been contested recently in a study by Roodman and Morduch (2009), however, showing that the instrumentation strategy may have failed and that results may be driven by omitted variables and/or reverse causation problems. Chemin (2008), using the same Bangladesh surveys, applies the propensity score matching technique and finds that access to microfinance has a positive impact on expenditures, supply of labor, and school enrollment. In contrast, Copestake, Dawson, Fanning, McKay, and Wright-Revolledo (2005) are less optimistic about the impact of microfinance. Based on data from a survey carried out in collaboration with a village banking program, Promuc, in Peru in 2002, and using a mix of evaluation methods (among which are the difference-in-difference approach and qualitative in-depth interviews) they find that it is the "better off" poor rather than the core poor who benefit most from access to microfinance.

As a response to the methodological flaws of non-randomized evaluations, studies of microfinance impact have recently shifted to randomized approaches. These studies use randomized controlled trials (or experiments), in which two groups—the treatment group and the control group—are exactly the same along all relevant dimensions, except that the treatment group has access to microfinance and the control group has not. The allocation of individuals in treatment or control groups is random. The randomization of the treatment may be deliberately carried out, for example, by a microfinance program, which randomly opens new branches in a previously untapped slum of a big city. It may also occur due to an external (natural) event, such as, for example, a volcanic interruption selectively hurting some microfinance clients, while leaving others unaffected. Differences in outcome variables, such as consumption, investment and health can then be causally linked to the treatment. [2]

Also the evidence from studies using randomized experiments appears to be mixed; some of the results seem to suggest that effects are stronger for groups that are not typically targeted by MFIs. Coleman (1999, 2006) is one of the first to use a randomized approach when evaluating the impact of microfinance. In his study he is able to make use of an external event, that is, a microcredit program introducing microfinance in the Northeastern part of Thailand with random and unannounced delays. Based upon this quasi-experimental setting, his analysis shows that microfinance has a positive impact on the more wealthy villagers only. Karlan and Zinman (2009) study the effect of microcredit on small business investment in Manila, the Philippines. The picture emerging from their results is rather diffuse. One important result is that profits from business increase especially for male and higher-income entrepreneurs. Moreover, they find rather striking results showing that businesses substitute away from labor into education and formal insurance into informal insurance. Banerjee, Duflo, Glennerster, and Kinnan (2009) evaluate the impact of the opening of MFI branches in the slums of Hyderabad. Half of the 104 slums were randomly selected