The illusion of poverty reduction

The much-celebrated 'microfinance' industry actually has a terrible record in reducing poverty. Its explosion in the past few decades has more to do with its usefulness to neoliberalism, argues **MILFORD BATEMAN**

With poverty rising rapidly in many developing and transition countries on account of the global financial crisis, the need for effective policies to address this key issue is of increasing importance. One development policy long hailed as important in this context is 'microfinance'. As originally conceived, microfinance (or microcredit as it is also known) is the provision of tiny loans to poor people who establish or expand a simple income-generating activity, thereby supposedly facilitating their escape from poverty.

Microfinance first came to prominence in the early 1980s thanks to the efforts of Dr Muhammad Yunus, the Bangladeshi economist and 2006 Nobel Peace Prize co-recipient. Yunus established the now iconic Grameen Bank, a bank that was owned by and worked exclusively with the very poor. A key aspect of Yunus's early idea was the argument that microfinance was a useful substitute for the local loan shark.

Once exposed to the idea, the main international development agencies became very keen on it, particularly the World Bank and the US government's aid assistance arm, USAID. Such was its obvious 'feel-good' appeal – 'a hand up, not a handout' – that microfinance was soon beloved of European and Middle Eastern royalty, Hollywood stars, major financial corporations, profile politicians (notably Bill Clinton) and 'troubleshooting' economists such as Jeffrey Sachs and Hernando de Soto. Microfinance also became the one international development policy that the ordinary person in the street knew a little about.

Basic problems

In first pitching his ideas to the international development community in the early 1980s, Muhammad Yunus held up the prospect that microfinance would be able to help into operation an unlimited number of microenterprises. He claimed that local economies would soon begin to thrive on account of so much bottom-up economic activity, making generalised poverty a thing of the past. His most famous claim was that the next generation would have to go to a 'poverty museum' to find out what all the fuss was about.

Yunus was dramatically wrong. A key dynamic that he missed was the generally fixed (or at best upward crawling) level of local demand for the very simple outputs associated with microenterprises. When microfinance-funded enterprises are set up, they tend simply to displace other tiny businesses without funding, meaning there is generally no net impact on poverty. Local demand is effectively shared out among the total number of microenterprises. Pre-existing microenterprises typically experience falling demand, leading to falling margins, wages and profits, and so also pressure to dismiss any employees.

In addition, most simple microenterprises fail after just a few years of operation. In Bosnia, for example, World Bank researchers reported that the failure rate of microenterprises within just one year of their establishment was approaching 50 per cent. Research undertaken on a number of microfinance programs in the Indian state of Tamil Nadu found that on average only 1 per cent of microenterprises were still in operation three years after their establishment.

Worse off than before

When a business venture fails, moreover, the microloan still has to be repaid, which means the poor typically have to sell off personal assets (including land), savings have to be drawn down, relatives are tapped for their support and other income flows (especially remittances) are diverted into loan repayment. Very many of the poor going down the microenterprise route, therefore, end up much worse off than before they accessed their microloans. In other words, microfinance ends up largely redistributing poverty within the community of the poor, not resolving it through sustainable growth of the local economy.

Supremely emblematic of what is actually the typical end result of the combination of displacement and client failure over time is the sad fate that has befallen Jobra, the famed village in Bangladesh where Muhammad Yunus effectively began the microfinance revolution back in the late 1970s. Unfortunately, after 30 or so years of unparalleled easy access to microfinance, its inhabitants remain trapped in extreme poverty and deprivation. It turns out that as more and more microenterprises were crowded into the same local economic space, the returns on each one began to fall dramatically. Starting a new trading business or a basket-making operation or driving a rickshaw required few skills and only a tiny amount of capital, but such a project generated very little income, because everyone else was pretty much already doing exactly the same things in order to survive.

In fact, most of the simple income-generating activities supported by the Grameen Bank ended up failing after a short time period. This included the bank's very first client, Sufiya Begum, who Muhammad Yunus widely praised for her advice and fortitude in his autobiography, but who actually died in abject poverty in 1998 after all her many tiny income-generating projects came to nothing. Similar outcomes abound in those countries and regions that are now, like Bangladesh, also effectively 'saturated' with microfinance (Bolivia, Andhra Pradesh state in India and Bosnia are notable examples).


An informal waste collector in India

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Deindustrialisation

Another wider and longer-term problem with microfinance is that it clearly helps facilitate the deindustrialisation and infantilisation of the local economy. This occurs precisely because microfinance institutions overwhelmingly support only the tiniest and simplest of microenterprises – that is, street vending, cross-border shuttle trading, petty services, and some simple production-based activities that add value very quickly. To the extent that local savings and remittance income are increasingly channelled into such simple activities via microfinance institutions, and so channelled away from more sophisticated and scaled-up activities associated with small and medium enterprises, the more the economic structure of that country, region or locality is inevitably undermined and destroyed.

In its 2010 flagship publication *The Age of Productivity: Transforming Economies from the Bottom Up*, the Inter-American Development Bank (IADB) brought together a wealth of case study material and statistical data confirming that a deindustrialisation trend has been underway in Latin America for some 30 years. Crucially, the IADB reported, the main impulse behind this debilitating trend was seen as the channelling of the continent's financial resources increasingly into low-productivity microenterprises and self-employment units, and so away from the far more productive, skills-intensive, innovative and hence growth-oriented small and medium enterprise (SME) sector.

Bolivia's experience

An obvious example of this is the situation in Bolivia. After more than 20 years of microfinance 'saturation', we find that the urban economy in Bolivia has been transformed into little more than a giant bazaar. Meanwhile, rather than breaking out of their subsistence origins thanks to investments in better technologies, inputs and collective structures (such as irrigation, storage facilities, joint marketing and so on), poor rural Bolivians have instead ended up more than ever isolated and effectively trapped working on their tiny unproductive land plots.

The main losers in Bolivia were the small and medium businesses and family farms working at or above minimum efficient scale, which are also the production units most capable of expansion, of creating decent jobs and of ultimately promoting productivity growth. Put simply, going without funds on affordable terms for so long has been a complete disaster for them.

Importantly, the government of Evo Morales (see Essay, page 28) has recognised the huge problems that have arisen due to microfinance saturation and begun to deal with the issue.

First, a new SME bank was established in 2007 to deal with the far more productive SME sector, including co-operative enterprises working in the important agro-processing and light industrial field. Second, the new Morales government quickly established a system of conditional cash transfers (CCTs) serving the very poor. This system of small grants offered in return for some simple commitment (regularly taking one's children to the health centre for check-ups, ensuring high attendance rates at school and so on) is not only an elemental form of wealth redistribution; it is also a way of helping the poor escape from the clutches of the microfinance industry and its still hugely expensive 'loan shark-lite' consumer loans.

Third, negotiations are underway with the main microfinance institutions with a view to getting interest rates down to single figures. The conventional justification for high interest rates everywhere – that this will allow microfinance institutions to rapidly expand their offer of microfinance to even more of the poor – clearly no longer holds any water if, as is the case, the typical Bolivian community is already saturated with microfinance. It has also not escaped the Morales government's attention that the high interest rates in Bolivia were, in many cases, used to fund the private enrichment goals of the managers of the microfinance institutions.

Disempowering women

Another largely false claim made by the microfinance industry and its supporters is that microfinance has opened up an historic opportunity to empower women. Indeed, such is the widely presumed positive impact of microfinance on women that in 2008 *Time* magazine went so far as to denote it as 'one of the ten ideas that are changing the world'. In fact, experience from wherever microfinance has become ubiquitous indicates quite the opposite.

The routine social pressure, threats and violence meted out to women to get them to repay any microloans they took out (or their husbands took out) has been extensively documented by researchers, notably by Lamia Karim in Bangladesh and Lesley Gill in Bolivia. All told, microenterprise activity undertaken by women actually reflects nothing more than the proliferation of hyper self-exploitative and patriarchal hegemony-strengthening outcomes – in a word, disempowerment.

Microfinance is popular in mainstream economic policy circles precisely because it acts to discipline and 'soften up' women in order for them to become more 'market-friendly'. Women in poverty are then far more likely to come to terms with whatever meagre rewards the market might deliver up to them, rather than petition the state for better services or collectively organise and agitate for the kind of fundamental change that comes at the expense of economic elites.

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A microenterprise in India involved in the hand production of sanitary towels

Commercialisation

The many problems associated with microfinance were exacerbated in the 1990s thanks to the commercialisation that took place in line with the ascendance of the neoliberal project. The idea of 'full cost recovery' was introduced – that is, the poor simply had to pay the full costs of any microfinance being provided to them. Interest rates had to rise to market levels to ensure that a microfinance institution was financially self-sustaining. As a result, those taking loans considered only the most immediately profitable business areas, such as street vending and shuttle trading across borders. Any sort of complicated or innovative or long-term focused business project simply could not contemplate trying to cover 40–50 per cent interest rates in its first difficult years of operation.

Another commercialisation-related problem was the rise of the so-called 'microfinance millionaires', who have tapped into international development funds in order to build a microfinance empire geared up to their own private enrichment rather more than helping the poor. Probably the most spectacular example of this anti-social yet increasingly common development is the case of the Mexican bank Compartamos. For a long time openly charging its poor women borrowers upwards of 100 per cent interest rates, today its rates are advertised as 'only' around 75 per cent, though they have actually been calculated at 129 per cent by the watchdog organisation Microfinance Transparency. Meanwhile, senior managers rewarded themselves with Wall Street-style salaries and bonuses.

A neoliberal ideology

So if microfinance is so counter-productive, why is it still being pushed? The answer here is not to be found in the economics, but in the politics and ideology of microfinance. Microfinance supports individual entrepreneurship, and in many ways it deliberately positions such activities as the sole legitimate way for the poor to try to escape their poverty. To the extent that the poor can be brought around to agreeing with this deeply neoliberal worldview, the more likely it is that they will willingly abandon the radical pro-poor policies (progressive taxation, wealth redistribution, a 'developmental state') that can most meaningfully resolve their poverty plight but that jeopardise established business and political interests. Microfinance is simply one more strand in the ongoing attempt by the most powerful western economies to impose neoliberal policies around the globe.

No one denies that microfinance has some benefit for the poor. As in any lottery or game of chance, a few in poverty do manage to establish microenterprises that produce a decent living. The poor also value microfinance in terms of consumption smoothing. However, as I have tried to show, these isolated and often temporary positives are swamped by the largely overlooked negatives. The international development community is now faced with the reality that, overall, microfinance has been a development policy blunder of quite historic proportions. The longer it fails to register this, the worse it will be for the poor everywhere.

Milford Bateman is a research fellow at the Overseas Development Institute, although he writes here in a personal capacity. His *Why Doesn't Microfinance Work? The destructive rise of local neoliberalism* was recently published by Zed Books

Alternatives to conventional microfinance

Conventional microfinance may be plagued with problems, but that doesn't mean that credit provision can't play a role in genuinely progressive development. Here are a few examples:

Venezuela

Largely using money from oil revenues that was previously used to enrich the small petro-elite, Venezuela under Hugo Chávez has seen a proliferation of bottom-up development programmes, placing particular emphasis on establishing networks of agricultural, marketing and worker co-operatives.

The Venezuelan government argues that co-operatives are central to 'an economic model with a rationality centred towards collective well-being rather than capital accumulation' and lending to co-operatives on affordable terms and maturities is prioritised in the three well-funded microcredit banks that have been established. Interest rates are kept low, there is a well-funded program of technical advice and funds are often disbursed on condition that microenterprises integrate into larger business networks to reap economies of scale.

The lenders also try to ensure that such businesses are identifying genuine market gaps, rather than adding to an already saturated sector – in other words taking a hands-on approach to help develop a strong local economy.

Kerala, India

The Indian state of Kerala is unique in managing to achieve relatively high levels of human development despite low levels of GDP growth, not least through higher wages, good working conditions and generous social provision. Less well known is Kerala's own form of microfinance, which makes a number of key departures from the Grameen Bank model. Planning is encouraged to avoid local overcapacity arising; informal sector operations are encouraged to formalise into co-operatives; and the state makes a deliberate effort to encourage the unionisation of informal sector workers.

Emilia-Romagna, Italy

Locally-based financial co-operatives played a key role in northern Italy's reconstruction after the second world war. Emilia-Romagna went from being one of the poorest Italian regions to one of the richest in Europe. Both savings and state funds were mobilised to support medium, small and micro enterprises which were relatively technology-intensive, often co-operatives themselves and needed long-term support. While there were a number of very local factors in the way the region developed, this model had a significant influence on Venezuela's efforts today.

Adapted from Milford Bateman's *Why Doesn't Microfinance Work?*