The Impact of Subsidies on Microfinance

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Abstract

In the next ten years, society will spend $20 billion U.S. on Microfinance Institutions (MFIs). Previous research on the impact of subsidies suggests that there is little if any consensus on an effective method to measure the impact of subsidies with considerable doubt existing that a financial variable is the most appropriate method. Findings suggest that in order for the impact of subsidies to be fully reconciled, some consideration must be given to the initial objectives and underlying motives of Microfinance Institutions (MFIs) and subsidy providers as this has an intrinsic bearing on any result they are attempting to achieve.

I have attempted to shed light on a significant failure of the microfinance movement to date, in that we still have not clearly articulated by what qualitative measure we are to determine the success of MFI’s. Identifying what is the priority issue, even if it is a combination of factors requires willingness on behalf of both pro and anti- subsidy lobbies to concede that their approach may not be the most important.

In order to transcend this discord a retrospective approach is taken to the impact of subsidies, whereby they are analysed from an initial substantive view in regard to underlying motive. I use this framework to assess microfinance in general and then apply my findings to a policy framework for microfinance institutions (MFIs) and subsidy providers.

1. Introduction

Microfinance has been one of the most remarkable innovations in the last century for poverty alleviation and advancement in lives of the poor in developing countries. Globally there are 500 million economically active poor people in the world operating microenterprises and small businesses (Microcredit Summit 2000). Most of them do not have access to adequate financial services. The primary role of microfinance is to provide financial intermediation involving the transfer of capital to low-income households close to or below the poverty line who are regarded as not bankable by the conventional financial institutions. The basic problem is that the market does not reconcile the price of small loans and deposits with the high average cost of managing and administering them. Unless there is a market failure, the social benefits of a tax and subsequent subsidy cannot possibly exceed social costs. Even then there is no guarantee.

In practice, market failures plague financial markets. But market failure, though necessary to justify public intervention, is not sufficient. In the end, an MFI wastes precious funds unless it resolves the market failure better than any other intervention. History has shown that the costs of interfering with markets quite often do more harm than good, with other measures more suitable to achieving the desired outcome of improving market efficiency in areas where they are sadly, not efficient. MFIs could improve social well-being by mitigating market failure, but this alone will not solve the problems for the world's poor.

When market failures persist, lenders face the problem of managing the risk of loan default (Von Pischke, 1991). To counter this they seek insurance against loan default by obtaining information about the actions of borrowers and the characteristics of loan applicants. However, it is costly to determine the risk of default for each borrower, ensure that borrowers take actions facilitating repayment and enforce contracts. These moral hazard problems, products of asymmetric information and imperfect enforcement, have led to the development of group based lending systems of financial intermediation which incorporate joint liability and monitoring.

Because donors are the primary providers for microfinance activities (since most MFIs do not collect and are not yet financially viable enough to access commercial funding), the approach they take to microfinance and the requirements they set for MFIs to access funding can greatly affect the development of the field of microfinance. However, a lack of coordination can quickly undermine the efforts of good microfinance providers, as evidenced by the many cases where donors (and governments) have distorted the entire micro finance market by subsidizing interest rates and consequently making it difficult for other micro finance providers to compete. The fundamental issue is that subsidising an MFI makes sense if it solves a market failure with more benefits net of costs than any other intervention.

Predominantly, the focus of research has been on an effective measure of subsidies in an attempt to determine whether subsidies should be used with MFIs, as a vehicle for providing assistance to the poor. The central issue that needs to be investigated is more in the lines of, why do we provide subsidies to assist the poor? Until the answer to this question has clearly been announced, then any measure of success will by its nature fall short of the mark, as it is motive that provides action, not a theoretically established framework, as important as this is. Until we confirm the underlying objectives and intentions of those who provide and use subsidies, how are we to know what to measure, let alone how to measure it?

The remainder of the paper is structured as follows. Section 2 provides a review of literature on microfinance subsidy and other policy support provided through microfinance to the poor. Section 3 develops a methodological framework of analysis for interpreting the role of subsidies, while section 4 deals with the inherent impact of subsidies and how this can be used to substantiate motive. The final section presents findings of the study and policy implications, with suggestions put forward for future research directions.

2. Literature review

There have been a host of studies conducted with regard to the impact of subsidies on microfinance. The ensuing discussion outlines research pertinent to this issue, highlighting limits and gaps within the existing literature. In particular, the survey of literature aims to identify where research to date is inconclusive and significant variances in opinions arise.

Table 1 provides an overview of selected pro and anti-subsidy institutions and authors with viewpoints that are often at extreme poles and synthesise opinions quite harshly, while at other times there is almost a balanced view with a range of positions in between. Overall, in order for subsidies to be justified, it needs to be shown that supporting an MFI is better that an alternative allocation and that support for MFIs does not have large negative side effects (Morduch, 1998; Campion, 2002; Hardy, Holden & Prokopenko, 2002; Schreiner, 2003a).

TABLE 1
SELECTED PRO AND ANTI-SUBSIDY INSTITUTIONS AND AUTHORS

Pro-Subsidy Advocates	Anti-Subsidy Advocates
Chao-Beroff (1997)	Campion (2002)
Conning (1999)	Christen, Rhyne, Vogel & McKean (1995)
Grameen Bank Bangladesh	Khandker, Khalily & Khan (1995)
Hardy, Holden and Prokopenko (2002)	Ledgerwood (1999)
Morduch (1998, 1999, 2000)	Paxton and Cuveas (1998)
Rodney (1997)	Rhyne (1998)
Rogaly (1996)	Schreiner (2003)
	USAID
	World Bank (Consultancy Group to Assist the Poor)

Source: Compilation by author

2.1 Impact of microfinance subsidy

Some of the earliest work on the savings and credit phenomenon during the 1970s was undertaken by Bouman (1977), who found that the key features that accounted for the success of microfinance were accessibility, flexibility and adaptability.

Access to innovative financial intermediation services has been the overriding reason behind the development of microfinance, with the impact subsidies have now playing a significant role in the determination of future policy for this mode of ODA.

2.1.1 Efficiency of subsidy

In Morduch's (1999a) ground breaking paper on the impact of subsidies on microfinance, a recurrent theme that is espoused throughout is that the promise of microfinance has pushed far ahead of the evidence. In a study of 72 MFIs from around the world, Morduch showed that high (reported) repayment rates have not translated into profits and studies of impacts on poverty yield a mixed picture, questioning the efficiency of subsidies used in microfinance.

2.1.2 Outreach, sustainability and other measures of success.

In relation to the impact of subsidies on outreach (the ability to reach large numbers of people, especially the very poor, with quality financial services) and financial sustainability (the ability to operate at a level of profitability that allows sustained service delivery with minimum or no dependence on donor inputs of MFIs to the poor) there are valid arguments on both sides.

Determining the outcome of this dispute will require a measure of success that is supported (at least theoretically) by all concerned. These models on the measurement of ODA and its intrinsic costs and benefits have their origins in the pioneering work of Sen (1973), which led to the development of dozens of poverty measures in the past three decades. In recent years, distribution sensitive, sub-group consistent poverty measures in the tradition of Foster, Greer and Thorbecke (1984) have gained popularity.

To complicate this issue even further, Paxton (2003) used the insights gained from the vast poverty measurement literature and applied them in a novel way to the empirical measurement of poverty outreach in MFIs with controversial results. In a significant finding that conflicted with traditional measures of outreach, this poverty measure rejected the common notion that there is a necessary trade-off between client outreach and institutional sustainability.

This is in direct contrast to current research findings and sheds light on why some studies have highlighted the trade-off between outreach and sustainability (Morduch, 1998; Conning, 1999; Hardy, Holden & Prokopenko, 2002) while other studies have questioned it (Christen, Rhyne, Vogel & McKean, 1995; Paxton & Cuveas, 1998).

2.1.3 Moral hazard

Another significant impact reported in a study by Christen (1997) associated with MFIs is that of moral hazard (the propensity for management to under perform and place priority on issues that are detrimental to the entity's performance due to mitigating incentives that favor or place priority on other outcomes). Moral hazard is likely to result in poor management and unsound financial practices, and should be accompanied by mechanisms to limit aid-dependence and promote competition between MFIs. Adding support to this theory, Marr (1999) found that governments and donors have learned that subsidizing the management of MFIs is more effective than subsidizing interest rates for the poor and will help alleviate issues of moral hazard.

2.1.4 Leveraging financial capital

Financial institutions rely on leveraging financial capital as a matter of course in conducting their business affairs. A microfinance program that is not self-sustaining (relies on subsidies to survive) is unlikely to leverage its donor funds by borrowing significant amounts from commercial sources. In order for ODA subsidies to make a significant difference to the impact of MFIs requires that the MFIs become self-sustaining (Christen, 1997).

Campion (2002) further suggests that it is evident that subsidies discourage natural market mechanisms and pose a significant obstacle to the growth of the industry, although the amount of support this theory receives is directly related to the perspective that a practitioner or researcher takes. As Christen (1997) and Campion (2002) strongly support these findings, while Vogel (1994), Woller, Dunford & Woodworth (1998) and Morduch (1999b) suggest that a careful balancing will be required in order to ensure that the potential leveraging benefits from enhanced prudential regulation and supervision will not be offset by the costs of inhibiting innovation and outreach by MFIs.

2.1.5 Information asymmetry

Information asymmetry problems occur when lenders cannot distinguish between inherently risky borrowers and safer borrowers.

Earlier studies by Hoff and Stiglitz (1990) on information asymmetries and enforcement problems, which are endemic in developing countries, found that subsidy interventions have been disappointing. Adding further insight into this study, Hardy, Holden and Prokopenko (2002) modeled asymmetric information, transaction fees and support for MFIs and looked at case studies from Chile, Ethiopia, Indonesia, Peru and Zambia. In contrast to earlier studies by Christen, Rhyne, Vogel and McKean (1995) and Khandker, Khalily and Khan (1995), Hardy, Holden and

Prokopenko (2002) found that there are good reasons to provide support for MFIs as they have informational advantages, can be more efficient than other financial institutions in bringing benefits to the poor, overcome high administrative costs and minimize risk in the start-up period.

2.2 Subsidy policies: bridging the gap to the poor

Some subsidy programs have made financial sustainability their chief goal, and others have centred on economic and social impacts. While there is much common ground, there are also critical differences. There appears to be ample room for a diversity of programs with competing methods and financial arrangements. However, while this may be the case, until the Microfinance movement has a model of providing assistance to the poor that both anti and pro-subsidy proponents adhere to, more energy will be diverted away from the core goal of providing effective assistance to the poor (Morduch, 2000; Paxton, 2003; Schreiner, 2003b).

An interesting slant on the argument is that where credit markets function imperfectly, interest rate subsidies may bring allocations closer to (second best) efficiency. If not, interest rate subsidies may be desirable on grounds of equity: if raising interest rates means losing clients or decreasing social impacts, subsidies may be justifiable, provided social benefits are commensurate and institutional efficiency can be maintained (Khandker, Khalily & Khan, 1995; Khandker, 1998; Morduch, 1999b).

2.2.1 Anti-subsidy policy – financially viable microfinance

Anti-subsidy groups argue that for a program to be successful, it must be able to stand-alone without subsidies in the long term. They assert that financial viability should be sufficient to show social impact and as such, propose that market forces should be allowed to dictate interest rates.[3] Successful poverty reduction requires a significant focus on scale, given the worldwide prevalence of poverty. But massive scale requires massive financial resources, far beyond the ability of donors to provide. Gonzales-Vega (1998) highlighted the importance of economic scarcity, in that even if donors had sufficient resources they are subject to fads, have their own agendas and are not a reliable long-term source of funds.

It is also widely maintained that the provision of subsidies tends to reduce the efficient operations of MFIs and essentially contradicts with the notion of market liberalization, globalization and growth.

2.2.2 Pro-subsidy policy – subsidised microfinance

Pro-subsidy groups stipulate that social benefits endowed on the recipient's well-being provide a more accurate reflection of success. They believe that commercializing microfinance to the extent envisaged by the anti-subsidy group is likely to undermine the very nature of what they are trying to do. Chao-Beroff (1997) surmised this point clearly in that the commercialization of microfinance and the need to satisfy the demands of outside investors is likely to result in profit motive replacing social mission. Rodney (1997) emphasized this point and argued that it is not only

[3] Anti-subsidy groups contend that raising interest rates to cover subsidies will not seriously impede depth of outreach.

whether we reach the numerical goal, but also how that will help determine the outcome. Further highlighting this point, Rodney (1997) emphasized this point and argued that the methodology adopted by MFIs has ensured the success of this form of ODA amidst the vast number of intervention failures in the recent past. A final concern expressed by Rogaly (1996) is the call for donors to withdraw support from programs that are not progressing towards financial sustainability, albeit without any concern for program impacts. Pro-subsidy groups see this as clear evidence that the drive to achieve financial success will become the overriding mandate. Unfortunately microfinance is clearly not yet profitable or sustainable in its current form.

Previous research on this form of financial intermediation and the stances taken by pro and anti-subsidy groups outlines the significant discords that exist between these constructs and also draws attention to a gap in the current literature in regard to the motive of MFIs and subsidy providers. There is considerable speculation and a shortage of direct evidence, with empirical research and impact studies a must if the truth is to be exposed, as both pro and anti-subsidy groups put forward quite bold statements albeit with little evidence to back up their positions. However, an issue of even more critical importance that was not clearly articulated within the literature was actually deciding, what is the truth that needs to be exposed? Little consideration has been given to the underlying objectives and motives of MFIs and subsidy providers. The existence of subsidies has for more reaching implications than the poor, and flow on effects have the potential to impact the move towards globalization and free trade under the auspices of the World Trade Organizations (WTO). Poverty is not a new phenomenon and neither are noble endeavours to alleviate this endemic problem, and yet the poor are still with us. Maybe the complexities of ODA and the poor necessitate a range of approaches within the pro and anti-subsidy policy range, as both methods are in essence serving the same goal - enabling the poor to more effectively enter into the world of capitalism, in one way or another.

3. Methodology

In the previous section a significant gap in the current literature was identified which calls for questioning the validity of the theoretical basis used to determine the impact of subsidies on microfinance.

3.1 Theoretical Models

As it turns out, the cost-effectiveness of microfinance in general is unknown. Past attempts to measure the impact of subsidies by Khandker, Khalily and Khan (1995), Hulme and Mosley (1996), Hashemi and Schuler (1997), Yaron, McDonald and Charitoneko (1998), Morduch (1999a) and others have been flawed. For example, some studies count cash grants as revenue, some forget to impute an opportunity cost to all resources, and all fail to discount cash flows.

However, the general problem with any of the currently used measures of outreach is that they are mean measures. As such, the currently used measures can be misleading since they fail to provide information about the scale of operations, income distribution of clients and also often use questionable proxies (such as loan size) for depth of outreach when no other data is available.

For example, typical benefit-cost analysis compares subsidy c with social benefits b. If $b>c$, then a project passes the benefit-cost test and is deemed a good social investment. Unfortunately, the test requires knowledge of worth to users w_{tsn}, cost to users c_{tsn} and the social value of net gains D_{tsn}. This knowledge is rarely available.

Given a discount factor δ and the assumption that w is additively separate across users, services and time, social benefits b is:

$$b = \sum^{T}\sum^{S}\sum^{N} \delta^{t}.D_{tsn} \, (w_{tsn} - c_{tsn})^{4} \quad \textbf{(1)}$$

These calculations provide an initial indication of impact, however they rest on a series of simplifications that either exclude difficult to measure social impacts or use irrelevant proxies. Questions also remain over how other measurable impacts such as household consumption and other micro level data are attained.

As an alternative Schreiner (2003b) uses cost-effectiveness analysis to compare subsidy with outputs, not benefits. In this case we let O_{tsn} be outputs of type s, for user n in year t. Cost-effectiveness replaces difficult-to-measure social benefits b with simple-to-measure outputs Ω:

$$\Omega = \sum^{T}\sum^{S}\sum^{N} \delta^{t}. \, o_{tsn} \quad \textbf{(2)}$$

[4] This model is adopted from Schreiner (2003b) to serve as an illustrative example highlighting the considerable variances in models used to measure the impact of subsidies and even more so the difficulties in attaining valid data to input into such models. To date there has still been no consensus on a method to effectively measure the impact of subsidies on microfinance and many conflicting opinions still exist.

However resolving these divergences of opinion requires making explicit social judgments and evaluating the sensitivity of impacts and subsidy demand to the rate of subsidy. But this is not as straightforward as one might think.

Debates about microfinance subsidization are often doomed to failure before they start as despite the lack of evidence as to the impact of various parameters on theoretical models proposed, experienced practitioners on both sides hold their ground exceptionally strongly. Studies by Hoff and Stiglitz (1998), Morduch (1999a) and Schreiner (2003b) have found that those who oppose subsidization tend to develop theoretical models which assume a relatively flat distribution of social weights, low sensitivity of credit demand to interest rates, positive impacts of interest rates on returns, low returns to investments by poorer households and negative externalities of subsidized credit on other lenders. On the other hand they found that those who support subsidies tend to put greater social weight on consumption by the poor, assume highly sensitive credit demand to interest rates, minimal impacts of interest rates on returns, strong returns to investments by poor households and positive spillovers to other lenders.

3.2 Assessment of underlying motives and objectives

The study seeks to provide insights and understanding into the impact of subsidies on microfinance based on a qualitative analytical framework which looks at the costs and benefits of subsidies from the perspective of underlying motive, subsidy permanence, institutional efficiency, MFI focus, self sufficiency and development objectives. The enquiry involves the use of inductive reasoning proceeding on the basis of observation (perceiving phenomena in a systematic manner) and analysis (critical examination in the pursuit of understanding). The problematic nature of the current debate, as outlined in the literature review, rests in the way different authors and practitioners have viewed the role of subsidies in microfinance, with no universally accepted methodology or models. In order to transcend this discord a retrospective approach is taken to the impact of subsidies, whereby they are analysed from an initial substantive view in regard to underlying motive.

The theory behind subsidies is straightforward. If there is a market failure, then industry assistance may have the scope to improve social well-being. Regardless of the externalities and informational and technological asymmetries, society needs to determine the impacts of subsidies. Market failure is needed for an intervention but it is not enough, because the intervention has costs and can disrupt a market. This is not to say that subsidies are a waste of resources or cannot mitigate market failure. But it is to say that subsidies might waste scarce funds or make markets worse. Society does not know the answers to these questions. It first needs to determine what are the priority objectives.

4. Analysis: costs and benefits of subsidies

This section undertakes a qualitative analysis involving a summative review of the costs and benefits of subsidies to microfinance. The analysis draws heavily on current literature to address issues of inherent market failure, underlying motives of the subsidy providers and the MFIs and impact of subsidy to microfinance programs.

Nearly all programs espouse financial sustainability as a key principle, yet at the same time, nearly all programs rely on subsidies of some form or another.[5] The anti-subsidy stance is not exclusive to microfinance and is the result of a number of serious concerns that are deemed detrimental to this form of ODA in the long term. First, donors are to some extent unreliable and this creates an air of uncertainty with regard to the future viability and destiny of the MFI. Second, scale of outreach is limited to donor budgets and access to leveraging capital is restricted for MFIs that are not self-sufficient. Third, there is an inherent risk of inefficiency. A final point of concern is that in the past subsidies have ended up in the wrong hands, quite often doing more harm than good.

4.1 Underlying motives of the subsidy provider

There are three types of investors that provide funds to the MFIs. The first provides subsidies and seeks only a social return in the form of lower infant mortality rates, access to clean water, education, essentially improved living and social conditions of some form or another. The second type seeks both a social benefit and a financial return in the form of interest income, dividends etc. These investors will accept a below market financial return in lieu of the social benefits attained. In contrast to the above a selfish group of investors seek purely a financial return from their investment. They will most likely be interested in the social mission, however this will be subordinated to the financial motives of the investor.

[5] For a more detailed analysis refer to studies by Khandker, Khalily and Khan (1995), Christen (1997), Schreiner (2003b), Khandker (1998), Conning (1999), Morduch (1999a) and Paxton (2003).

Accordingly, in response to the first issue of donor reliability, any performance measure must take into consideration the motives of the investor. Obviously, there will be MFIs that do not meet the requisite performance measures of purely social investors due to poor outreach and poor impact. Likewise, for the selfish investor there will be times when the financial return is not commensurate with expectations causing funds to be deviated to other investments. Hence, if the expected return - be that social, financial or a combination of the two - is not met, then funds in the form of subsidies and investments will be diverted to better performing institutions.

4.2 Permanence of subsidies

Subsidies have been a part of the microfinance landscape since its inception. Donors, despite being unreliable and fickle, sometimes are as rational as any other economic entity. The problem intrinsically lies with our expectations of this economic entity that does not have profit as its overriding motive and therefore the predicted behaviour does not conform to the economic measures that we are accustomed to applying. But this does not necessarily imply that donors are any less permanent than other investors. The issue rests with the attainment of expected outcomes based on underlying motive and objectives. As such, investors will remain with microfinance as long as they are getting what they want - whether that is a social benefit, financial return or a combination of the two. Like all institutions the important priority is to satisfy the demand of investors.

Issues of scale complicate the impact of subsidies further, as there can be no doubt that as financial performance increases the ability of the MFI to leverage capital at affordable rates will also increase.[6] The key point that needs to be highlighted is what impact this will have on depth of outreach to the poor. The answer to this question will depend on whose research one adheres to, as some studies have highlighted the trade-off between outreach and sustainability while other studies have questioned it.[7] This further alludes to the proposition that the anti-subsidy lobby's main concern is not with the subsidy per se, but the permanence of the subsidy, which will ultimately depend on the initial objectives of the subsidy provider and whether their performance criteria have been met.

4.3 Institutional inefficiency

Evidence of institutional inefficiency has been demonstrated in the past by many commercial banks attempting to break into this underserved market and this issue also poses as a serious concern to MFIs. Assertions by anti-subsidy groups that subsidised institutions are intrinsically inefficient and cannot achieve significant scale and outreach are an indictment on the not-for-profit industry. Subsidised institutions simply have at their core a mission that is not necessarily profit driven and this is often looked on by for-profit institutions as an inherent weakness. Numerous organisations have stood the test of time such as the Red Cross, United Way, Green Peace, Grameen Bank, CARE Australia, Freedom from Hunger and World Vision, just to name a few. In contradiction to the argument that subsidies necessarily imply inefficiency, there have been numerous institutions (in and outside of microfinance) that have a significant legacy of sustainability and impact, and at the same time just

[6] For a more detailed discussion of the impact of financial leverage on scale refer to studies by Christen (1997), Morduch (1999b) and Campion (2002).
[7] Refer to Section Two for a more detailed discussion.

as many for profit institutions that have failed through managerial or operational inefficiencies.

Institutional efficiency is only one way by which to measure the performance of an entity. Operative, technical, financial and resource efficiencies provide important indicators with regard to the assistance MFIs receive in terms of subsidy. A sweeping assertion by anti-subsidy groups that for-profit organisations are superior to not-for-profit organisations is more a reflection of the anti-subsidy lobby's bias than it is an objective assessment of the entity's performance. A key point being a failure to clarify the criteria by which we are to measure the performance of the entity in the first place. Other efficiency measures for MFIs would consider resource allocations, depth of outreach, social development, poverty alleviation and other constructs.

4.4 Focus on missions versus focus on profit

Pro-subsidy groups maintain that if the overriding emphasis is self-sufficiency then profit will become the mission rather than poverty alleviation, with MFIs eventually straying from their core vision to serve the poor. Rhyne (1998) suggests this will be managed by board members who will ensure that maximising returns does not overtake the priority objective of reaching the poor. However, with an overriding emphasis on becoming self-sufficient and attracting 'selfish' investors who demand a requisite return on their investment, well intentioned anti-subsidy groups are in fact jeopardising the core values of microfinance and all it stands for. By matter of law a board's fiduciary duty is to represent the interests of its owners not those of the clients. Thus when there are conflicting priorities (as will occur at times) between the poor and investors, the board must give greater weight to the owners.

Interestingly, a simple measure to alleviate this problem is to have the interests of the poor represented by investors who have alternative motives and are willing to trade off selfish returns for social returns. In other words, by having MFIs subsidised, to some extent we are ensuring that the MFIs focus does not digress from the original vision.

4.5 Self-sufficiency and social development

Anti-subsidy groups clearly articulate that the key measure of MFI performance is financial self-sufficiency. Many writers[8] have espoused this, however ostensibly they fail to mention improved social development in the performance criteria of MFIs, instead assuming that financial self-sufficiency and improved social welfare are the same. Pro-subsidy groups, in contrast, contend that adopting financial performance as a measurement basis is likely to detract from social development objectives and is more likely to focus the MFI on issues other than poverty alleviation. Hence, any consideration as to the impact of subsidies will, by reason of logic, be entrenched within this framework of measurement, dependant on whether our bias is pro or anti-subsidy. This continuum of competing objectives places the determination of motive and underlying objective high on the agenda of all concerned in ensuring MFIs deliver on their much anticipated promise.

[8] For a more detailed discussion of financial self-sufficiency refer to studies by Christen (1997), Ledgerwood (1999), Morduch (1999a) and Paxton (2003).

4.6 Difficulties in measuring aid effectiveness

If a developing country receives foreign aid in the form of subsidies, how can it best use the foreign aid to increase its people's welfare? In assessing the effectiveness of aid, three major difficulties arise. The first question that must be put forward is that the objectives of donors may not be purely economic. The second difficulty is that aid is typically only a small part of a country's investment. Third, an assumption that aid programs are transferable across countries and regions, where macroeconomic considerations may vary considerably, is fraught with danger.

Aid cannot accomplish goals by themself; they can only work to assist governments and societies in pursuing their objectives. Even the best designed foreign assistance cannot succeed if it is being provided to governments that are uninterested or incapable of, for instance, delivering public services to the poor. Research by Stiglitz (1997) has also shown that aid needs to be combined with fiscal prudence, monetary restraint, and an outward orientation. Without these, it is unlikely that aid can make contributions to growth.

5. Conclusion and policy recommendations

5.1 Review of findings

Evidence suggests that practitioners and researchers have developed soundly entrenched positions with little basis, in an apparent effort to validate policy choice. Subsidy impact can be either positive or negative and is dependant on the qualitative characteristics of subsidy policy allegiance, model or methodology used for measurement and priority or weighting given to competing objectives.

The findings indicate that subsidies are an intrinsic part of MFIs and without them it is likely that a significant number of MFIs would be unable to meet the requisite conditions of financial sustainability to ensure survival in the long term. However, as the analysis reveals, the presence of subsidies creates issues of moral hazard and potentially reduces the likelihood that the MFI will attain the same breadth of scale as its unsubsidised counterpart.

The impact of subsidies may be more strongly linked to other aspects of MFI and subsidy donor operations, rather than the strongly suggested financial implications and correspondent measures suggested. There is little if any consensus on an effective method to measure the impact of subsidies with considerable doubt existing that a financial variable is the most appropriate method to determine the impact of subsidies.

5.2 Policy implications

5.2.1 Prioritising objectives

Unsubsidised MFIs appear to address significant market failures by providing financial services to the marginally poor and not so poor, however the needs of the poor are not their priority focus. Likewise subsidised MFIs appear to achieve significant depth of outreach and social development impact however financial sustainability is not their priority focus.

Evidence to date demonstrates conflicting results and even more so conflicting priorities, philosophies, motives and objectives. Are subsidies beneficial to microfinance? The answer to this question depends on whom you ask. Are the pro or anti-subsidy groups fundamentally correct? Even more interestingly the answer to this question depends by what criteria we measure. Are financial indicators, social development benefits or some other performance criteria more important? The answer to this question remains unknown and will depend on the underlying objective.

This study has attempted to shed light on a significant failure of the microfinance movement to date, in that we still have not clearly articulated by what qualitative measure we are to determine the success of MFIs. Any attempt at measurement before this has been addressed is futile. Identifying what is the priority issue, even if it is a combination of factors requires a willingness on behalf of both groups to concede that theirs may not be the most important approach. To date this has proved difficult to do however it is a necessity if microfinance is to have any chance in transforming the lives of the poor.

5.2.2 MFIs

A core requirement of all MFIs is to enhance the efficiency of operations by developing firm budget constraints with a focus on the institution's bottom line. This is best achieved by monitoring and cutting costs either by developing systems that enhance the output and performance of staff, reducing administration overheads generally or putting into place enforcement systems that provide better repayment rates.

Commitment to underlying philosophies, social development objectives and a target base that is focused on the poor should form the foundational mission of MFIs established with a priority objective of serving the poor, with a true test of character being whether they are willing to sacrifice potential profits to remain focused on the poor to which they aim to serve. In contrast to this point, where the MFI is established with a mission to achieve financial sustainability then this vision should be clearly articulated as it will potentially impact on the target base to which they serve, as conflicting priorities will arrive between profits and the poor from time to time, which may impact on the allocation of subsidies by donors.

5.2.3 Subsidy donors

The primary recommendation for subsidy donors is to provide subsidies to MFIs that align with their own internal priority objectives and also focus on remaining committed to the MFI in the long-term. This will enhance the stability of the MFI and also more effectively enable the long-term vision of microfinance to be achieved aiding in MFI sustainability and also depth and scale of outreach to the poor.

5.3 Limitations and future research possibilities

Conflicting views in regard to whether subsidies are required in microfinance predominate any discussion of policy recommendations for MFIs. Many questions in relation to subsidies need to be answered. Do subsidies need to be provided to MFIs to ensure they reach the poor? Should subsidies be universally accepted or should they be used for targeting special need niches? Alternatively, should they just be used for start-up purposes? These questions need to be framed into any analysis that attempts to determine the impact of subsidies whether it is for microfinance or any other market failure induced activity.

5.4 Concluding remarks

Unsubsidized microfinance might be preferable, however it is not feasible…for the moment. Realities of practical life quite often do not match with best practice theoretical models. Although we certainly wish they would. It is within the heart of man to be generous and also within the heart of man to be greedy. As much as one entity gives subsidies another takes them away in the form of corruption or pure greed. This is the nature of the world we live in. Likewise to be totally anti-subsidy is unwise in that it ignores the practical realities that market failures do exist, else wise we would live in a world without poverty and hunger.

Subsidy reliant microfinance has achieved much in it current form. Sustainable profitability, social development, financial efficiency, scale and depth of outreach are important considerations. Determining the priority issue is of paramount importance if microfinance is to move into the next phase. Consideration of the underlying motives, intentions and objectives of MFI's and subsidy providers is required in order to ensure the needs of the poor are kept as priority.

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