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Microfinance: *Fortune at or also for the bottom of the pyramid?*

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Introduction

Over the last 50 years, several trillion dollars have been spent on foreign aid and developing programs aimed at alleviating poverty, most typically in the form of top-down approaches mediated through government channels (Easterly, 2006). Although extreme poverty has been declining across some regions in recent decades, high rates still persist in others (Westover, 2008). In an attempt to challenge the development community, the United Nations established the Millennium Development Goals in the year 2000 (MDGs) (which include the poor as participants in the design of a more inclusive process of economic development, as well as the role of international trade and private-sector companies) (London, 2005; Barr, 2005). The Doha session of the World Trade Organization (WTO) negotiations, for example, explicitly addressed the role of trade in development.[1] At the centre of attention is the contention that poverty diminishes the possibilities of financial development, as Stiglitz (1994) points out: 'market failure' is a cause of poverty.

In recent years, globalization has been posited at the heart of this discussion, as many authors have recognized that the benefits of globalization have been disproportionate. There have been clear winners and losers and an increase in the gap between the rich and poor (Soros, 2002), with globalization failing to positively influence many of the world's poor altogether (Stiglitz, 2002). In adopting this perspective, great pressure is being exerted on the creation of a more inclusive system of capitalism that better responds to the needs of the poor (Hart & London, 2005). Indeed, Yunus (1997) points out that the fight against poverty, to date the domain of public agencies, should be replaced by private organizations and bottom-up solutions. He argues that only a

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[1] http://www.wto.org/english/tratop_e/dda_e/dda_e.htm

commercial approach can provide the scale to reach those suffering from poverty as well as creating enduring, sustainable and efficient solutions (Emmons, 2007).

The intersection of these two perspectives (public and private sector), namely the acknowledgement that top-down poverty alleviation approaches have failed to provide results, and the increasing appreciation of a larger role for market-based approaches (London, 2007), offers the potential to show that there is no contradiction between social impact and profitability (Emmons, 2007). It is the aim of this essay to evaluate whether business-oriented motivations of growth and profit can be aligned with poverty alleviation objectives.

Prahalad (2004) proposes the idea that commercial businesses can be part of the solution to eliminating poverty as part of a mutual value creation. In his opinion, those living at the bottom of the economic pyramid (BOP) should be seen as 'resilient entrepreneurs and value-conscious consumers' (Prahalad, 2004), representing significant purchasing power rather than mere charity cases (The Economist, 2009), and thus increasing profits for international business whilst bringing prosperity to the poor (Chatterjee, 2009; Karnani, 2007a). In spite of their small per capita income, the sheer number of BOP individuals make up a potential market of trillions of dollars in disposable income (Davidson, 2009). Entering developing markets is within private sector companies' self-interest, enabling them to exploit current market inefficiencies at the BOP (Prahalad & Hammond, 2002).

Proponents of the BOP approach argue that in order to break the vicious cycle of poverty, buyer power should be created through the provision of credit access, which can potentially increase earnings (Prahalad & Hart, 1999). However, a large proportion of the world's poor lack access to financial services, with estimations varying from 40-80% (Khandker, 2005; Beck *et al*., 2008). The rural poor in particular are largely neglected by formal banking institutions and have no access to institutional credit (Haque *et al*., 2008). Informal sources of various kinds, such as moneylenders, are available, but they are exploitative and inadequate, charging up to 20% interest per day (Prahalad & Hart, 2002).

Muhammed Yunus identified the paradox that those at the BOP lack access to financial services, which are often necessary to enable income generation. Yunus, who

was awarded the Nobel Peace Prize in 2006, developed the idea of microfinance, leading to the foundation of the Grameen Bank in Bangladesh in 1976 (Lanzi, 2008). Microfinance offers financial services to low-income individuals excluded from the traditional financial system and considered 'unbankable' due to their lack of collateral, steady employment and a verifiable credit history (Westover, 2008).

One of its distinguishing aspects is the 'joint liability' concept, whereby groups of individuals, usually women, group together to apply for loans (Westover, 2008). Originally, microfinance was designed to lift individuals, families and communities out of poverty by providing small amounts of start-up capital for entrepreneurial projects, which help individuals generate income, build wealth and exit poverty (Sengupta & Aubuchon, 2008; Bateman, 2011). Other objectives include the promotion of innovations, consumption-smoothing, female empowerment and financial sector development (Dunford, 2006). Today, the idea of microfinance expands past microcredits into savings, insurance and payment services (Duvendack *et al.*, 2011). In 2008, there existed more than 973 microfinance institutions in more than 105 different countries (Sengupta & Aubuchon, 2008). Despite the emergence of microfinance institutions, many communities still lack access to bank services with market penetration being as low as 19% worldwide (Akula, 2008).

Initially motivated largely by development paradigms, a global industry increasingly informed by a commercial paradigm has evolved (Brau & Woller, 2004). Examples of for-profit institutions (such as Banco Sol of Bolivia,

Compartamos of Mexico, and ICICI Bank of India) have shown that it is financially feasible to target BOP consumers (Littlefield *et al.*, 2003), emphasizing Prahalad's (2004) contention that by targeting BOP consumers, it is indeed possible to 'do well by doing good' (Brau & Woller, 2004). Their emphasis is on profit maximization, stating poverty alleviation as a secondary goal (Sengupta & Aubuchon, 2008). Several initial public offerings (IPOs) of microfinance institutions in India and Mexico (Khavul, 2010) as well as the release of the Standard & Poor's report on the rating methodology of microfinance institutions (Sengupta & Aubuchon, 2008) illustrate the emergence of foreign investment,

which identify microfinance institutions as profitable investment opportunities.

Positive Effects of Microfinance

As an alternative to the abusive practices of village moneylenders (Sengupta & Aubuchon, 2008), microfinance can be an effective way to provide financial services to BOP customers (Westover, 2008), being both reliable (repayment rates of 98% and higher; see Cull *et al*., 2009) and to a large extent profitable (54% of NGOs and 73% of commercial banks have reported profits; see Khavul, 2010). Moreover, the fact that microfinance institutions are expanding both in coverage and range of services offered can be seen as prima facie evidence of their success (Islam, 2009), bringing reliability to the financial lives of poor households (Rosenberg, 2010), offering a means to reduce risk exposure (Islam, 2009) and vulnerability (Littlefield *et al*., 2003) as well as smoothing poor consumption over periods of cyclical or unexpected crisis (Karnani, 2007b).

Economic theory suggests that financial development can contribute to economic growth, which in turn can alleviate poverty (Barr, 2005). Along the lines of Schumpeter (2003), who argued that banks are key to economic development because they channel society's savings to innovating entrepreneurs, financial development can improve a society's allocation of resources (Barr, 2005). Microfinance, a more formal and institutionalised business relationship than moneylenders, represents a move towards a larger scale of trade and business organization, which contributes to financial development at the BOP (Boudreaux & Cowen, 2008).

As argued above, it is the contention of the BOP approach that both access to credit and an increase of earning potential will increase buying power (Prahalad & Hart, 1999), which in turn will enable poverty alleviation. Being able to borrow a small amount of money to take advantage of a business opportunity can be a first step in breaking the cycle of poverty (Yunus, 1997). Disposable income levels of individuals and families can be increased whilst helping in the development and growth of the local economy (Westover, 2008).

Microfinance can help reduce credit constraints that potential entrepreneurs in poor communities often face and that preclude enterprise development (Stiglitz, 1998; Bateman, 2011), spurring entrepreneurship and empowering borrowers to help themselves (Khavul, 2010). Banerjee *et al*., (2009) found that in areas where microfinance became available, 32% more new businesses were created. Moreover, up to 5% of Grameen borrowers rise above the poverty level in a typical year (Khandker, 1998; Roodman & Morduch, 2009), although this figure has been corrected to 2% in follow-up studies (Emmons, 2007). For example, Amul, a company founded in India, is able to engage the poor in decentralized milk production through the provision of microloans which aid in the purchase of cattle, generating income for thousands (Jaiswal, 2008). As Tom Friedman points out (Lehr, 2008): 'People grow out of poverty when they create small businesses that employ their neighbours. Nothing else lasts.'

As the private sector recognizes the increase in buyer power, those at the BOP can more easily benefit from globalized markets. Through lower prices (due to lower market inefficiencies) as well as access to welfare-oriented goods (such as fertilizers, pesticides, cattle feed and other agricultural inputs), an increase in consumption can improve healthcare, nutrition and education (Jaiswal, 2008). Indeed, studies have shown that children of microfinance clients are more likely to go to school, stay in school longer (Littlefield et al, 2003), and have better nutrition and health than comparable non-client households (Pitt & Khandker, 1998; Brau & Woller, 2004). Moreover, as most microfinance loans are targeted towards women, gender-based barriers in developing countries may be broken, although research findings on this are mixed (Goetz & Gupta, 1996; Sengupta & Aubuchon, 2008).

Empirical evidence of the effects of microfinance yields inconclusive results (Rosenberg, 2010; Cull et al, 2009). Randomized control trials found little evidence of improvements in household incomes (Khandker, 2005: reduction of moderate/extreme poverty 17%/13%). Nevertheless, the mere fact that customers are borrowing from year to year and maintain high loan repayment rates is a sign that they value the microfinance

services offered. In the following, possible drawbacks to microfinance will be explored.

Negative Effects of Microfinance

Most microfinance institutions are more successful at reaching the wealthier poor (those living just above and below the poverty line), and fail to reach the poorest of the poor (Navajas *et al*., 2000; Simanis & Hart, 2006). Those with more income are more willing to take the risks of investing in new technologies, which may in turn increase income. Poor borrowers, on the other hand, often misuse borrowed money (Haque *et al*., 2008), taking out microloans to cover basic consumption needs rather than fuelling enterprises (Dichter, 2006).

Others have argued that credit constraints affecting microenterprises are not the core problem. Rather, the overall lack of institutions providing access to credit for small and medium enterprises (Bateman, 2011) prevent microenterprises to grow into 'Baumolian' entrepreneurship (Baumol, 1990).

Another problem is based on the businesses microfinance clients intend to fund. In Schumpeter's (2003) definition, entrepreneurs are people of vision and creativity, who convert new ideas into successful business models or innovations through engagement in 'creative destruction' (Karnani, 2007a). Although some microcredit clients have created visionary businesses, the vast majority are caught in subsistence activities, do not have specialized skills, vision, creativity and have to compete with all the other self-employed in entry-level trades. (Karnani, 2007a) Even in developed countries with high levels of education and access to financial services, about 90% of the labour force are employees, not entrepreneurs (Karnani, 2007b). The failure rate of start-up businesses in the US has been estimated to reach 85% in certain sectors, despite the available resources in relation to the rural poor (Simanis & Hart, 2006). Most microcredit clients are not entrepreneurs by choice and would gladly take a job at reasonable wages if it were available (Karnani, 2009). Thus, there is little evidence to support Prahalad's assertion that those at the BOP are 'resilient and creative entrepreneurs'.

For-profit providers of microfinance have been accused of overcharging their poor customers. At the time of its IPO, Compartmos's customers were paying interest rates of 94% per year (The Economist, 2009), whilst giving bonuses of tens of millions of

dollars to key managers (Waterfield, 2008). However, the bank argues that these high profits have enabled them to serve hundreds of thousands of customers who otherwise would have had even worse financial options (The Economist, 2009). Nonetheless, it is debatable whether interest rates could not have been reduced since they were so extraordinarily profitable (Davidson, 2009). In fact, Yunus (1997) argues that microfinance institutions should be 'social businesses' driven by social missions, maximizing consumer welfare rather than profit.

On a more conceptual level, it is arguable whether providing microloans changes the affordability of a product (Karnani, 2007b). The poor are vulnerable by virtue of their lack of education and information as well as economic, cultural and social deprivations. Moreover, just like consumers in the developed world, the choices made by those at the BOP may 'not always be the best ones' (The Economist, 2007) and can actually counteract their own self-interest. By spending money on luxury products (such as alcohol, tobacco and television) rather than higher priority needs (such as nutrition and education), welfare could actually be reduced (Banerjee & Duflo, 2006). The poor may not be the 'value-conscious consumers' Prahalad sets them out to be (Karnani, 2007b).

Future Directions

It has been argued that the best way to eradicate poverty is to create opportunities for steady employment and increase worker productivity, thus providing reasonable wages. This is illustrated in the following example, proposed by Karnani (2007a). If a microfinance institution lends $200 each to 500 women to buy sewing machines and set up sewing microenterprises, these women must each make enough money to pay off the high interest loans whilst competing with each other in the same market niche. If a lending institution lends $100,000 to one skilled entrepreneur and helps him/her set up a sewing manufacturing business that employs 500 people, this enterprise can exploit economies of scale and use modern manufacturing processes and organizational techniques (Karnani, 2007a). Through increasing employment levels as well as labour productivity, countries like China, Vietnam and South Korea have significantly reduced poverty in recent years, with very low microfinance activity (Karnani, 2007b).

The BOP concept ignores many fundamental elements of poverty alleviation by

deemphasizing the role of the government (Jaiswal, 2008; Chatterjee, 2009). For example, by encouraging the poor to accept that 'access to running water is not a realistic option', Prahalad (2004) assumes that people living at the BOP are passive and voiceless individuals who accept the harsh conditions of life without protest and resistance (Chatterjee, 2009). Confusing basic needs like water with consumer items by asking 'can we wash clothes without water?' or 'can we refresh ourselves without a shower?' (Prahalad, 2004) ignores issues related to unequal access to water, a basic amenity of life denied to billions. No amount of consumer goods, such as mobile phones or televisions, can improve the quality of life at the BOP if people lack basic amenities (Chatterjee, 2009). The BOP proposition views social, cultural and political benefits as by-products of economic gain; however, these are themselves desirable objectives (Karnani, 2007a). Thus, a market-based approach to poverty alleviation must include a government that provides services such as public safety, basic education, public health and financial development, including regulation and supervision (Barr, 2005). For example, an ineffective government has accompanied the boom in India's private sector, with the poor having little or no access to public services whilst being unable to pay the high prices for private services (Jaiswal, 2008).

Conclusion

Even when relying on 35 years of evidence, proof that microfinance reduces poverty is extraordinarily scarce (Roodman & Morduch, 2009). It has become clear that microfinance alone is no panacea for poverty alleviation, as Bangladesh and Bolivia, countries that have experienced a significant expansion of microfinance, are still desperately poor (Islam, 2009; Boudreaux & Cowen, 2008). Nonetheless, access to financial services forms a fundamental basis on which many other essential interventions depend (Littlefield *et al.*, 2003; Sengupta & Aubuchon, 2008) and can play an important role in the financial development of developing countries and the achievement of the MDGs (Barr, 2005; Dunford, 2006). Moreover, microfinance differs from traditional poverty solutions due to its potential to be self-sustaining (Rosenberg, 2010). However, poverty is not just a matter of low income. As Sen (2000) points out, development efforts must be seen as a 'process of expanding the real freedoms that people enjoy', and thus

poverty alleviation must include multiple aspects of well-being. It is imperative to go beyond increasing the income of the poor and focus on improving capabilities and freedoms along social, cultural and political dimensions (London, 2007).

Through the BOP approach, private companies certainly help to alleviate poverty, by focusing on the poor as both consumers of their products through the provision of globalized markets and viewing them as entrepreneurial producers who are aided by the access of financial services. However, as outlined above, Prahalad's (2004) analysis is not without shortcomings. Arguably, an expansion of his argument towards urging firms to upgrade skills and productivity of the poor to help create more employment opportunities (Karnani, 2007b) may indicate a more substantial option for private-sector organizations. Moreover, as Soros (2002) and Stiglitz (2002) have pointed out, globalisation has had clear winners and losers. Microfinance, a concept initially developed with the objective to challenge this inequality, has not brought about the desired change. Although charging less than informal moneylenders, for-profit microfinance institutions that give out loans with interest rates of up to 94% per year are the only definite winners. In order to bring fortune to the bottom of the pyramid, more innovative developmental solutions, which should include microfinance as well as other aspects of well-being (Sen, 2000), need to be developed.

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