Problems with micro-finance*

Imperium Anglorum†

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The World Assembly's current legislation on micro-finance, passed in the context of GA 94 "Microcredit and Microgrants" (2010) is at odds with the increasingly robust empirical literature on the topic.

I am, of course, fully aware that literature on the topic has changed since 2010, not only in that the literature now exists, but also in that the public can find it. With this, I mean not to disparage the goals of the target or the resolution's author, but rather, to shed light on whether this policy actually has positive outcomes.

Starting from the top, the resolution has the World Assembly—

> BELIEVING that through focused initiatives and international cooperation, poverty and suffering can be ended,
>
> NOTICING that micro-finance allows the impoverished access to much-needed financial assistance,
>
> RECOGNIZING that those living in poverty may be targeted by unfair, deceptive, and fraudulent lending practices, [and]
>
> SEEKING to protect those persons from predatory lending through specialized, safe credit opportunities . . .

Other than the *Recognising* clause, these claims are all false or true in unhelpful ways. Recent randomised controlled trials (and meta-analysis of such trials) find "little evidence of transformative effects" and no "clear evidence, or even much in the way of suggestive evidence, of reductions in poverty or substantial improvements in living standards [or] social indicators" for microloans.[1] There were some benefits found: less personal consumption and more durable goods purchases, but also no major changes to health or education expenditures.[2] Another review mentions that both in the long run and the short run, there is "no evidence of large sustained consumption or income gains as a result of access to microcredit".[3]

These results are reinforced in a randomised controlled trial conducted in Ethiopia, where Tarozzi et al find that although borrowing substantially increased, the null hypothesis that treatment has no effect "cannot be rejected for a large majority of outcomes".[4] A randomised evaluation of group-lending in Hyderabad, India also found no significant changes in consumption, health, education, or women's empowerment: "two years later. . . [although] households in treatment area had borrowed for longer and in larger amounts, very few significant differences persist".[5] These small or non-existent impacts are borne out also by later meta-analysis of various randomly controlled trials.[6] All of this is reasonably consistent with macroeconomic models' microfoundations on consumption heterogeneity and

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1 AV Banerjee et al, "Six Randomized Evaluations of Microcredit: Introduction and Further Steps" (2015) 7 American Econ J: Applied Econ 1, 13.

2 Ibid.

3 AV Banerjee, "Microcredit Under the Microscope" (2013) 5 Annual Rev Econ 487, 508.

4 Alessandro Tarozzi et al, "The Impacts of Microcredit" (2015) 7 American Econ J: Applied Econ 54.

5 Banerjee et al, "The miracle of microfinance?" (2015) 7 American Econ J: Applied Econ 22.

6 Rachael Meager, "Understanding the Average Impact of Microcredit Expansions: A Bayesian Hierarchical Analysis of Seven Randomized Experiments" (2019) 11 American Econ J: Applied Econ 57.

lifetime income.[7]

The question of why microcredit is so unable to improve outcomes is unclear. Developing world borrowers might not be credit constrained. A randomised trial of capital drops in Tanzania produced no effect on investment and insignificant effects on profits or revenue.[8] And while some evidence exists that the poor are credit constrained, those constraints are on consumption, not on business expansion or production.[9] It may also be possible that these small impacts are caused by consumption being moved forward – ie a large purchase today followed by austerity to repay a loan later – or business expansion *to repay the loan* but not as a prolonged entrepreneurial activity, [10] implying that borrowers did not find their investments worthwhile. Further research on this topic needs doing, and sadly, it may take another decade to reach consensus.

As to the much vaunted goal of female household empowerment that microcredit was to advance,[11] Banerjee et al find no effects in four of six studies, with "a small but [statistically] significant increase in female decision power" in Mexico. And while some also positive impacts on subjective well-being were also found in Mexico, they are not seen in the other areas. In fact, the long term effects of prioritising female credit constraints may actually forgo substantial returns in patriarchal societies, as in such places, only men have the social connections or education needed to set up successful business and access market opportunities.[12] Reviews of this literature argue that the most impactful microcredit programmes for household consumption writ large target all persons.[13]

Micro-finance advocates also have argued[14] that credit extension could permit people to pay for child education,[15] but there is no positive impact on education in any of the six studies, with one study in Bosnia showing a decline in school attendance among older teenagers.[16]

That said, there also seems to be no evidence for the worst harmful effects predicted by micro-finance's detractors: eg a debt spiral among individual borrowers.[17] Karlan and Valdivia noted "large positive effects on [female entrepreneur] business profits", when *micro-finance and entrepreneurship training are combined*,[18] but improvements do not seem to follow through to the general population or to their households. Later studies by the same team also seemed paradoxically to show entrepreneurship training leading to *disinvestment*, possibly as a result of such training helping people know when to close an unprofitable firm.[19]

Impacts on the price of credit, vital in making it cheaper for people to smooth over consumption shocks,[20] also seem to be minimal. Moneylenders in many developing countries do charge astronomical rates.[21] And while micro-finance institutions do reduce rates from such absurdities, they also have plainly usurious interest rates: in Mexico, yearly rates of 100 per cent are common, and in South Africa, standard rates are at 11 per cent a month (350 per cent a year).[22] At such high rates, it is very doubtful that micro-finance induces substantial

7 See eg Edmund Crawley and Andreas Kuchler, "Consumption Heterogeneity: Micro Drivers and Macro Implications" (2020) Finance and Economics Discussion Series 2020-005.

8 Ibid 510.

9 Ibid.

10 Ibid.

11 Eg Michael P Todaro and Stephen C Smith, *Economic Devleopment* (2015) 796.

12 See de Mel et al, "Returns to capital in microenterprises" (2008) 123 Quarterly J Econ 1329 (finding that a capital drop of between 250–500 dollars given to women had not effect on profits, while one given to men improved business profits significantly).

13 *Banerjee* (n 3) 513.

14 Ibid 795.

15 Contra models suggesting that micro-loans increase opportunity costs to education, diverting investment away from human capital. Patrick M Emerson and Bruce McGough, "Microloans, education and growth" (2018) 22 Rev Development Econ 250.

16 *Banjeree et al* (n 1) 13.

17 Eg Jason Hickel, "The micro-finance delusion: who really wins?" *The Guardian* (10 Jun 2015).

18 Dean Karlan and Martin Valdivia, "Teaching entrepreneurship" (2011) 93 Rev Econ and Statistics 510.

19 David Karlan et al, *Hoping to win, expected to lose*(2012) NBER Working Paper 18325.

20 Eg if a person loses their job, they would have to borrow to pay for expenses until finding a new one. They would borrow less if rates are high.

21 *Banerjee* (n 3) 488 (describing rates as high as 5 per cent *per day*, implying over 54 million per cent a year).

22 Ibid.

consumption smoothing.

Returning to the World Assembly resolution at hand: the small positive (or less generously, almost non-existent,) impacts of micro-lending would be themselves of little impact for the World Assembly. Surely, if no impact were had, the industry would view itself as superfluous and self-contain. But this does not happen. Developing nation poverty alleviation programmes have a strong incentives to disburse funds to justify their own existence, even when the constraints on which such funds were supposedly conditioned were broken.[23] Nor would micro-lenders, necessarily turning profits from their high interest rates, self-terminate. The impact of a direct World Assembly subsidy created by the clause below the World Microcredit Foundation (WMF) to does two things:

> [Reimburse] lenders the balance of the principle [*recte* principal] investment in cases of defaulted loans and borrower insolvency

If the WMF is appropriated by the WA General Fund, large sums of member nation money are tied to an ineffective programme. If it is not, the entire program is ineffective, regardless of micro-finance efficacy, by depriving the WMF of funds necessary to support a success in the first place.

The ability of the resolution to handle risk by its use of "solidarity lending", commonly referred to in the literature as "group lending", is also doubtful. The resolution would have us believe that solidarity lending would reduce risk and improve success:

> DEFINES solidarity lending as practice of lending microcredit collectively to a group of persons, to decrease risk for lenders by increasing the probability of debt repayment...
>
> ENCOURAGES WMF lenders to practice solidarity lending, believing it to be a building block of successful microcredit lending;

But the empirical evidence goes the other way, showing that different kinds of liability have no impact on default rates upon random conversion.[24] It is possible that default rates might actually increase under group liability if the group as a whole decides to default, raising possible losses substantially.

Other small interventions at the personal finance level seem also not to produce any major or significant benefits: access to individual savings accounts has little impact on outcomes.[25] There is some possibility that village savings and loan associations improve outcomes, but research on this topic is new and contradictory.[26]

Concluding, I would support of repeal of GA 94 "Microcredit and Microgrants" (2010). The positive impact of such a resolution is minor to the point of non-existence. Support of the existing micro-finance programmes costs the World Assembly money – be it direct subsidy or personnel costs – while saddling the poorest of member nation citizens with debts that offer no tangible benefits. While financial inclusion is vital to household financial security and consumer confidence,[27] micro-loans specifically have little impact on outcomes in developing countries. Repeal without replacement ought to be pursued.

[23] Cf Dambisa Moyo, *Dead Aid* (2009) 54–6 (for a readable synopsis of this in the case of bilateral and multilateral aid organisations).

[24] Xavier Giné and David Karlan, "Group versus individual liability: Short and long term evidence from Philippine microcredit lending groups" (2014) 107 J Development Econ 65 (finding "no increase in short-run or long-run default" after converting group liability to individual liability).

[25] Ibid.

[26] Pascaline Dupas et al, "Banking the Unbanked? Evidence from Three Countries" (2018) 10 American Econ J: Applied Econ 257 (finding no effect); Janina I Steinert et al, "Do saving promotion interventions increase household savings, consumption, and investments in Sub-Saharan Africa? A systematic review and meta-analysis" (2018) 104 World Development 238 (showing improved incomes).

[27] Eg Federal Deposit Insurance Corporation, *FDIC National Survey of Unbanked and Underbanked Households* (2017) 15.