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Microfinance, Redistribution and Poverty

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OUTLINE

This paper examines the role of microfinance in poverty alleviation. The widely held view is that microfinance is an important tool for poverty alleviation in the developing countries. This view is held despite the fact that there is lack of conclusive evidence. The case for microfinance as an effective tool for poverty alleviation is primarily backed by anecdotes. Arguably, impact assessment is difficult due to methodological limitations. This paper seeks to examine this issue with the help of a theoretical framework which yields some important insights into the mechanism of microfinance.

This paper focuses on these two effects emanating from microfinance : (i) growth effect, and (ii) redistribution effect. We begin by considering the allocation of microfinance on the basis of its purpose. Five purposes are listed : (i) investment, (ii) consumption smoothening; (iii) health emergencies; (iv) educational expenses; and (v) social ceremonies and festivals. We depart from the dominant view point that microfinance is exclusively livelihood finance which remains entrenched despite lack of empirical support. Our categorization is based on the evidence presented in a number of studies on microfinance in India.

The growth effect is analyzed on the basis of present value of the future income stream. It is equal to the net present value (NPV) of an investment which is determined by discounting its future income stream to the present at the rate of interest charged by the MFI and then subtracting the initial borrowing. The NPV may be positive or negative. In case of investment financing, it is unambiguously positive and in case of social ceremonies, it is unambiguously negative. It is likely to be negative in case of educational financing since the rates of interest charged by the microfinance institutions (MFIs) are much higher than the estimates of rates of return to education obtained by a number of studies across countries.

Expenses on health care are quite necessary for survival but they are to be paid by the future earnings. The burden depends on the proportion of out of pocket expenses. In India out of pocket expenses on health care are around 80 per cent for an average household. In case of the poor households it is likely to be still higher since a number of studies have found that public expenditures on health care benefit higher and middle classes more than the poorer classes in the developing countries. The growth effect of health care financing by the MFIs is therefore likely to be negative and quite strong.

The growth effect of consumption smoothening is likely to be positive because it improves the food intake of the poor borrowers. A number of studies have emphasized a strong correlation between food intake and work effort.

The overall growth effect of microfinance is likely to be negative because borrowing from the MFIs for the purposes which have negative growth effect are much larger than the other borrowings. The proponents of the view that microfinance is an important tool of poverty alleviation emphasize only the positive effect associated with the livelihood finance argument. Their optimism rests on the underlying presumption that there is vast potential for micro-entrepreneurs which remains untapped due to lack of access to finance. This argument, however, does not hold in the context of Indian experience. Since independence, government has provided generous support to village and cottage industries. But due to the demand constraint, the impact has been quite limited.

However, negative growth effect cannot be construed as an argument against microfinance. The negative effect is not due to microfinance *per se.* The underlying cause is low level of public expenditures on health care and education. The public expenditures on health care and education had experienced immense increase in the developed countries in their initial stages of development. These expenditures are, however, declining in terms of their share in a national income in case of the Indian economy.

The redistributive effect is negative because of the interest burden on the borrowers which has to be borne by the clients of the MFIs. The microfinance has replaced the moneylender who used to charge much higher rates of interest. Thus microfinance has, to some extent, weakened the negative redistributive effect. However, in case of loans which owe their origin to the improvement in access to credit associated with the emergence of the microfinance, the additional burden of interest is evident.

A caveat is necessary. Even with a negative overall impact, the case for microfinance is not weakened. Negative impact is due to the problem of indebtedness of the poor. In the absence of microfinance, indebtedness would be a bigger problem for the poor. Microfinance is good for the poor but it is not good enough.

The paper is organized as follows. Section II presents the formulation of the model. The theoretical framework provides important insights into the functioning of the MFIs and their implications for poverty alleviation. This is attempted in section III with the help of a numerical example. Section IV discusses policy implications. Concluding observations are offered in section V.