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Post-script to Microfinance, Redistribution and Poverty

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Parallel Session 4A: Financial Services : Measurement and Impact

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Post-script to
Microfinance, Redistribution and Poverty*

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*The draft of the paper did not include Figure1, Figure 2, Figure 3 and Appendix I. The omission is regretted. Post-script includes these omitted items and explanatory notes to these figures. (Submitted on August 16, 2010.)

Appendix I

We begin this exercise by examining the dynamics of poverty with the help of data on poverty obtained from Lanjouw and Stern (1991). Their study is based a comprehensive study of the households in an Indian village for four years – 1957-58, 1962-63, 1974-75 and 1983-84. They have ranked the households into income decile groups. We define the poor in a relative sense. In a particular year they comprise bottom 30 per cent of the population. Almost two third of the population are poor at least once (Table 1A). Only one third of the households are immune to poverty. The poor belong to two categories: chronic poor and transient poor or temporary poor. Chronic poverty is due to either loss of the main earning member of the family or due to permanent disability. Another factor responsible for chronic poverty is indebtedness due to unaffordable expenses on sickness, injury and to a lesser extent on social ceremonies. Temporary poverty is, on the other hand, due to bad harvest, lack of employment opportunities, indebtedness, sickness and injury. Another reason is low productivity and high dependency ratio giving rise to the phenomenon of "earning capacity poor".

Table 1A
Incidence of Temporary and Chronic Poverty over Time

Particulars	No. of households
No. of households covered in all surveys	111
No. of very severely chronic poor households (poor in all surveys)	5
No. of severely chronic poor households (poor in three surveys)	9
No. of moderately chronic households (poor in two surveys)	20
Number of temporary poor (poor in one survey)	41
No. of Non-poor households in all surveys	36

How can microfinance intervention help the poor? A microfinance expert would recommend grant of microcredit for income enhancement activities. A note issued by the CGAP states: "Microfinance allows poor people to protect, diversify and increase their source of income, the essential path out of poverty and hunger." In support of their argument they have quoted a number of studies. But how do the incomes of poor increase by microfinance intervention? This is not explained.

Incomes of the poor are very volatile. This is evident from Table 2A and 3A.

Table 2A
Status of Poor in the Subsequent Periods

Year	No. of poor households	No. of households who escaped out of poverty in next period (period 2)	No. of households who fell back in poverty in the subsequent period (period 3)
1957-58	33	18	10
1963-64	33	20	3
1974-75	35	21	N.A.

Note : Calculated from Lanjouw and Stern (1991)

Table 3A
Dynamics of poverty

	Percentage of households by income decile groups in current year									
Percentage of households by income decile groups in base year	I	II	III	IV	V	VI	VII	VIII	IX	X
I	0.35	1.73	1.03	1.38	0.69	1.38	1.03	1.03	0.35	1.03
II	0.31	1.56	0.94	1.25	0.94	0.94	1.56	0.63	1.56	0.31
III	1.14	2.00	2.00	1.43	0.86	0.00	0.57	0.86	0.28	0.86
IV	0.91	0.91	1.82	2.42	1.21	0.30	0.61	0.61	1.21	0.00
V	2.43	0.54	0.81	0.81	0.81	1.62	1.08	0.81	0.00	1.08
VI	0.27	0.27	0.00	0.81	1.62	0.81	1.62	1.89	1.08	1.62
VII	0.94	0.63	2.19	0.63	1.56	1.56	0.31	0.31	1.25	0.63
VIII	0.83	1.11	0.83	0.56	0.83	1.11	1.11	0.83	1.67	1.11
IX	0.34	0.69	.34	0.34	0.34	1.38	1.03	2.07	2.07	1.38

X	0.69	0.34	0.00	0.69	0.69	0.69	1.03	2.07	1.38	2.41

Note : Calculated from Tables 7, 8 and 9 of Lanjouw and Stern (1991)

There was neither microfinance intervention nor any other intervention yet many households escaped poverty and many non-poor were pushed into poverty. In fact, there is a basic flaw in the above argument. They tend to target access to credit as the driving force in generation of additional income for the poor. But it is not access to credit rather it is the entrepreneurial talent which is the driving force. This is not to suggest that the poor entrepreneurs do not benefit from microfinance. They can certainly benefit. But their number is quite limited. Most of the borrowers use microfinance for other purposes. It does not enhance their incomes but it does have consumption smoothing effect. The emphasis on consumption smoothing effect changes the vision of microfinance and also challenges its central tenet – access to credit matters, the cost of microcredit does not matter. The underlying argument that the returns to credit for the micro-entrepreneurs are quite high and, therefore, they can afford to pay high rates of interest charged by the MFIs is thus untenable if microcredit is not used by the micro-entrepreneurs.

If microcredit is used for consumption smoothing, high cost of credit would be a drag on the future earnings of the clients of the MFIs. Whether the credit is offered by the MFIs or by the informal moneylenders, both situations give rise to indebtedness among the poor. But there is a difference, microfinance is relatively cheaper than the informal sector. The cost of credit for them has fallen; their terms of trade have improved. We may call it the redistributive effect.

The poor borrow not only for investment and consumption smoothing purposes, they also borrow for less essential needs. We may call it the temptation effect.

The overall impact of microfinance on poverty thus depends on the magnitude of these three effects: (i) growth effect; (ii) redistributive effect and (iii) temptation effect.

Traditionally, borrowings are considered troublesome because they give rise to indebtedness and decline. This can happen even in case of microcredit if the temptation effect is predominant. For example, a near poor household gets an offer of loan when it does not face minimum consumption constraint. Such a situation arises quite often and a number of such households do not resist the temptation and borrow to spend on less essential goods. Given the volatility of their incomes due to seasonal and cyclical factors, indebtedness of this type can result in a downward slide (Figure 1).

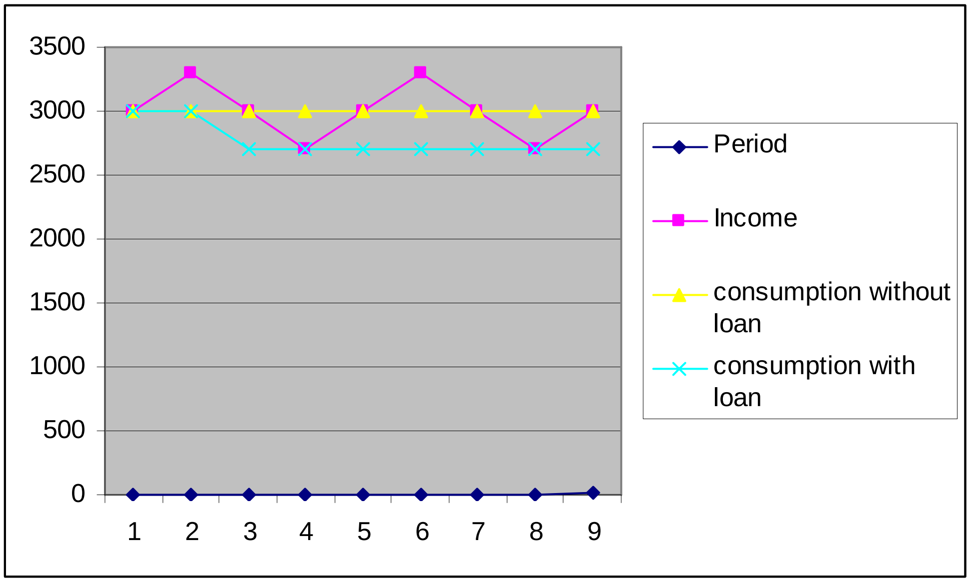

Figure 1

We have assumed in Figure 1 that the household's consumption level is equal to the average income level. It is assumed that the household saves during the upswing and dis-saves during the downswing. But some poor and near-poor households do not save during the upswing. Even when their average income is more than the minimum consumption constraint (poverty line), they are pushed below the poverty line during the downswing. Temporary poverty of this type is avoidable, to a certain extent, with the help of microfinance (Figure 2).

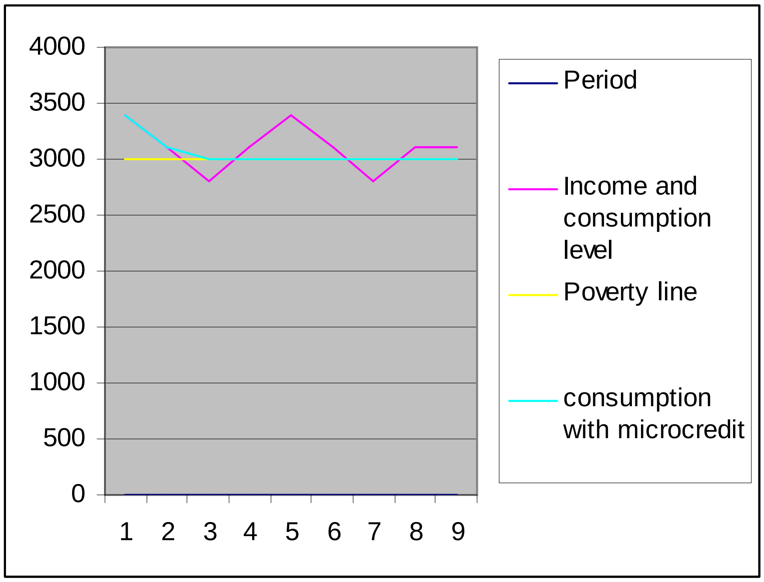

Figure 2

The poverty in case of near poor is avoidable in case of microfinance, but it is unavoidable in case of the households having average income at the minimum level because of the cost of credit. In traditional societies, subsistence credit is on reciprocal basis and therefore poverty is avoidable even in marginal cases (Figure 3)

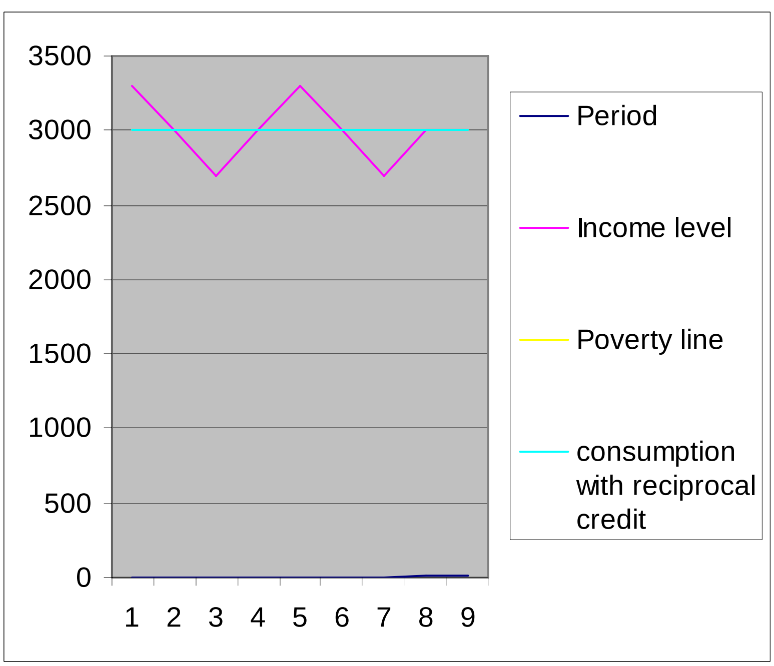

Figure 3

We have described the effect of credit on incidence of poverty in specific situations. To understand its overall impact, we consider the relative importance of these three effects.

Growth effect depends on the proportion of microcredit which is used for the entrepreneurial activities by the poor and near poor households. Contribution of microfinance in this regard seems to be quite limited. In this context, we quote Collins, *et al*. (2009), " In Bangladesh, the microcredit providers, whose self-declared job was to provide business capital to poor households, … were responsible for only a minority share of them; about three times as many sums went into businesses from informal private sources than from moneylenders." Dependence on informal sources is quite intriguing. Perhaps, it is due to rigidity in the functioning of microfinance. Estimation of return to these investments is another difficult problem. The return to additional investment is estimated to be around 3.5 – 4.0 per cent (see de Mel *et al*., 2008). Are entrepreneurs with such high returns to investment are among the poor clients of microfinance? One does not find such instances in Collins, *et al*. (2009). They state, "Out of the 43 borrowers in the sample, a handful – just six – were responsible for … -three quarters – of the value of loans in the biggest category, "business," and between them took two-thirds of all loans issues in that category…. The six households who dominate the business category all have well-established retail or trading businesses and borrow to buy stock as often as they are allowed."

Redistributive effect, on the other hand, seems to be quite substantial because most of the loans obtained by the poor and near poor clients are for this purpose. Its effect can be perceived in terms of reduction in the poverty gap. Temptation effect, on the other hand, is likely to have a negative impact.

Overall impact of microfinance = growth effect + redistributive effect + temptation effect

Where growth effect = (rate of return to investment – rate of interest) * borrowings for investment;

Redistributive effect = (rate of interest in the informal sector – rate of interest of MFIs) * borrowings for consumption smoothing;

Temptation effect = (- rate of interest of the MFIs) * borrowings for temptation goods and services.

We may draw up the following table to illustrate the impact of microfinance:

I	S	T	r(%)	i_{mf}(%)	i_{is}(%)	Estimated impact
1,000	1,000	0.00	0.04	0.025	0.035	+25
1,000	1,000	1,000	0.04	0.025	0.035	0
1,000		1,000	0.04	0.025	0.035	-10
1,000			0.01	0.025		-15

Before commenting on the above illustration, it is imperative to explain the redistributive effect. Obviously, interest on consumption loans is a drag. But due to irregular and uncertain incomes, the poor may have to borrow for their subsistence needs even from traditional moneylenders; lower cost of borrowing for this category of borrowers is a big relief.

The overall impact may be positive or negative. It depends on various factors. If the poor are tempted to borrow even when they do not face a minimum consumption constraint then the impact is not favourable for the poor.

Regarding the return to investment, the possibility of negative returns cannot be ignored. Keeping this in mind we have constructed the fourth row.

We do not expect that it is feasible to estimate the impact of microfinance as illustrated above. Rather, we intend to show that impact of microfinance would be different in case of different households. It is difficult to formulate a pattern in this regard because earnings of the poor and the near poor are both irregular and uncertain. This is is evident from Table 3A. Further, the responses of the households placed in similar conditions are also different. Many near poor households save when they have upswings in their incomes whereas there are many others who do not save.

Microfinance is certainly a pro-poor innovation. But its pro-poor effectiveness depends on its availability at the appropriate time and in an appropriate quantity. Microfinance can and does provide relief to the poor in times of distress. But it does not overcome chronic poverty. Chronic poverty can be overcome by overcoming the structural constraints like lack of human capital and high dependency ratio. Educational expansion can overcome both these constraints but there is lack of high school movement in many developing countries including India.