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Is Microfinance Poverty's "Magic Bullet"?

This article summarizes Chapter 2 from Award-Winning Economists Speak on Contemporary Economic Issues, *edited by Jean Kimmel, forthcoming in 2016 from the Upjohn Institute.*

In the academic year 2013–14, the Department of Economics at Western Michigan University commemorated the 50th anniversary of the Werner Sichel Lecture Series. This annual series, sponsored jointly by the economics department and the W.E. Upjohn Institute for Employment Research, is named for Dr. Sichel, a longtime Western Michigan University economics professor and department chair who retired in 2004. The success and longevity of this series is a testament to his vision and guidance.

The title of the anniversary series was "Award-Winning Economists Speak on Contemporary Economic Issues." See the box below for a list of the six renowned economists. While each speaker discussed a specific subject, they all adhered to the series theme of highlighting the various ways that economics can inform policymakers to facilitate the development and evaluation of public policy, including the construction of public institutions. The topics were wide ranging: immigration policy reform, human resource economics, human capital, microfinance, societal institutions, and efficient and effective regulation. The presentations will be published this year in a forthcoming edited volume by the Upjohn Institute.

The focus of this article is the work presented by Erica Field, a professor of economics and global health at Duke University. The American Economic Association's Committee on the Status of Women in the Economics Profession awarder her with the Elaine Bennett Research Prize, which is given annually to the most successful and promising young female U.S. economist. She presented her research, joint with Abraham Holland and Rohini Pande, both of Harvard University, in a talk titled "Microfinance: Points of Promise."

The book chapter of the same name, written by Field and her co-researchers, describes microfinance, a popular antipoverty tool in developing nations that relies on small-group social pressure in lieu of the requirement of collateral to guarantee small personal loans. The authors discuss the early implementation of microfinance and the ways that it has evolved over time, much of which, at least in recent years, has been in response to rigorous economic analysis. Most interesting, they present a thoughtful discussion of what is meant, generally, by policy success or policy failure, and how economists ought to evaluate policy, followed by an application of this evaluation process to microfinance.

Measuring Policy Success

Policymakers must understand the goals of policies, as well as determine how they will ascertain the degree to which a policy has been successful; accomplishing the latter requires a careful understanding of what is meant by success. For purely illustrative purposes, Field, Holland, and Pande draw from perhaps the most shining example in medicine: the discovery of penicillin, widely known as a "magic bullet" that seemed to have appeared out of nowhere to become one of the most important developments in modern medicine. "Our experience with penicillin and antibiotics provides three critical lessons about 'magic bullets.' First, the development of such products is far from miraculous, but rather reflects years of research and development. Second, the application of a miracle cure may be remarkably constrained—antibiotic 'miracle drugs' are only effective when their use is well-defined, targeted, and consistently applied. Third, maintaining the miracle is a dynamic process—continuous innovation is required to prolong the effectiveness of these magic bullets" (Field, Holland, and Pande, forthcoming, pp. 2–3)

Field and her coauthors explain the depth of poverty in developing nations and describe the origin of the theory that it can be treated by improving access to credit. Traditionally, banks loan funds to individuals who can offer up some sort of collateral to secure the loan and who can document a continuing stream of income to facilitate repayment. Poor individuals in developing economies typically lack

Award-Winning Economists Speaking at the 2013–14 Werner Sichel Lecture Series

Erica Field, Professor of Economics and Global Health at Duke University (winner of the Elaine Bennett Research Prize)

Nancy Folbre, Emerita Professor of Economics at the University of Massachusetts-Amherst (winner of a MacArthur Foundation Fellowship; formerly known as the MacArthur Genius Grant)

Avner Greif, Professor of Economics and Bowman Family Endowed Professor in Humanities and Sciences at Stanford University (also a winner of a MacArthur Foundation Fellowship)

David Kreps, Adams Distinguished Professor of Management in the Graduate School of Business at Stanford University (winner of the John Bates Clark medal, awarded by the American Economic Association to the most prominent young U.S. economist)

Michael J. Piore, David W. Skinner Professor of Political Economy, Emeritus, at the Masssachusetts Institute of Technology (also a winner of a MacArthur Foundation Fellowship)

David Card, Class of 1950 Professor of Economics at the University of California, Berkeley; (also a winner of the John Bates Clark medal, awarded by the American Economic Association to the most prominent young U.S. economist) both. Additionally, due to their income vulnerability, they are unlikely to be able to save for "rainy days," and even less able to save for self-employment business ventures, despite the fact that self-employment is the most common source of earned income for families in many developing nations.

When microfinance is viewed from afar, much like penicillin, it is often considered a glowing success. If one sees the problem it is designed to solve as access to credit (and assume that a substantive cause of poverty in developing nations is lack of access to credit), then microfinance is indeed accomplishing its goal. Framing the policy discussion this way, microfinance appears extraordinarily successful, both in its reach and with its low default rates. However, when Field, Holland, and Pande recognize that the original motivation for the development of microfinance was frightfully high poverty rates in developing nations, the determination of the policy's success or failure becomes more nuanced. As the authors explain in their chapter, to evaluate a policy tool that has been evolving for several decades, researchers must take a step back to consider the problem that motivated the first microloans. Then, it becomes more straightforward to gauge the effectiveness of the program. Fine-tuning the "product" supplied by the microfinance program requires considering the effectiveness of these loans in improving the well-being of poor households.

How Microloans Work to Reduce Poverty

The chapter provides a thorough review of the history of microloans with a focus on the loan structure. From the earliest days of microfinance, microloans were provided to individuals in social groups, with the requirement of collateral from the individual borrower replaced with small group pressure to assure loan term compliance. The loans typically were very small, with weekly repayment set to begin shortly after the date of loan origination.

A critical factor in whether microloans are an effective poverty-reduction tool is whether the loans actually are used for investment because an implicit goal of microfinance is to encourage secure self-employment ventures. Somewhat disappointingly, some research has shown that only about one-half of the value of microloans is used for investment, with the remaining funds used in other ways. According to the authors, "A review of seven recent experimental studies reveals no evidence of microcredit leading to sustained increases in income or consumption" (p. 9). Additionally, there is very little evidence of a positive impact on business creation.

While microfinance has enjoyed explosive growth, there is limited evidence of "success" when focusing on outcomes that still result in households being extremely poor. Concentrating on the fundamentals of the policy details, Field, Holland, and Pande identify specific policy components that show the greatest promise. To enhance the impact of microcredit, they present evidence that microfinance contracts need more flexibility, particularly in the grace period.

The authors themselves have been involved in the design and implementation of policy experiments that manipulate various loan details incrementally to determine the impact of specific changes. In one study, Field et al. (2013) show that extending the grace period has a substantial positive impact on small business formation as well as an impressive accompanying increase in household income. Another experiment (Field et al. 2012) focuses on varying the frequency of repayment; the results were impressive, with substantial increases in household income and business profits along with no increase in default rates.

Field, Holland, and Pande (forthcoming) say that it is important for lenders to have the ability to vary interest rates if they are to offer a wider variety of loan options. Additionally, they explain that success rates are improved when lenders provide more investment information and guidance to borrowers and when the loan delivery model encourages social interaction amongst peers.

Most interesting, the authors discuss the benefits of targeting females with microloans. Theoretically, if such targeting improves female empowerment, this would also improve the bargaining power of women in households. They explain that there is indeed some evidence of this, with one study showing increases in female labor force participation and the marriage age of daughters, along with reductions in fertility. "In the long run, the social and economic benefits of reductions in unwanted births may contribute to significant improvements in the lives of the poor" (p. 19).

Conclusion

By examining the evolution of microfinance with a focus on the experimental evidence, Field, Holland, and Pande explain that "we have experienced the same roller coaster of invention, failure, and reinvention," as was seen with the development and eventual success of penicillin (p. 17). If this process continues, with regulation in the sector "both smart and light-handed," the authors are convinced that microfinance will improve its ability to ameliorate poverty. It is also likely that if policymakers in other realms apply the analytical approach to evaluating policy as outlined in this chapter, many more policy successes will follow.

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