



# The Microfinance Schism

JONATHAN MORDUCH\*

*Princeton University, New Jersey, USA*

**Summary.** — Leading advocates for microfinance have put forward an enticing “win-win” proposition: microfinance institutions that follow the principles of good banking will also be those that alleviate the most poverty. This vision forms the core of widely-circulated “best practices,” but as a general proposition the vision is fully supported neither by logic nor by the available empirical evidence. Recognizing the limits to the win-win proposition is an important step toward reaching a more constructive dialogue between microfinance advocates that privilege financial development and those that privilege social impacts. © 2000 Elsevier Science Ltd. All rights reserved.

*Key words* — poverty, credit, microenterprise, Bangladesh, Indonesia

## 1. INTRODUCTION

Few recent ideas have generated as much hope for alleviating poverty in low-income countries as the idea of microfinance. Microfinance promises both to combat poverty and to develop the institutional capacity of financial systems through finding ways to cost-effectively lend money to poor households.<sup>1</sup> Poor households are typically excluded from the formal banking system for lack of collateral, but the microfinance movement exploits new contractual structures and organizational forms that reduce the riskiness and costs of making small, uncollateralized loans. Microfinance programs have also demonstrated that even poor households can save in substantial quantities. Success stories are being written around the world, from Jakarta to Dhaka to Nairobi to La Paz. Advocates have broadcast these successes widely, and donors have been quick to pledge billions of dollars to support the expansion of programs in the next decade.

Much of the enthusiasm rests on an enticing “win-win” proposition: microfinance institutions that follow the principles of good banking will also be those that alleviate the most poverty. By eventually eschewing subsidies and achieving financial sustainability, microfinance institutions will be able to grow without the constraints imposed by donor budgets. In the process, according to the argument, these institutions will be able to serve more poor people than can be served by programs fueled by subsidies. A key tenet is that poor

households demand *access* to credit, not “cheap” credit. Thus, programs can charge high interest rates without compromising outreach.

If the argument is right, much poverty alleviation can be achieved at no cost to governments and donors—or perhaps even at a small profit. The vision has been translated into a series of “best practices” circulated widely by the Consultative Group to Assist the Poorest (CGAP; a donor consortium housed within the World Bank), the US Agency for International

\* The paper was initially prompted by a meeting with representatives of the Consultative Group to Assist the Poorest, the US Agency for International Development, ACCION International, and the Harvard Institute for International Development, convened in Cambridge in Spring 1997. My views have evolved through conversations with Abhijit Banerjee, Gregory Chen, Monique Cohen, Peter Fidler, Mike Goldberg, Claudio Gonzalez-Vega, Albert Park, Marguerite Robinson, Richard Rosenberg, Jay Rosengard, J. D. von Pischke, Jacob Yaron, and participants at lively seminars at Ohio State and the World Bank. I have particularly benefited from input from practitioners in Bangladesh, Indonesia, and China, and from Christopher Dunford and his colleagues at Freedom From Hunger. Throughout, Mark Schreiner has provided particularly comprehensive and thoughtful criticisms. The paper was completed during a year as a National Fellow at the Hoover Institution, Stanford University. The views expressed here are mine solely. Final revision accepted: 30 June 1999.

Development, the United Nations Development Program, and other key donors.

While some find the win-win argument to be self-evident, most practitioners appear to be convinced by only part of the message. Despite keen awareness of “best practices,” nearly all programs remain substantially subsidized. This is especially so for those with explicitly social objectives. For example, the most careful and comprehensive recent survey shows that the programs that target the poorest borrowers generate revenues sufficient to cover just 70% of their full costs (MicroBanking Bulletin, 1998).<sup>2</sup> While subsidy rates will surely fall as more programs gain age and scale, even many older, larger programs are far from being able to make ends meet with their own revenues. Some donors believe that little more than 5% of all programs today will be financially sustainable ever.<sup>3</sup>

Why are programs not raising interest rates and moving over to “best practices” more quickly? Much of the answer is that the win-win proposition turns out to be far more complicated than it would seem at first. It rests on a series of empirical assumptions and logical connections that do not generalize easily and which have yet to be demonstrated through careful empirical studies. Almost no studies provide comparable and reliable evidence on attributes as basic as the incomes, occupations, or loan uses of clients—and of comparable nonparticipants (the Hulme & Mosley, 1996, studies are an important exception). So while advocates continually trumpet the advantages and successes of one program or another, practitioners concerned with *who* they serve have inevitably discounted the success stories for fear that someone else’s oranges are being compared to their apples.

By far, loan size has been the predominant metric for comparison of outreach. But loan size is a rough and indirect measure (Hatch & Frederick, 1998). A poverty-focused nongovernmental organization (NGO) in Nepal or Malawi will be understandably reluctant to assume that lessons can be learned directly from the experience of say, the Badan Kredit Desa of Indonesia—a series of village-based financial facilities that are financially self-sufficient despite serving clients with an average loan balance of just \$38 (relative to \$101 for the Grameen Bank; Christen, Rhyne, Vogel & McKean, 1995). The practitioners are probably right. The main clients of the BKD system are petty traders or owners of small service enterprises like restaurants and tailor shops, typi-

cally making high margin, quick turnaround investments. As a result, the clients are capable of paying real interest rates approaching 50% per year on 3–4 month loans (as is true for clients of Bolivia’s well-known BancoSol).<sup>4</sup> Elsewhere, in contrast, the best available investments of many microfinance clients involve longer term loans for moderate-return activities like livestock raising, handicrafts, and agricultural processing. Programs fear that increasing the costs of borrowing will put these investment opportunities beyond the reach of their target clients. Not surprisingly, donor exhortations to follow the full slate of “best practices” have frustrated many NGOs. Until recently, consideration of *who* is being served has been almost entirely absent from the “best practices” conversation.

Instead, socially-minded practitioners have had to contend with the assertion that those clients that cannot pay the kinds of charges required for programs to break-even then certainly must be destitute, in need of direct health and education programs (or simple charity) rather than credit (e.g., Gonzalez-Vega, 1998). But socially-minded practitioners argue that their target group of clients is somewhere between destitute households and richer households. These target households (termed here the “core” poor) can potentially benefit from microfinance services, even if average loan sizes are too small to allow the kinds of economies of scale that have delivered financial sustainability for well-known programs such as BancoSol and Bank Rakyat Indonesia’s *unit desa* system.<sup>5</sup>

Confronting the schism between rhetoric and action—and between financially-minded donors and socially-minded programs—will first require that both donors and practitioners pay greater attention to who is being served (Woller, Dunford & Woodworth, 1999; Rhyne, 1998). Constructing profiles of clients by occupation, loan use, and income level is an important first step. The call to best practices will only be convincing if backed by a series of well-documented examples of institution that are (truly) breaking even financially while serving clients with profiles very close to those served by socially-minded NGOs. Bangladesh’s Association for Social Advancement (ASA) provides one promising example, as do some programs built on the village banking model. But these cases need to be expanded upon and more carefully documented with an eye to crosscountry comparisons.<sup>6</sup>

Second, much could be gained by focusing more sharply on the mechanisms through which financial services are delivered, as well as the menu of services provided. Best practices have centered on important but general aspects of institutional performance, such as maintaining financial transparency, standardizing products, and achieving scale. A high level of generality has been natural given the diversity of contexts and programs at issue. But, spurred by win-win optimism, one result has been widespread replications of standard models (especially the Grameen Bank model and FINCA's village banking model) in a wide diversity of economies. Many of these direct replicates appear however to do far better in terms of outreach than financial sustainability.

Instead, programs like Dhaka's SafeSave have found that it has been necessary to go back to the drawing board and create new financial services products that can be sold at interest rates high enough to allow the institution to break even while maintaining—or even improving—outreach.<sup>7</sup> SafeSave has found it necessary to depart from standard models in Bangladesh and make safe and flexible savings accounts, including the possibility of daily deposits, a key part of their services. In this they have drawn on lessons from informal institutions in Dhaka's slums, as well as on successful experiences with deposit mobilization in Indonesia (Rutherford, 1997). Bangladesh's ASA has similarly departed from Grameen's model to develop a simple management structure and accounting system that have reduced costs substantially, making it possible to approach financial sustainability without imposing excessively high costs on clients (Rutherford, 1995). Other programs, such as the village banks initiated by Freedom from Hunger, have found substantial benefits in bundling financial services with client education (MkNelly & Dunford, 1996 and 1998).

These examples show that mechanisms clearly matter. But the power of the win-win vision—that clients demand credit access at whatever the cost—has hindered the broader encouragement of experimentation, innovation, and the exchange of experiences that can lead to (a) new financial products for which the "core" poor are willing and able to pay relatively high charges and (b) cheaper ways to deliver financial services to poor clients.

Third, the most important lessons to be learned from the failures of subsidized credit programs of the past are the need for efficiency,

transparency, and appropriate management incentives. Although excessive subsidies were a large part of the problem, these key program attributes can be achieved with or without full financial sustainability. For some programs, ongoing subsidization can be an important means through which social missions are achieved.

If such programs lose access to government or donor funding, they will have no option but to close down, attempt radical cost-cutting innovations, or attempt to cross-subsidize. But it is not clear why the starting point for so many is the belief that, as a matter of course, funding will be pulled away from programs, even those able to demonstrate sustained social effectiveness. Moreover, there has never been a general presumption that the most effective poverty alleviation programs can be—or should be—self-financing. Despite early optimism to the contrary, the microfinance experience so far presents little to change that view.

The aim of this paper is not to argue for one type of program over another. To the contrary, evidence suggests that achieving the richness of programs appropriate for broad and changing populations will require a diversity of programs at varying levels of outreach and financial sustainability. The aim is to help clarify discussions, to examine the logic of critical arguments, and to highlight salient tensions. The next section briefly reviews lessons and inferences from subsidized credit programs of the 1960s and 1970s. The following section takes apart the arguments underlying the win-win proposition. The final section puts forward an agenda for research on issues at the heart of the microfinance schism.

## 2. THE SUBSIDY TRAP

All sides agree on the importance of avoiding mistakes of the past. Earlier attempts to address gaps in financial markets focused on a now-familiar set of problems: First, banks face high transactions costs per loan when lending at small scales. Second, determining the riskiness of potential borrowers and monitoring the progress of clients is particularly difficult when clients are poor and in the informal sector. Third, many low-income households lack assets to put up as collateral.

The early programs recognized that many households could generate high returns if given credit and that, by starting small enterprises,

the households could earn enough income to exit poverty, expand their businesses, and improve the quality of their lives. As a result, governments subsidized banks' loans to poor households, providing incentives to overcome banks' reluctance to lend. Recognizing the social mission of the project, interest rates were also kept below market-clearing levels.

Despite the promise, the subsidized credit programs of the last three decades failed nearly universally, and disaster stories are well-catalogued (Adams, Graham & von Pischke, 1984). The costs of these programs mounted quickly and, since no way was found around the collateral problem, default rates ballooned, with many borrowers expressing ambivalence about defaulting on government-backed loans, especially when most everyone else was doing so. Either the programs quickly ran out of money or they drained government accounts.

Moreover, because banks were losing money so steadily on the lending-side but were amply capitalized by governments, they had little incentive to mobilize savings: deposit mobilization is costly and re-lending the deposits would just lead to greater losses. Instead, saving accounts were weighed down with restrictions and downward pressure was put on interest rates on deposits, generally to keep interest rates paid to depositors below the rates charged to borrowers. The result was that real rates on deposits fell to zero or below and savers had little incentive to build up accounts. Ultimately, little saving was generated, and money stayed under mattresses or was moved into nonfinancial assets.

Government involvement had another negative consequence. Loans often ended up subsidizing well-off, politically-connected entrepreneurs rather than poor households, and few mechanisms were in place to stem the leakages. The ultimate result was high costs and little benefit for the intended beneficiaries.

The new programs have set out to avoid these traps. Foremost, they have seen the importance of maintaining high repayment rates. By employing contractual innovations like group-lending and by exploiting dynamic incentives, many programs have achieved repayment rates above 95% (Christen *et al.*, 1995; MicroBanking Bulletin, 1998). They have also kept an arm's length from government involvement, and most programs are run by NGOs.

The successes have bred false generalizations, however. The first is that subsidization, ineffi-

ciency, and limited scale necessarily go hand in hand. The second is that government involvement means trouble. The third is that effective savings mobilization is incompatible with subsidized credit. As described below, none of these ideas is fully consistent with logic or experience. The challenge is to draw appropriate lessons from both the mistakes of the past and the successes of the present.

### 3. THE LOGIC OF THE WIN-WIN PROPOSITION

The win-win proposition has been a powerful piece of rhetoric, and it has kept many programs from repeating past disasters. But if it was fully convincing, the microfinance landscape would look very different from its present state—where subsidized programs far outnumber sustainable programs. Why has it not been fully convincing?

The win-win proposition rests on a series of supporting arguments. The most important is the argument that households require access to credit, not cheap credit. This is joined by eight principal claims. First, that raising the costs of financial services does not diminish demand. Second, that due to their scale, financially sustainable programs can make the greatest dent in poverty. Third, that financial sustainability will give programs access to commercial financial markets. Fourth, that since they come at no cost to donors, financially sustainable programs are superior weapons for fighting poverty. Fifth, that subsidized programs are inefficient and thus bound to fail. Sixth, that subsidized credit most often ends up in the hands of the nonpoor. Seventh, that successful microfinance programs must be nongovernment programs. And, eighth, that subsidizing credit undermines savings mobilization.

Not all of those who believe in the importance of financial sustainability will accept each claim. But the claims are often heard together, and they form a core set of ideas. Each is rooted in the experience of some programs in some places and at some times. But as general propositions they each rest on problematic logical extrapolations, inappropriate assumptions, or misreadings of evidence. In taking them apart, my objective is not to push for subsidized credit at all costs. Rather, it is to illustrate the "disconnect"—i.e., why these arguments have not translated into action.

(a) *Interest-insensitive credit demand*

*Claim: Raising interest rates does not substantially diminish demand for loans.*

In Las Vegas, pawnshop owners charge borrowers effective annual interest rates of 120%, while in the gambling town of Biloxi, Mississippi, typical rates are 300% per year (*New York Times*, December 13, 1997). Demand remains high in both settings. But no one would argue that the typical small entrepreneur in the United States can repay loans at those rates. This, though, is the sort of argument that is commonly made in the microfinance context—that since moneylenders charge high interest rates, microfinance programs can too. But while poor households in low-income countries may borrow from moneylenders at rates above 100% per year, they are generally doing so to meet short-term consumption needs, not to make long-term productive investments.

Moreover, the distinction between *which* poor households are served by microfinance programs is obscured by observations that financially sustainable programs reach *some* poor households. For example, it is asserted in CGAP (1996; prepared by Richard Rosenberg):

CAN microborrowers pay high interest rates? ... [Microfinance institutions] charging very high interest rates almost always find that demand far outstrips their ability to supply it. Most of their customers repay their loans, and return repeatedly for new loans: this pattern demonstrates the customers' conviction that the loans allow them to earn more than the interest they have to pay. ... Thus, there is abundant proof that poor people's tiny businesses can often pay interest rates that would strangle a larger business. Still, this proposition strikes many as counterintuitive.

The argument above makes the point that there are poor households that are able to pay high rates. The concern of many subsidized programs, however, is that there are also many borrowers who *cannot* pay high rates. (This has been a particular concern in South Asia.) These latter households tend to be poorer and harder to reach with traditional programs, and they constitute a large fraction of client bases. They are not the petty traders that can repay at rates above 50% per year. If these programs raised interest rates, they might not suffer for lack of demand either. But that is not the point. The programs fear losing much of their current client base, including the particularly vulnerable and underserved segments of poor popula-

tions that appear to be served well by moderately-subsidized microfinance programs versus other economic development initiatives. Programs inevitably point to anecdotal evidence to support their claims, but even without harder data, it is clear that considering only aggregate demand is inadequate for programs seeking to maximize social welfare.

The argument is allied to another logical stretch. The assertion above implicitly invokes the principle of declining marginal returns to capital as a defense of charging high interest rates to poor clients while charging lower rates to richer clients.<sup>8</sup> The idea is that there are a limited number of great projects in which to invest. The first units of capital go to the best projects and subsequent units go to projects with increasingly lower returns. The principle is generally right, but its application is wrong. The basic principle applies to a single firm, holding all else fixed. It does not necessarily hold across firms (or across household microenterprises) as in the application here. Producing and selling goods requires more than capital. It requires skills, other materials, information, connections, transportation, etc. Since richer households tend to have more of these inputs, marginal returns to capital are often far higher for them than for poorer households. These richer households will thus be willing to pay far higher interest rates than poorer households. (In fact, the basic principle is unclear even when controlling for other inputs, since scale economies alone can yield higher marginal returns to later increments of capital than earlier increments.)

The ability to pay high interest rates is thus an empirical issue, dependent on the amount of capital being used, as well as the amount of all other inputs available. It cannot be inferred that because one group of poor households can pay high rates then even poorer households can pay those interest rates as well. Moreover, sensitivity to the costs of financial services is not likely to be common across economies. For example, practitioners argue that sensitivity tends to be much greater in South Asia than in Latin America. But careful studies have yet to demonstrate this in either context.

(b) *Advantages of scale*

*Claim: Financially-sustainable programs can achieve greater scale than subsidized programs. Thus, they can make a bigger dent in poverty.*

The diversity within poor households is similarly obscured by common arguments on the advantages of achieving a broad scale of operations. Again, the argument is put well in CGAP (1996):

Some people treat [the question of how high to set interest rates] as if it comes down to a value judgement: which do you care more about—poor people or profits (... or financial system ... or neoliberal ideology). To avoid any such confusion, let's assume that the only objective we care about is maximizing benefit to poor people. From this perspective, the argument for high interest rates is straightforward. In most countries, donor funding is a limited quantity that will never be capable of reaching more than a tiny fraction of those poor households who could benefit from quality financial services.

The argument has greatest power if concern with poverty rests exclusively with minimizing the *number* of people below the poverty line (making no distinction between groups within the working poor population). But it loses power if we also consider the distribution of income below the poverty line—and this makes value judgements paramount. Value judgements cannot be so easily swept away.

Consider tradeoffs in scale and outreach when the objective is to minimize a poverty measure that is sensitive to the distribution of incomes below the poverty line. Since clients in subsidized credit programs tend to be much poorer than those in sustainable programs, for illustration assume that the typical client in a subsidized program has an income of, say, 50% of the poverty line, while the typical client of a sustainable (high interest rate) program has an income of 90% of the poverty line. To focus the comparison, assume that borrowers receive identical net returns (after repaying loans with interest).<sup>9</sup>

One metric of social welfare is the poverty rate as measured by a distributionally-sensitive index like the Watts measure or “average exit time” of Morduch (1998). By this measure, raising the poorer borrower's income by one dollar has 1.8 times greater impact than doing the same for the less poor borrower. The same calculation for the commonly-used “squared poverty gap” of Foster, Greer and Thorbecke (1984) gives a ratio of 5 to 1. The “cubed poverty gap” yields a ratio of 25 to 1.

The numbers can be put in perspective by comparing the required scale of subsidized and sustainable programs that would have equivalent impacts on measured poverty. Say that the

sustainable program has 75,000 clients (roughly the size of Bolivia's BancoSol). How large would the subsidized program need to be to have an equivalent impact (under the assumptions above)? When measuring poverty with the Watts measure, the subsidized program would need to reach at least 42,000 clients. When measuring poverty with the squared poverty gap, the subsidized program would need to reach 15,000 clients. It would also need to serve just 3,000 clients as measured by the cubed poverty gap.

The exact comparison is a matter of value judgement—which poverty measure best captures the social value of poverty reduction? The initial claim above makes sense only under specific assumptions about objective functions, relative outreach, and the elasticity of credit demand with respect to interest rates. Under plausible assumptions, the claim could hold, but it is not a general proposition. Well-targeted programs can often do more for poverty reduction than much larger programs reaching mainly better-off households.

#### (c) *Access to commercial finance*

*Claim: Financial sustainability is critical for institutions as it is the route to being able to access capital from commercial financial markets rather than donors.*

The argument in CGAP (1996) continues:

We can hope to reach most of those households only if [microfinance institutions] can mobilize relatively large amounts of commercial finance at market rates. They cannot do this unless they charge interest rates that cover [total costs].

This claim also requires re-examination. This step in the argument goes beyond the untethering from donor strings. The vision described is one in which the equity of programs is multiplied through access to commercial finance—i.e., the creation of leverage. The vision opens up exciting prospects, but as Conning (1999) argues, they are not likely to be shared as amply by programs focused on poorer households—even if the programs charge “market rates.”

The scenario parallels that of a poor borrower unable to obtain loans from formal sector banks for lack of collateral (e.g., Banerjee & Newman, 1994). The story is well-known: banks are reluctant to lend because it is difficult to identify the truly reliable borrowers,

to then monitor borrowers' behaviors, and, if needed, to implement effective punishments. Combating this phenomenon has been the driving impetus for the microfinance movement.

The same kinds of difficulties emerge when the microfinance program itself seeks commercial funds, since it lacks collateral to back its portfolio. As the borrowers found, merely being able to generate positive expected returns is not enough to secure commercial credit. Thus, even financially sustainable banks will not necessarily be able to gain sufficient access to wider capital markets. As Conning argues, banks focused on poor borrowers are likely to face the greatest difficulties in creating leverage since their portfolios are likely to appear that much riskier to capital suppliers. Relying on commercial finance can thus lead to further reductions in the depth of outreach.

As a point of economic logic, of course, it is not incompatible to both subsidize interest rates charged to clients and to obtain commercial finance. The Grameen Bank, for example, has sold bonds (guaranteed by the government) while not passing all costs on to clients. While there is debate about whether the price of the bonds is at market rates, the principle remains that subsidization does not rule out tapping commercial finance for partial funding. The chief constraint is not subsidization *per se* but the ability to limit perceived riskiness.

(d) *Irrelevance of cost-benefit comparisons*

*Claim: Since sustainable programs do not require outside funding, consideration of costs and benefits is irrelevant. There are no costs borne by governments or aid agencies—there are only benefits. Sustainable programs are thus superior to subsidized programs.*

The idea of cost-free poverty alleviation is appealing, but consider this simple analogy. When diners go to a restaurant, they have the option of drinking water or purchasing a beverage. The water is free and adequate, but most diners also buy wine, beer, or soft drinks to complement their meal. To them, the zero-cost option is not always the one that leads to the greatest satisfaction, and the same logic holds here. When funding is available, subsidizing credit beats the zero-cost option as long as benefits outweigh costs.

A problem with the “best practices” approach is that it proceeds as if there has to be

just *one* interest rate policy and one sort of program in an area. Sustainable programs may have advantages in achieving scale. Subsidized programs appear to have advantages in outreach. Just as all diners are not forced to drink the same beverages, general social welfare perspectives suggest that it can make sense to support multiple programs within the same region, some focusing on scale and others on outreach.

(e) *Subsidies reduce efficiency*

*Claim: Subsidized credit programs are inefficient and ultimately bound to fail.*

A much sharper criticism of subsidized credit programs is that they cannot survive over the long term. Nancy Barry of Women's World Banking (CGAP, 1995) asserts, for example, that “few low income entrepreneurs end up benefiting from subsidized programs, because these programs fail before they reach significant numbers.” She argues further that “microenterprise financial intermediaries have learned that they cannot depend on governments and donors as reliable, long-term sources of subsidized funding.”

Barry's assertion evokes the lessons of past failures. But microfinance advocates have argued strenuously that the new programs are radically different from those of the past. Subsidized programs like the Grameen Bank and Bangladesh Rural Advancement Committee together, for example, have together reached around four million borrowers and face substantial competition from other groups like the Association for Social Advancement and Proshika. Barry's first assertion is hard to reconcile with the experience in Bangladesh to date.

The second issue is whether subsidized funding will dry up. Since donors and governments remain committed to poverty alleviation as a top priority, advocates are not unreasonable in arguing for allocating some poverty-alleviation funds to support innovative and effective microfinance programs over the long-term. How this will play out exactly is a matter of speculation, but there is no reason to think that concern with poverty alleviation will quickly wither. Nor is there reason to think that support for subsidized microfinance programs will wither—as long as they remain vigilant in containing costs and maximizing outreach.

A third issue is whether subsidized programs can be efficient. Barry (CGAP, 1996), for example, argues that “efficient financial intermediaries need to charge high rates to cover the costs of making small loans.”

Typically, judging institutional performance by profitability gives managers the right incentives. But appropriate incentives can also be provided in nonprofit enterprises. Maintaining “hard” budget constraints is the key, not maximizing profits. The two mechanisms are often confused, but it is the former that is critical for efficiency, not the latter. If budget constraints are soft and performance criteria are not carefully specified, managers can expect to be bailed out after poor performances. If constraints are kept hard and performance criteria are made clear, managers must cope with failures, and efficiency can be maintained, even in nonprofit programs.

One important mechanism for achieving efficiency in subsidized programs is to use socially-determined transfer prices and to be rigid in evaluating performance according to those prices. Transfer prices are the internal prices used by institutions to value capital and determine relative performance at branch levels. In a profit-making enterprise, the transfer prices reflect the full value of capital, a system used very effectively by the Bank Rakyat Indonesia’s *unit desa* program. In a subsidized program, they are shadow prices, adjusted downward so that prices reflect the social gains delivered by lending. The transfer prices can be used to calculate shadow profits. Thus, while bank managers may not be able to lend at an actual profit, they may be able to lend at a net social gain, and efficiency can be achieved by tying their compensation to performance on the basis of transfer prices and shadow profits.

Translating the theory into practice takes creativity and experimentation, but the basic idea can be implemented with simple rules of thumb. This is not an academic dream: most universities and many hospitals run on a not-for-profit basis with purely social objectives. Managers of not-for-profit microfinance institutions can learn from their weaknesses and build on their successes.

(f) *Subsidies lead to mistargeting*

*Claim: Subsidized credit most often ends up in the hands of nonpoor households.*

A common experience in the credit programs of the 1960s and 1970s was that subsidized credit was often diverted away from poor households. Since the subsidies were valuable, politically powerful groups, usually not poor, muscled their way in and managed to grab a share. The problem was compounded by the fact that most programs were government-run, providing further incentives for misfeasance as the granting of loans was often partly a political payoff (this is discussed further below).

These problems are fully avoided when subsidies are eliminated. But the problems may also be greatly reduced by just partial elimination of subsidies. The concern with targeting introduces a floor to interest rates—it does not mean that interest rates need be at break-even rates. The floor is determined by the rates at which others (the politically powerful, say) can get loans.

Consider a program lending exclusively to poor borrowers. It would have to charge, say, 30% per year in order to break even. In contrast, a formal sector program aimed at richer borrowers could break even when charging, say, 15% per year since it can more easily take advantage of returns to scale. Loans at 5% per year will seem appealing to *all* households when the alternative, formal sector sources charge 15%. Nearly without fail, such *absolutely* cheap credit has led to subsidy traps.

Loans around 20% will seem however much less appealing to the richer households. Rates around 20% provide meaningful subsidies for poor households, and are not seen as gifts. The loans are cheap relative to full costs, but they are not absolutely cheap. Mistargeting has thus not been a major concern for those programs providing moderate-sized subsidies. The lesson from the failures of the 1960s and 1970s is to avoid excessive subsidies. The lesson is not to avoid subsidies altogether. Discussions of interest rates in microfinance programs often equate subsidized credit with cheap credit, and this has created considerable confusion. *Absolutely* cheap credit is typically the problem. *Relatively* cheap credit can, in principle, work.

(g) *Minimal role of government*

*Claim: Microfinance has been and should continue to be a movement with minimal government involvement.*

Governments in low-income countries have played very little direct role in the microfinance movement, and this has been no accident. The



movement is fundamentally an NGO movement, free of many of the political biases of earlier subsidized programs. This creates its own problems, of course. There are good and bad NGOs and often little apparatus for effective oversight, but so far the microfinance track record has allayed most fears.

Governments, though, have played critical indirect roles. The Bank Rakyat Indonesia and Thailand's Bank of Agriculture and Agricultural Cooperatives, for example, are state-owned although run as standard commercial banks. The Grameen Bank, which sometimes finds itself at odds with Bangladeshi politicians, nonetheless has obtained loans at concessional rates from the Bangladesh Bank (and began as a special project of the Bangladesh Bank).<sup>10</sup> The spread of microfinance in China will also of necessity proceed with heavy government involvement, at least in the near term (Morduch, Park, & Wang, 1997).

While sustainable programs can afford to eschew government involvement, subsidized programs cannot. Subsidized programs need NGOs, foundations, international donors, or their own governments for funding. If subsidized programs are to continue at current funding levels, they will likely need to rely increasingly on their own governments. Rather than backing away from governments, subsidized programs will need to build constructive relationships. Lessons from past failures suggest that this will require a clear understanding of the (sharp) limits to direct government involvement and a commitment to the transparency and accountability of programs.

#### (h) *Subsidies limit savings mobilization*

*Claim: Mobilizing savings is not likely to make sense for subsidized credit programs.*

Household welfare can be greatly improved through the chance to mobilize savings. Early microfinance programs were not effective in mobilizing savings and showed little interest in doing so. Partly, it was thought that poor households were too poor to save. One of the lessons from the recent microfinance experience, however, is that, even poor households are eager to save if given appealing interest rates and/or flexible accounts. The Bank Rakyat Indonesia, for example counted over 16 million low-income depositors by the end of 1996.

Incorporating savings mobilization in microfinance programs makes sense for a

number of reasons (Robinson, 1995). First, it can provide a relatively inexpensive source of capital for re-lending. Second, today's depositors may be tomorrow's borrowers, creating a natural client pool. Third, savings deposits offer important advantages to low-income households, allowing low-income households to build up assets to use as collateral, to reduce consumption volatility over time, and to self-finance investments rather than always turning to creditors (Wright, Hossain & Rutherford, 1997).

Thus, a savings program may be an essential feature of both subsidized and sustainable programs. It has been sustainable programs however, that have been most aggressive in mobilizing savings, partly because mobilization can greatly aid the financial bottom line. Subsidized programs have tended to focus on "forced saving" programs, forcing borrowers to put aside a fixed percentage of borrowed money to draw upon in case repayment difficulties arise, rather than mobilizing voluntary savings.

Maintaining savings deposits can be expensive for programs, and when programs are losing money in their lending operations, they have little incentive to mobilize deposits if capital can be obtained more cheaply from donors. This was part of the subsidy trap described above. If, however, programs can generate capital from depositors more cheaply than donors can generate capital, it can be in all parties' interests to encourage programs to mobilize savings. One way to do so is to split the difference between programs' costs of generating capital and donors' costs of obtaining capital. For every dollar that programs mobilize, donors can then reduce their loans to the programs by one dollar. The arrangement can reduce costs for both donors and programs and at the same time encourage savings mobilization.

For example, the Grameen Bank obtained funds from the Bangladesh Bank at just 5–6% in the mid-1990s while alternative sources of funds would have cost 12–15%. If Grameen could have mobilized savings at a cost below the Bangladesh Bank's opportunity cost of funds, the social cost of subsidization could have been reduced. Under early, failed credit schemes, everyone lost out through savings mobilization. Under the proposed scheme, however, everyone can benefit.

Practical constraints to savings mobilization must be worked out, though. The most

important constraint is that NGOs are not chartered to hold savings deposits. Prudence dictates that only tightly-regulated institutions are given the privilege and responsibility of holding savings. This thus creates a problem for microfinance programs (except those that are fully chartered banks). One answer is that fully-chartered savings banks could operate independently but alongside NGOs engaged in lending. A contractual link to exploit the rebate opportunity above could still be used to reduce costs of subsidization on the lending side.

Both the rebate proposal and the savings bank/microcredit partnership proposal are straightforward in principle but require careful, transparent contracts to work well. The ideas are speculative but suggest that there may be creative ways around roadblocks.

#### 4. THE CHALLENGE AHEAD: A RESEARCH AGENDA

The arguments above suggest holes in the win-win logic that help to explain why “best practices” have not been adopted more widely. But subsidization raises its own tensions, particularly surrounding issues of governance. Among the key questions are: Can new product development and program design sufficiently improve financial performance without compromising outreach such that subsidies are not needed? If not, are the costs of subsidies typically justified by the social benefits of programs? Can innovations be implemented to help subsidized programs maintain efficiency and effective targeting? Which groups among the poor are best served by which types of programs? Can social benefits be easily and reliably measured on an ongoing basis? Can funding be sustained over the long run?<sup>11</sup>

The socially-oriented programs should have careful economic and social evaluations at the top of their research list. The Grameen Bank and BRAC have been pioneers in this area, with a large, comprehensive survey completed in 1991–92 and a follow-up survey underway. The key to this survey has been use of a sample frame that incorporates stratified randomization and the collection of data on both participants and *nonparticipants*, including random samples from villages not served by any program.<sup>12</sup> The survey, though, has been expensive, and devising ways to complete cheap, ongoing surveys is the next step.

The role of competition is an additional issue of growing importance. Practitioners need to know much more about problems that arise when multiple programs—some subsidized, some not—coexist. Here, the issue is a supply elasticity: how sensitive is the performance of financially sustainable programs to the presence of targeted, subsidized programs?

Another set of questions surrounds the functioning of specific program features. All types of programs may be able to learn from studies that explore the effectiveness and costliness of various lending mechanisms—for example, weekly versus bi-weekly versus monthly payment schedules, lending to individuals versus lending to groups, intensive versus minimal group-lending operations, and increasing loan size quickly or slowly with successful repayment. Systematic experimentation and evaluation with household-level data can be critical along these lines.

#### 5. CONCLUSIONS

The optimism of the win-win vision has generated much energy for the microfinance movement, and it has helped to discourage repetitions of the costly mistakes of the past. But the past decade shows that it has also discouraged constructive dialogues and the sorts of serious empirical studies that can help to resolve continuing debates. As a result, the empirical agenda remains wide open and the schism persists, fueled by competing anecdotes.

The microfinance movement encompasses diverse programs, all of which focus on providing financial services to poor households. Some programs have made financial sustainability the chief goal, and others have centered on economic and social impacts. While there is much common ground, there are also critical differences. There appears to be ample room, however, for a diversity of programs, with competing methods and financial arrangements.

Addressing the schism opens up the chance to address misconceptions. It is not profit maximization that makes a program efficient. Instead, what matters is having a hard budget constraint, something possible even with subsidies. Nor is it so that subsidization necessarily leads to mistargeting. Fear of mistargeting may limit the size of the optimal subsidy, but it does not necessarily make it

zero. Nor is it so that savings mobilization is necessarily held down by charging interest rates on loans that are below levels needed to break even. Moreover, as Conning (1999) has argued, the need to preserve management incentives means that even financially sustainable, socially-minded programs will likely have ongoing difficulties raising substantial amounts of capital on the open market.

While these arguments run counter to hard-line positions on financial sustainability, opening up the discussion may also help foster continued efforts to develop new financial products that ultimately are financially sustainable. Addressing the schism may also mitigate the emerging backlash against the microfinance movement. The insistence on the win-win proposition has alienated many potential supporters. Those willing to trade off costs for benefits have become frustrated as microfinance institutions stretch accounting data in order to claim profitability while simultaneously eschewing social evaluations.

Perhaps more problematically, those interested in replicating the well-known success stories have only had partial and unreliable evaluations on which to base their plans.

The arguments above stand in opposition to “lessons” of failed programs of the past. And the arguments suggest that there is much yet to learn.

As Hulme and Mosley (1996, p. 135) conclude,

Ironically, it is the success of the “first wave” finance-for-the-poor schemes, and particularly the Grameen Bank, that is the greatest obstacle to future experimentation. Most designers and sponsors of new initiatives have abandoned innovation, and “replication” is leading to a growing uniformity in financial interventions.

This paper has mapped avenues to pursue in rethinking microfinance to date and in constructing foundations for a next wave of microfinance innovation.

## NOTES

1. See, for example, Brugger and Rajapatirana (1995), Hulme and Mosley (1996), Otero and Rhyne (1994) and Morduch (1999) for broader discussions of microfinance programs.

2. The relevant groups are those whose clients maintain average loan balances under \$150 or loans as a percentage of GNP per capita under 20%; they include, for example, village banks such as FINCA programs and exclude programs like BancoSol and the Bank Rakyat Indonesia *unit desa* system. The figures are after adjustments to account for subsidies on capital costs, the erosion of the value of equity due to inflation, and adequate provisioning for non-recoverable loans. As best possible, the figures are comparable to data for standard commercial enterprises. The included programs all have a “commitment” to achieving financial sustainability and voluntarily submitted the financial information, so they are already a self-selected group. Some of the programs are young and their financial performance will likely improve over time.

3. This speculation has been widely cited, and Richard Rosenberg reports that its origin is a microfinance panel discussion at Boulder, Colorado. The consensus among a group of (sustainability-minded) panelists was that 1% or fewer of programs were presently sustainable and that no more than 5% would ever be. These rough

speculations concerned NGO programs only, excluding, for example, credit unions, the Indonesian BKDs, or private banks that are serving poor clients. Even if experience shows the correct number to be 10%—or 15% or 25%—there remains a fundamental “disconnect” between rhetoric and action. In the end, the most important measure concerns the number of clients served, not the numbers of particular types of programs.

4. Information is from the unpublished notes of Don Johnston. His calculation shows average BKD loan sizes to be \$71 at the end of 1994, still well below the Grameen Bank level.

5. A growing list of examples demonstrates the ability to serve these richer households without ongoing subsidies, and their experiences hold important lessons for programs with poorer target clients. But, as documented in a recent study of BancoSol, typical clients are among the “richest of the poor” and the nonpoor (where poverty is based on access to a set of basic needs like shelter and education; Navajas, Schreiner, Meyer, Gonzalez-Vega & Rodriguez-Meza, 1998). Average loan balances for BancoSol and BRI are around \$500, while they are around just \$100 for well-known poverty-focused programs in Bangladesh like the Grameen Bank, Bangladesh Rural Advancement Committee (BRAC), and Association for Social Advancement (ASA).

6. Apart from the Indonesian BKDs (caveats aside), no programs that I know have achieved demonstrably outstanding outreach while achieving clear financial sustainability, but some like ASA appear to be doing remarkably well on both fronts (Rutherford, 1995). Mexico's Compartamos and El Salvador's Financiera Calpia also deliver impressive financial performance while serving poor (but not close to the poorest) rural clients. In urban Bolivia, both BancoSol and Caja los Andes serve a broad range of clients, including a minority that are among the "core" poor (Navajas *et al.*, 1998). Indonesia's BRI provides savings facilities to many relatively poor clients, although they are excluded from borrowing for lack of collateral.
7. At present SafeSave is covering operating costs but is not fully financially sustainable. It has only been operating since August 1996 and trends appear promising (SafeSave, 1998).
8. The idea is related to Hulme and Mosley's (1996) idea to charge "tapered" interest rates that fall with loan size—although the proposition would appear to conflict with their evidence that poorer households do not in general receive higher returns than richer households.
9. Hulme and Mosley (1996) suggest that impacts may be greater for less poor households. This provides additional support for sustainable programs in the calculation.
10. While Grameen no longer receives concessional loans from the Bangladesh Bank, they do receive guarantees from the government for the bonds that they now rely upon for the majority of their funding.
11. A related series of questions has been raised by van de Walle (1997), and Morduch (1999) provides a more comprehensive discussion of the empirical research agenda and cost-benefit studies.
12. See also MkNelly's and Dunford's (1998) work in Ghana. The argument about whether financially sustainable or subsidized programs have the greatest impact on poverty comes down to a question about the elasticity of demand for financial services with respect to their costs. This elasticity (and social impacts more broadly) can only be estimated with information on both participants and non-participants.

## REFERENCES

- Adams, D., Graham, D., & von Pischke, J. D. (1984). *Undermining rural development with cheap credit*. Boulder, CO: Westview Press.
- Banerjee, A., & Newman, A. (1994). Poverty, incentives and development. *American Economic Review (AEA Papers and Proceedings)*, 84 (2), 211–215.
- Brugger, E., & Rajapatirana, S. (1995). *New perspectives on financing small business in developing countries*. San Francisco: ICS Press.
- Christen, R., Rhyne, E., Vogel, R., & McKean, C. (1995). *Maximizing the outreach of microenterprise finance: an analysis of successful programs, program and operations*. Assessment Report No. 10, United States Agency for International Development, Washington, DC.
- Conning, Jonathan (1999). Outreach, sustainability and leverage in microlending: a contract design approach. *Journal of Development Economics*, 60 (1), October.
- Consultative Group for Assistance to the Poorest (CGAP). (1995). The missing links: financial systems that work for the majority. CGAP Focus, No. 3, October.
- Consultative Group for Assistance to the Poorest (CGAP). (1996). Microcredit interest rates. CGAP Occasional Paper, No. 1, August.
- Foster, J., Greer, J., & Thorbecke, E. (1984). A class of decomposable poverty measures. *Econometrica*, 52 (3), 761–766.
- Gonzalez-Vega, C. (1998). Do financial institutions have a role in assisting the poor? In M. Kimenyi, R. Wieland, & J. D. von Pischke (Eds.), *Strategic Issues in Microfinance*. Aldershot, UK: Ashgate Publishing.
- Hatch, J., & Frederick, L. (1998). *Poverty assessment by microfinance institutions: a review of current practice*. Microenterprise Best Practices Report, Development Alternatives, Inc., Washington, DC.
- Hulme, D., & Mosley, P. (1996). *Finance against poverty*. London: Routledge.
- MkNelly, B., & Dunford, C. (1996). Are credit services effective against hunger and malnutrition? – a literature review and analysis. Freedom From Hunger Research Paper No. 1, Davis, CA.
- MkNelly, B., & Dunford, C. (1998). Impact of credit with education on mothers and their young children's nutrition: Lower Pra Rural bank credit with education program in Ghana. Freedom From Hunger Research Paper No. 4, Davis, CA.
- Morduch, J. (1998). Poverty, growth, and average exit time. *Economics Letters*, 59, 385–390.
- Morduch, J. (1999). The microfinance promise. *Journal of Economic Literature*, 37 (4).
- Morduch, J., Park, A., & Wang, S. (1997). *Microfinance in China. Poverty and Development*. Beijing.
- Navajas, S., Schreiner, M., Meyer, R., Gonzalez-Vega, C., & Rodriguez-Meza, J. (1998). *Microcredit and the poorest of the poor: theory and evidence from Bolivia*. Department of Agricultural, Environmental, and Development Economics, Ohio State University, Columbus, OH.
- New York Times (1997). In Gulf casinos' wake, a pawnshop boom. December 13, A1, A13.

- Otero, M., & Rhyne, E. (1994). *The New World of Microenterprise Finance*. West Hartford, CT: Kumarian Press.
- Rhyne, E. (1998). The yin and yang of microfinance: reaching the poor and sustainability. *MicroBanking Bulletin*.
- Robinson, M. (1995). Indonesia: The role of savings in developing sustainable Commercial financing of small and micro enterprises. In E. Brugger, & S. Rajapatirana (Eds.), *New perspectives on financing small business in developing countries*. San Francisco: ICS Press.
- Robert, C., & Jennifer, M. D. (1998). *MicroBanking Bulletin*. Boulder CO: Economics Institute.
- Rutherford, S. (1995). *ASA: the biography of an NGO*. Dhaka: Association for Social Advancement.
- Rutherford, S. (1997). Informal financial services in Dhaka's slums. In G. Wood, & I. Sharif (Eds.), *Who needs credit? Poverty and finance in Bangladesh*. Dhaka: University Press.
- SafeSave, (1998). 30 September 1998 Update, Dhaka.
- van de Walle, D. (1997). Comment on rural finance in Africa: institutional developments and access for the poor by Ernest Aryeetey. In *Annual World Bank Conference on Development Economics 1996* (pp. 52–56). Washington, DC: World Bank.
- Woller, G., Dunford, C., & Woodworth, W. (1999) Where to microfinance? *International Journal of Economic Development*.
- Wright, G., Hossain, M., & Rutherford, S. (1997). Savings: Flexible financial services for the poor. In G. Wood, & I. Sharif (Eds.), *Who needs credit? Poverty and finance in Bangladesh*. Dhaka: University Press Limited.