The Great Divide in Microfinance: Political Economy in Microcosm

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As a scholar trained in international political economy (IPE), I cannot encounter the Great Divide in microfinance (Morduch, 2000) without harkening back to IPE's own grand chasm (Gilpin, 1987). The classical literature on schools of thought in political economy makes the same ideological arguments, accepts the same gross assumptions, and commits the same errors as its newer microfinance counterpart. There is considerable irony in this because one source of the great interest in microfinance lies precisely in its potential to bridge the ideological divide found elsewhere in the political economy of development (Weber, 2002, 2004).

This essay muses about those commonalities, identifies several issues central to the microfinance literature that were anticipated by the IPE literature of a generation earlier, and sketches some components of a research agenda for the analysis of microfinance that would be appropriate for IPE and development scholars.[2]

The Great Divide in Microfinance

Woller et al. (1999) and Morduch (2000) were among the first to discuss the existence of a "schism" in the study of microfinance.[3] While the exact dimensions that define this divide are stated differently by various authors, the existence of alternative schools of thought seems widely accepted (Brett, 2006; Bhatt and Tang, 2001; Mitlin, 2002; Robinson, 2001; Rhyne, 1998).

Morduch's (2000: 618) schism "between rhetoric and action" is defined narrowly around the necessity of subsidies.[4] On the one hand, the rhetoric employed by exponents of commercialized microfinance – such as the Consultative Group to Assist the Poor (CGAP) – associates subsidies with inefficiency, impermanence, and a limited scale of operations. Since subsidies are inherently unsustainable, programs not weaned from them must ultimately dissolve, and thus the compilation of "best practices" by CGAP eschews subsidy and embraces commercialization. Those commercialized MFIs which operate without subsidies are able to grow in scale to meet more of the nearly limitless demand for access to credit. The key performance criteria for this school of thought is "sustainability" and the practical essence of their position is that the best, perhaps only feasible, method of delivering microfinance services is through the quintessential market participant, the for-profit enterprise.

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[2] Similarly, Rankin (2002: 2) notes that : "The microfinance sector offers an instructive context for exploring the different programmatic implications of liberal and Marxian theories of social capital."

[3] A brief, readable, but rigorous introduction to microfinance is Matin et al. (2002).

[4] "[T]he two literatures [by practitioners and academic economists] have for the most part grown up separately and arguments have seldom been put into serious conversation with each other." (Armendáriz de Aghion and Morduch, 2005: x)

On the other hand, many practitioners doubt that unsubsidized credit delivered through the market can be cheap enough to benefit the poor, who are most often conceived as the target of microfinance. Even though well-known innovations, beginning with Grameen's group lending, have reduced costs, private firms motivated by profit still have not found this sector an attractive investment. Indeed, if they had, the microfinance phenomena would never have been born. NGO practitioners interpret the unavailability of financial services for the poor as an instance of "market failure" which reflects fundamental limitations of what markets and firms can contribute to poverty alleviation.

In particular, they contend that subsidies are necessary to fill the gap between the high transaction costs inherent in very small scale lending and the interest rates that can be afforded by the poor (and justified by the commitment to avoid usury). Without subsidies, lenders are forced to move upscale to richer clients that demand (and can service) larger loans, because fixed operational costs comprise a lower percentage of these larger loan volumes and thus allow lower interest rates. According to most practitioners, the trade-off is real between outreach – the number of poor successfully targeted – and sustainable financial performance – operating at break even or better – despite the rhetoric of microfinance proselytizers that it is illusory.[5] That does not imply a fixed trade-off, however, because "the exact relationship between financial self-sufficiency and depth of outreach in a given situation will depend on the way in which all these factors interact with each other. " (Woller and Schreiner, u.d. :3)[6]

Woller et al. (1999) notes that the schism cuts across many dimensions of the literature that go far beyond the question of sustainability. In my view, many writers have been too quick to turn these multiple issues into a single dichotomy, in part by invoking underlying philosophical, normative, and meta-theoretical considerations that incline individuals to gravitate toward one of two ideological positions. These poles are often represented as "welfarist" vs. "institutionalist" perspectives, encompassing cleavages on issues such as (1) the populations thought to be best served by microfinance (welfarists are concerned with the poorest while institutionalists tend to emphasize the entrepreneurial poor), (2) lending designs (the alternatives include individual, small solidarity groups, or large village banks), (3) institutional structure (options include NGOs, community-based credit unions and banks, commercial banks and finance companies, and state programs including rural development banks). The rigidity of views with respect to each is discussed below. Robinson (2001) refers to them as the "poverty lending" and "financial systems" approaches, respectively.

Acceptance of the necessity of subsidies is an element of a "welfarist" approach which is defined by the vision that microfinance is but one tool to achieve broad-scale social or human

[5] Morduch (1999: 1587) estimates that no more than 5% of all MFIs are profitable without subsidies.

[6] The trade-offs required by the dual goals of sustainability and broad/deep outreach include: serving urban over rural areas (to cut costs), emphasizing loan volume over portfolio quality, keeping field staff salaries low and work levels high (leading to high turnover and low morale), loaning mostly for retail trade and service with high cash flow and de-emphasizing manufacturing and fixed asset lending, making short-term loans rather than agricultural loans, and an "upward creep" in the prosperity of clients and loan sizes.

development. Consequently, the practitioners and development-oriented scholars who make up this school of thought naturally compare the performance of microfinance against various forms of foreign aid and other humanitarian programs that seek developmental outcomes.[7] My interview with Ryan Young of Common Interest International in Chang Mai, Thailand illustrated the perspective perfectly. His largest donors, a private family in Canada, viewed microfinance as a charitable contribution designed to solve development problems – and different from direct grants only in that the partially rotating fund leveraged their initial donation. Grameen and FINCA-style village banking are operational examples of MFIs associated with this viewpoint. They are firmly committed in principle to poverty alleviation and various other development goals; they support MFIs to the extent that they succeed in promoting those goals. But they remain open to the best means of achieving such goals and frequently combine microfinance with other programs to do so.[8]

The "institutionist" approach represents the opposite position. It views microfinance from the perspective of banking practices and its adherents remain transfixed by the potential of microfinance to surmount the four great problems of small-scale lending: high transaction costs, the difficulty of measuring risk, the cost of monitoring clients, and the absence of collateral. Adherents to this approach seem committed in principle to commercialized microfinance and more interested in determining its profitability than determining its impact on poverty.[9] Their efforts sometimes seem to welfarists like a solution in search of a problem. Woller associates it with "virtually all the literature coming out of the Ohio State University Rural Finance Program, the World Bank and its Consultative Group to Assist the Poorest (CGAP), and USAID. It is also found in the many writings of Maria Otero (ACCION International) and Elisabeth Rhyne (formerly of USAID) (see, for example, Otero and Rhyne, 1994). Most published literature in the field of microfinance espouses the institutionist view." Operational examples are BRI and BancoSol, the former a commercial branch of a state-owned bank and the latter a commercialized successor to an NGO.

The antecedents of both approaches, but now more closely identified with the welfare orientation, lie in the early government rural credit programs that proliferated in the 1960s and 1970s. Their operations may be characterized as constituting a "productive" approach, because they were introduced in the context of overall efforts to improve economic productivity through technical assistance, "green revolution" technologies, irrigation, etc. (Tapella, 2002). Rural (mostly agricultural) finance was the instrument for achieving that productivity, often dangling loans as incentives for individual farmers to adopt whatever innovation was thought likely to achieve the various goals embraced by particular government programs. Of course, real financing

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[7] Of course, there is real controversy over whether government programs should engage in private subsidies at all when there is evidence that investment in public goods (R&D, education, environmental assets, and infrastructure) produces much better results (Lopez and Galinato, 2007).

[8] This does not mean, of course, that they fail to recognize the importance of management issues or the relevance of financial markets that are emphasized by institutionists.

[9] This does not mean, of course, that they are uninterested in poverty outcomes, but only that their expertise and interests incline them toward addressing the more institutional aspects of the microfinance project.

needs lay beneath that leverage: the informal finance usually available in rural areas (money-lenders, family finance, local cooperatives, etc.) were clearly insufficient because the volumes were too low and the costs too high (in part to compensate for the covariant risks of any local finance which can't be broadened over space). Furthermore, financial products were limited and short-term.

Gonzalez-Vega and Graham's (1995: 3) view is indicative of the OSU critique of rural development banks:

> "Governments have frequently attempted to use financial markets to pursue a broad range of nonfinancial objectives, with disastrous consequences (Adams, Graham, and Von Pischke, 1984). Prominent among the reasons for the generalized failure of most state-owned agricultural development banks were precisely attempts to use them as instruments to promote a number of (development) objectives (growth of agricultural production, adoption of new technology, agrarian reform and regional development) at the expense of sound financial intermediation, when such directives created excessive costs and risks for the organizations. Moreover, arbitrary (politicized) criteria adopted in the approval of loans contributed to worsen, rather than improve, resource allocation."

This critique, and the response to it, mirrors the broader neo-classical economic literature in emphasizing the familiar goal of "getting prices right" so as to avoid decision distortions. In so doing, it decries any goal other than narrowly-conceived efficiency as a dangerous impediment to "best practices". It also insists upon a universality of principles rooted in faith in the orthodox theory that free markets must maximize welfare and the conviction that the modern corporation is the embodiment of that goal-oriented behavior. In the words of Rhyne and Otero (1994: 11):

> "The principles behind the emerging techniques for offering financial services to the poor are the same as those found in any financial system ...[10] These principles require the institution to break even or turn a profit in its financial operations and raise funds from non-subsidized sources."

In response, the later financial market or institutionist approach shifted the focus to finance itself, with market interest rates, a smaller role for the state, and an abandonment of the other elements of development to focus more narrowly and effectively on finance.[11]

A welfarist would note the comparison of microfinance to other financial systems in the above quote and offer the rejoinder that "the principles behind the emerging techniques for offering financial services to the poor are the same as those found in any" *development program*

[10] "...and involve ... a market perspective that understands the preferences of the client group and designs products to meet them; a recognition that savings can be as important as credit for micro enterprises, financial institutions, and the economy; and insistence that financially viable institutions provide only financial services..."

[11] Of course, more recently even many "institutionalist" programs have embraced partnering with other agencies or programs that can provide some of those other elements.

designed to help the poor.[12] In effect, we see here the extent to which microfinance is less the arena in which the fields of finance and development *converge* than where they *collide*. For example, consider that Gonzalez-Vega identifies four problems with state-owned rural banks, one of which is that they are reliant on agriculture, an inherently precarious sector. From the standpoint of running a successful bank, this critique is fair enough – if you are expecting stable profitability, agricultural clients are, indeed, a poor choice. But from the standpoint of alleviating poverty, your choices are limited because agriculture is what the poor do. More than half of the world's poor are employed in agriculture or live in rural areas where their best hope for employment lies in agriculture (World Bank, 20??). If you run away from agriculture, you are running away from the problem.

These microfinance approaches mirror political economy concerns over how human interactions should be ordered, especially with respect to the allocation of goods and other things of value. The Great Divide in Microfinance is fundamentally a clash over whether financial services for the poor should be provided by market-oriented private firms, state-run development banks, or NGOs, which are said to represent broader societal interests and values. This choice merely reflects deeper disagreements that have ideological counterparts in the political economy literature.[13]

In political economy, the central issue is whether allocation should be performed by the market, by the state, or by institutions of civil society (Best and Connolly, 1982). Allocation can occur through different processes, in accordance with different institutions, expressing different values or priorities, and generating different norms and standards of behavior. In economic processes centered on the market, individuals buy and sell according to their wealth. In political processes centered on the state, individuals acquire opportunities, rights, and income according to their access to political power. In social processes like those of civil society, individuals acquire things of value according to convention or the goodwill (or power or obligation) of others. The latter is the academic province of sociology and anthropology, whereas the first describes the venue of economics and the second the realm of political science.

The ideologies of political economy

Political economy re-emerged as a multi-disciplinary field in the 1970s after a century of division between its economic and political side (). When it did, its agenda was dominated by the conflict over alternative and competing mechanisms of allocation, especially between the state

[12] Similarly, Littlefield and Rosenberg (2004) have written on "breaking down walls between microfinance and formal finance" but not on breaking down walls between microfinance and development.

[13] Of course, those who engage microfinance positively represent a limited portion of the ideological spectrum. It is not hard to recognize the extent to which the rejection of microfinance altogether is also rooted in these same broader traditions of political economy, as exemplified by McDermott (2001: 72): "One might say that microfinance fits the neo-liberal framework like a glove on a fist, snugly adhering to its values while threatening none of its power."

and market. The iconic formulation of Robert Gilpin (1987:25) defines the field as conceived in its first two decades of re-birth:

> "It may not be an exaggeration to say that every controversy in the field of international political economy is ultimately reducible to differing conceptions of the relationships among society, state, and market."[14]

Those conceptions have hardened into ideologies – liberalism, mercantilism, and Marxism in Gilpin's scheme –

> "because each position entails a total belief system concerning the nature of human beings and society.... [and] intellectual commitments are held tenaciously and can seldom be dislodged by logic or contrary evidence. This is due to the fact that these commitments or ideologies allege to provide scientific descriptions of how the world *does* work while they also constitute normative positions regarding how the world *should* work."

The institutionist approach to microfinance can be seen as one expression of the (neo-) liberal perspective embodied in orthodox economics.[15] No brief caricature can do justice to the deep and rich tradition of liberalism, which predates Adam Smith, its earliest evangelist, but the following tenets help to define its main elements. Markets should be free from political interference by the state so as to achieve efficiency, growth, individual welfare, and freedom. The system rests on individual rationality, a materialist conception of utility, and the conviction embodied in Smith's "invisible hand" that individual pursuit of self-interest yields maximization of aggregate welfare. Markets arise naturally and tend to stability while "market failure" is rare. If all of these premises are accepted without reflection – as is usually the case for ideologies so strongly held that they are seldom even noticed and so cannot be acknowledged by their advocates – the case for commercialization of microfinance follows.[16] The Great Divide in microfinance exists precisely because virtually all economists largely share those premises, whereas one must look long and hard to find a political scientist, sociologist, or anthropologist who does not instinctively reject them.[17]

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[14] Thus the title of Susan Strange's influential introduction to IPE, *States and Markets* and Herman Schwartz's later book *States versus Markets: The Emergence of a Global Economy*.

[15] Weber (2004:360) is most explicit: "As a 'micro-level' strategy it [microcredit programmes] mirrors at the 'local' level the wider trend of neoliberal restructuring and can be understood in terms of a process that seeks to establish on a global scale the (legal) political framework for the trade in financial services agenda more specifically."

[16] Indeed, as Weber (2002) puts it, "The idea that microcredit - as the road to self-reliance—is an effective intervention for the 'empowerment of women' in particular, and poverty reduction more generally, has come to occupy the status of a hegemonic discourse."

[17] An elaboration of the critique of the economistic conception would carry us too far afield (Fallows,1993; Polanyi, 1944; Rodrick, 1997)

In political economy traditions, the strongest competitor to the market is the state.[18] Its advocates lead with doubts about the normative foundations and actual performance of markets, but quickly follow by noting the special strengths of the state. According to standard democratic theory, the state represents the broad interests of all citizens (with an implication that it does so more or less equally) – and is the only institution to do so (Dahl, 1998). Often, there is an implicit "social contract" which mythologizes a necessary link between the needs of society and the behavior of the state, as in Hobbes, Locke, and Rousseau.[19]

The tenor of the center-left literature on the political economy of the state tends toward the evangelistic, especially in those treatments that embrace a romantic, idealist conception of the state. These include Polanyi (1944), who sees the state as the instrumentality of society as a whole (acting to protect society from the "satanic mill" of an unregulated market), German conceptions of the *volkgeist*, and American liberal ideology, which spreads the myth in a form that attributes it to the state's democratic character. Oddly, the importance of democracy is often lost, even though the democratic mechanism is clearly central to the conception of a marketplace of ideas that yields the consensus which is implemented by a Weberian bureaucratic state through technocratic state personnel. Without democracy, it is hard to sustain the conviction that the state acts differently than – and morally superior to – the market, which focuses on only materialist values and aggregates them to achieve societal outcomes through a wealth-weighted algorithm. This is a point not lost on critics of state-run microfinance, whose expectations of the non-democratic states that administer many of these programs could not be lower.

More pluralist views share the general expectation of a state that operates in the public interest, though it attributes it to the leverage "the people" have over politicians that compete for their vote with good policy. A marketplace of interests is not as romantic as a marketplace of ideas, but a state that functions as a neutral arbiter of the interests of the many will reflect the balance of power in society, which pluralists assume to be relatively egalitarian. Thus, it is likely to produce bargained outcomes among organized interests in civil society which are generally moderate.

Such pluralist perspectives on the state form the core of development theories which emphasize state-planning and other quasi-mercantilist statist programs. If accepted, these democratic-pluralist premises lead to a belief that state-run microfinance institutions would outperform commercial ones, in part because such values as equity, empowerment, and long-run development would receive their due consideration, especially where markets regularly fail. Even

[18] For one attempt to apply political economy views of the state to microfinance, see Fernando (ud).

[19] Of course, their conceptions of those needs could hardly be more different, with some emphasizing security issues and others welfare considerations. The more modern empirical literature on the origins of the European state tend to be more rooted in the security needs that led to the Westphalian state, but the need to accommodate domestic power relations and local conditions obviate any universal expectations for the character or behavior of the variegated states that resulted. The literature on the origins of the Asian state is more diverse yet (Hui, 2005).

where they do not, the center-left hopes for a populist (and more expansive) state that will act as a check on the power of a market that inevitably benefits the wealthy. The center-right, by contrast, fears that state efforts to be "fair" will degenerate into populism that embraces redistribution, which will inevitably compromise the efficiency goal and growth.

'New institutionalist' writers, claiming allegiance to Weber, reject these society-centered understandings of state behavior as a reaction to the political activities of groups within society, such as classes or interest groups. They emphasize the autonomy of the state from social forces, seeing state personnel as just another set of interest groups with interests and values of their own, which they can and do pursue independently (at times in conflict with) actors in civil society. Some conservative writers, including institutionists who attack state-run MFIs, would seem to belong in this camp because their hostility to the state doesn't seem to emanate from worries about societal influences (Friedman, 1962) . Though they do express some concern about capture of the state by civil society actors (unions, trial lawyers, "radical humanists", and liberals in general), their greatest target seems to be generic bureaucrats. Most other adherents to this view find that universal expectations are unwarranted and that empirical analysis is required, since state behavior is fundamentally molded by the institutions in which it is embedded and it is likely to vary with circumstances.

While the early, predominantly centrist, political economy literature was dominated by such "state vs. market" clashes, the most theoretically sophisticated critique of the state and the most vehement attack on the market both came from the left (Gold, Lo, and Wright, 1975).[20] The same appears to be true of the critical literature in microfinance. At its most extreme, this perspective is represented by the instrumentalist Marxist contention that the state is the "executive committee for managing the common affairs of the whole bourgeoisie" (Marx and Engels, 1848) and therefore incapable of correcting "market failure" (Sweezy, 1942; Miliband, 1969). As a practical matter, this view rules out the possibility that the state could act against the interests of dominant economic actors, which would seem to preclude any optimism that state-run banks could challenge the dominance of formal financial institutions in micro-finance (or anywhere else). Hegelian and Gramscian traditions would emphasize that such dominance would take the form of theoretical hegemony, in which the superiority of private finance is pronounced as an objective fact, dissent from which is seen as not just mistaken but positively delusional. CGAP's bid for theoretical hegemony seems an obvious example.

Structuralist Marxists also reject the democratic-pluralist view of the state (Poulantzas, 1969; O'Connor, 1973). As Baran (1968) puts it, "Mechanically, one could list the steps a state could take to correct market outcomes, but the exercise would reveal the utter implausibility of the view that they could be carried out by the governments existing in most underdeveloped countries...The crucial fact rendering the realization of a developmental program illusory is the political and social structure of the government in power." While dodging the question of whether

[20] The less charged critiques of the state from mainstream economists emphasize its capture by rent-seeking actors that misuse its authority, distort incentives, and frustrate the growth dynamics of the self-regulated economy (Krueger, 1974; Olsen, 1982).

the Northern state should be identified as more capitalist than democratic, this more empirical perspective underlines the absence of any good reason to expect that Southern governments would advance the interest of the mass public against more powerful actors. Such a structural understanding informs critics of microfinance who see it as a thinly disguised effort to coopt those who would otherwise direct their rage at development failures toward a more fundamental, radical, and system-threatening critique.

If no pluralist-democratic state exists, some other agency to avoid the limitations of markets must be found.[21] The most famous candidate historically is the vanguard Communist party of Marx or Lenin, but in the modern era this role is fulfilled by the various institutions of civil society, represented at the international level by values-oriented non-governmental organizations (NGOs), the vaunted "third force" (Florini, 2000). Like the case for civil society more broadly, the argument for NGOs rests on the importance of "social capital" as a macro-developmental force as potent as the standard classical factors of production in micro-economics – land, labor, and capital (World Bank, 2006).

Neoliberal theories are little more tolerant of NGOs than states, however. Their basic conviction remains: "markets function most efficiently when drained of social content and encumbrances" (Skidmore, ud). Critics from the left question the ability of NGOs to avoid the limitations of all organizations (Petras, 1997; Cooley and Ron, 2002).

Gilpin (1987) argues that political economy is the struggle between these alternative methods of social organization – the state, the market, and civil society.[22] Each tries to control the world and organize it according to its own principles. Each supports some values and opposes others. Each has developed theories and ideologies to support its case that it represents a superior form of organization. Each operates to benefit some groups and harm others. Thus, each has allies. Political economy is the study of the struggle between these "imperialistic" forces. So is the Great Divide in microfinance.

What lessons can microfinance learn from political economy?

There are at least six, discussed more thoroughly below.

1.We must avoid polarizing attitudes, false comparisons and over-simplifications. Great Divides are usually more apparent than real, the product of an inherent need to achieve simplicity in the face of complex arguments. But reducing multiple controversies into a single rigid ideological division impedes conversation and progress.

[21] These limitations include the "market failure" acknowledged even by neo-classicals as well as the more extensive "ravages of the satanic mill" which Polanyi (1944) associates with unregulated markets.

[22] O'Loughlin (2002) sees a second generation of IPE emerging in the early 1990s which accepts the mutual dependence of state and market rather than competition between them, as well as an important role for NGOs in governance. A decade later a third generation dissolves distinctions among politics and economic altogether.

2. Forms of organization are not as important as ideologues think. To subsidize or not to subsidize is not the question. Successful microfinance can – and has – occurred in state-run programs, for-profit firms, and NGOs; it is not exclusive to any one type. We must focus on the methods used by successful organizations, not their organizational form.

3. We must place the diagnosis of poverty before the solution to poverty. A proper diagnosis is logically prior to treatment, but much of the writing and practice in the institutionist vein has *assumed* that the lack of credit was responsible for poverty. We cannot ignore either the general theory that identifies the requisites of development nor the specific presence or absence of those requisites in individual cases.

4. Our research should seek explanations for variance rather than universality in microfinance experiences. We can be certain that microfinance works sometimes and not others; we should focus on the "when" rather than on the "how much". Even the importance of scale is conditional.

5. We must take seriously differences of opinion about the appropriate goals for both microfinance and development. Microfinance has become a meeting point for a wide variety of scholars and practitioners who have commuted large theoretical distances, but they have not lost their values and interests during their journey. Misunderstandings can be avoided by careful attention to translations.

6. We must join empiricism to theory by conducting proper evaluation studies to establish truths rather than relying on ideology. Deeper understanding of microfinance impacts will follow from a better specification of "process tracing", identifying the mechanisms or channels through which effects are conducted.

The dangers of over-simplification and polarization

The construction of "schools of thought" can be very helpful as an organizational device to characterize a wide-ranging literature, but it should not be taken too seriously for at least two reasons. First, schools of thought are gross simplifications that invariably conceal differences within groups and exaggerate differences between groups. Second, these constructions encourage the formation of ideological positions that can be very difficult to break through.

Both tendencies impede honest exploration of the underlying questions and the sharing of ideas among potentially cross-fertilizing groups. This is especially damaging in an area like microfinance where different intellectual traditions and academic specializations must meet, because ideologies form so easily when pre-existing divisions invite "us-them" visions. That has clearly occurred in IPE, where the economics vs. politics divide has never really narrowed and continues to impose real constraints on conversation and therefore intellectual progress (Rao and Woolcock, 2007). Indeed, it often appears that fighting the ideological and disciplinary battles has become more important than solving the underlying problems.

For studies of microfinance to fulfill their potential to energize the intersection of financial economics and the other social sciences, it is imperative that they de-emphasize ideological divisions or actively seek to bridge them. We are not off to a good start.

One pole is defined by CGAP (1996), actually written by Richard Rosenberg, which lays out the “best practices” concerning financial sustainability that allow “win-win” optimism for institutionists (Morduch, 2000: 619). Those “best practices” are served on a bed of pure neo-liberalism: Financially sustainable programs can make the greatest dent in poverty due to their scale, which is attained through access to commercial financial markets, which in turn requires a minimal level of profitability. Subsidized programs are inefficient and thus bound to fail. Government programs do not work.[23]

Critics from the opposite pole are already put off by the language of “best practices”, which implies far greater certainty and universalism than seems warranted by the absence of rigorous evaluation studies, a persistent theme of the remainder of this essay to which we will often return. The focus on financial self-sufficiency is seen as overly narrow and suspiciously in tune with neo-liberal values, interests, and perspectives. Motivations are questioned in a way that makes conversation stilted where it occurs at all. Consider Woller’s take on the issue:

> “According to Elisabeth Rhyne (1998, p. 7), for example, ‘Sustainability is but a means to achieve [outreach]. . . . Sustainability is in no way an end in itself; it is only valued for what it brings to the clients of microfinance. This is a point on which the 'poverty' camp frequently misstates the motives of the 'sustainability' camp. It would do wonders for the state of the debate if the poverty camp more readily acknowledged that the sustainability camp values sustainability only as a tool.’ While we do not doubt the sincerity of Rhyne's avowal, it is contradicted both in the writings of leading institutionist writers and in the internal logic of their arguments.”

The reaction of such welfare-centric scholars is no doubt a consequence of their prior engagement with the ideological battles in political economy, where the most complex of social phenomena and the theoretical ideas surrounding them have been reduced to comic books. One example concerns the famous “Washington consensus”, a kind of “best practices” compilation of neoliberal development policy established by the IMF, World Bank, and U.S. Treasury early in the Reagan years and still the dominant paradigm in many economics circles (Gore, 2000).

A leading advocate who coined the phrase, John Williamson (1990?1993: 1329) described the Washington Consensus as a “universal convergence” and “the common core of wisdom embraced by all serious economists,” though it was, of course, nothing of the sort in the Global South or among development scholars. It was, however, widely applied in exactly the imperialist manner discussed by Gilpin. Indeed, Williamson (1990) acknowledged that “none of the ideas spawned by the development literature ... plays any essential role in motivating the Washington

[23] Also assumed: households require *access* to credit, not cheap credit, a proposition supported by the observation that raising the costs of financial services does not diminish demand. Subsidized credit most often ends up in the hands of the non-poor. Subsidizing credit undermines savings mobilization.

consensus" which constitutes an "implicit dismissal of the development literature as a diversion from the harsh realities of the dismal science". Many economists who thought they were pretty serious in their critiques of neoliberalism were deeply offended by Williamson's dismissal of them as "cranks":

> [T]he superior economic performance of countries that establish and maintain outward-oriented market economies subject to macro-economic discipline is essentially a positive question. The proof may not be quite as conclusive as the proof that the Earth is not flat, but it is sufficiently well established as to give sensible people better things to do with their time than to challenge its veracity (p. 1330).

It is no wonder that a leading textbook of international political economy (Lairson and Skidmore, 2003: 12) observes that "the arguments of (neo)liberals sometimes extend beyond respecting to worshiping markets." Nor is it surprising that Fallows (1993) comments that:

> The Anglo-American [liberal] system of politics and economics, like any system, rests on certain principles and beliefs. But rather than acting as if these are the best principles, or the ones their societies prefer, Britons and Americans often act as if these were the only possible principles and no one, except in error, could choose any others. Political economics becomes an essentially religious question, subject to the standard drawback of any religion – the failure to understand why people outside the faith might act as they do."

Certainly, the study of microfinance must avoid the certainty of ideologues, especially when we have such limited empirical evidence. Three kinds of pernicious simplifications well known in the political economy literature should be avoided in dealing with microfinance, especially so as to prevent the hardening of potentially complimentary viewpoints into competing and impenetrable ideologies.

First, we must avoid false comparisons when using theoretical ideas as counterfactuals to critique current microfinance institutions. For example, the political economy literature is full of descriptions of the failures of import substitution policies in Latin America, which are then compared to what liberal theory says about the (hypothetical) effect of free trade. On the other side, the dismal record of stabilization policies through the IMF is paired with the theoretical benefits associated with a (hypothetical) program that was more sensitive to state concerns. The lesson is clear: "actually existing" arrangements can never meet the standard of "theoretical" alternatives. Yes, state-owned rural development banks did not perform as well as liberal theory indicates a modern, efficient, commercial bank would have. But it is equally true – and equally irrelevant – that "actually existing" commercial banks underperform the ideal public-sector bank described by statist theory. Empirical comparisons are the appropriate method of adjudicating such disputes – but, as importantly, the very insistence that such disputes must be cleanly adjudicated is itself part of the problem. It is not at all clear, as we see below, that the ownership form of the MFI is an especially important determinant of its success.

A second "apples and oranges" comparison occurs when policies or institutions are evaluated according to criteria that do not match up with their goals. Liberals, who espouse growth goals, laud the superiority of liberal policies because they generate faster growth than statist policies. State-planning theorists, who espouse equity goals, laud the superiority of statist policies because they achieve greater equity than liberal policies. Since both can be right (or wrong), lowering the volume of the chest-thumping might produce a dialogue with more satisfying outcomes.

Similarly, it can't be a surprise that commercial banks which are structured to achieve profit are closer to profitability than NGO programs structured to empower individuals or alleviate poverty. But that can't be the end of the analysis. It is a lot easier to run a bank than to end poverty. Thousands have done the former; almost no one has done the latter. Poverty is persistent and hard to eradicate. We don't expect a high success rate for any institution in doing it – including microfinance. Thus, even if we find lackluster poverty impact records for MFIs, they must be seen in the context of the records of other poverty efforts. Indeed, as we see below, such comparisons might be brought directly into the evaluation process by including microfinance (with its lending logic) in an experimental format paired against something like the Heifer Project's "pass along the gift" motif.

Third, we must acknowledge that many debates in microfinance should be seen in terms of differing levels of analysis (Singer, 1961). In effect, the "double bottom line" contains one set of goals – sustainability or profitability – that are expressed at the level of the program or firm and a second set – poverty alleviation, empowerment and the like – that makes sense only at the level of the community. Not only does this imply that evaluations must encompass both levels and that success must be achieved in both domains, but it also reminds us that considerable slippage occurs between them in our theoretical accounts.

For example, microfinance proponents often attribute microfinance's success to the fact that joint liability schemes eliminate the costs of evaluating clients and monitoring the performance of their micro-enterprises. Not true. Marr (2004) argues that such functions are still performed and that they are still costly, but that the burden has been shifted off of the bank and onto civil society, as the costs are now expressed in units of lost social capital rather than money.[24] Monitoring takes time and social sanctions undermine trust and affect social interactions. Are friendship patterns disrupted by selection or non-selection in group? By failures to repay? By monitoring performance? We cannot ignore social psychology and non-economic effects in our zeal to achieve income gains – and that requires a conscious balancing of effects that arise at both the firm and societal level of analysis.

These simplifications and the dangers of lumping disparate issues into a single dichotomy are most obvious in the debate over the proper form of microfinance institution.

[24] Nor are these functions necessarily performed well by joint liability groups, because the motivations of participants are divided between microfinance-related incentives and other factors, including structural power among group members and family as well as questions of social status.

Forms of organization and the issue of subsidization

The Great Divide in Microfinance is most easily defined in terms of controversies over which of the ownership forms (and the program attributes that flow from them) are most likely to achieve success. While plausible arguments have been formulated by proponents of each of the main forms – for-profit firms, states, and NGOs – there are theoretical, empirical, and practical reasons to doubt that any such generalized answer is possible.[25]

From the institutionist camp comes arguments that seem to be translations from the conservative wing of the broader political economy literature: the state and other non-profit or subsidized enterprises are doomed to inefficiency. 'Nancy Barry of Women's World Banking (CGAP, 1995) asserts, for example, that ``few low income entrepreneurs end up benefitting from subsidized programs, because these programs fail before they reach significant numbers.'... (Morduch, 2000:623) But, as Morduch notes, "this is hard to reconcile with the experience in Bangladesh to date, where subsidized programs like the Grameen Bank and Bangladesh Rural Advancement Committee, for example, have together reached around four million borrowers." Furthermore, the state-run IRDP of India is about 4 times that size. The highest penetration of the poor reached by micro-finance occurs in Thailand, largely through the efforts of the state-run BAAC. Robinson (2001:xxxi) explains that "Because subsidized programs are constrained by their budgets, relatively few borrowers can be served." Yet, *all* organizations have budget limitations and, as Robinson herself points out, Indonesia's state-run BRI is exemplary. The contrary findings of Rosenberg (2006) – that the projects involving the most government involvement perform the worst – deserves greater scrutiny.[26]

Why can't government programs work? Good microfinance is said to be difficult for governments because the soundest principles (high interest rates, exclusion of high risk borrowers, vigorous enforcement) are not politically popular, so the program needs to be insulated from political forces. Also, state-run programs are vulnerable to political intrusion, including loan

[25] Mitlin (2002: 176) summarizes. "A broad sweep of history suggests that there are three sources of development finance for pro-poor activities, in addition to the funds of the poor themselves: market investment funds, state redistribution and charitable contributions....[T]heir presence shows remarkable persistence. Markets have existed in some shape or form for millennia... States have been equally persistent.... On many occasions, these states have had a redistributive role. They have sought to provide for those in need and not as able as others to provide for themselves. At the same time, people have felt a direct empathy with those in need. Charity also has a long and persistent role in human society and is a central tenet of most of the world's religions." This essay does not treat informal credit, which is most often provided by family and friends, nor the range of revolving funds and cooperatives described by Armendariz de Aghion and Morduch (2005: chapter 3) and critiqued by Rosenberg (2006:6) – the revolving fund "project practically never works well: most of the revolving funds don't revolve for very long, because defaulters expropriate the resources that were meant to fund lending services for all group members over time."

[26] He also finds that savings and insurance are easier than loans, and that multi-component projects in which microfinance is but one element don't do as well as pure microfinance. "In the final analysis, the quality of technical input and management that the microfinance activity receives is more important than the project structure. Nevertheless, the important point is that microfinance components in multisector projects are less likely to get strong technical input and management. "

forgiveness. Woller identifies the origin of this "institutionist" position in the interpretation by researchers at OSU's Rural Finance Program of governmental rural development institutions in the 1960s and 1970s, not recent ones : "From the beginning these RDIs were plagued by a number of problems, including a grant mentality among clients, high overhead and transaction costs, and heavy corruption." They also suffered poor repayment rates and concentration of subsidies to the already rich. Gonzalez-Vega (:15) diagnosed the problem this way: "No one was concerned with viability, as available (donor and government) funds were apparently abundant. This was a model of the development bank as a top-bottom conduit to disburse funds from outside sources; it was expected to be "successful" only as long as the external resources lasted."

Beyond the influence of ideological predispositions, it is not at all obvious why we should attribute these failures to "stateness" when the alternative explanation is just that they were the first attempts at organized rural finance, from which we have subsequently learned. Barry argues that what we have learned is that we "cannot depend on governments and donors as reliable, long-term sources of subsidized funding." Really? But what is the evidence that they fail or that outcomes are bad when they do?

It is far from clear that subsidization precludes "sustainability", if that refers to the actual continuation of programs rather than a formal accounting concept concerning covering costs. After all, program sustainability and financial self-sufficiency are two different things, since measures of the latter typically exclude subsidies from actual revenues and add imputed (market) rates of interest to actual costs. Any relationship between sustainability and self-sufficiency should be argued theoretically and established empirically.[27] On both grounds, we have reason to doubt that the institutionist perspective relies on anything more than what Mitlin (2002: 175) refers to as "somewhat incredulous faith in markets", akin to the worship seen by Lairson and Skidmore.

Morduch (2000:619) denies that subsidized programs are necessarily doomed to fail, because he questions "the belief that 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." Donors are as rational as any other investor and will value efficiency in "bang for the buck" terms even if the bang is measured in outcomes other than profitability. As a result, subsidized programs do not seem to be inherently inefficient or short-lived. Robinson (2001: xxxi) dismisses Grameen – "the poverty lending approach has required large amounts of continuing subsidies and has not proven a globally affordable model" – without acknowledging the fundamentally ideological meaning assigned to "sustainability" or "affordable". In point of fact, the continuation of the subsidies enjoyed by Grameen seem to establish the point that they *are* sustainable by the soundest possible empirical criteria – that they have actually been sustained! The Grameen family now consists of more than two dozen organizations and its

[27]Mitlin (2002: 175) wonders whether sustainability is necessarily a good thing? "Looking more broadly at the present scale of environmental destruction, social inequity and exclusion, war and natural disaster, it might be argued that there is little that we should aspire to sustain."

microlending program has reached more than five million borrowers (Grameen, 2007).

Moreover, non-profit organizations are quite ubiquitous in areas outside of micro-finance and the theory of shadow prices computed in connection with net social gain, transaction prices, and the like is quite well developed (Thys et al., 2005). Many NGOs are seen as highly efficient and it is not obvious why their success in other development areas can't be duplicated in micro-finance: FINCA, CARE, Catholic Relief Services, Save the Children, Christian Children's Fund, Red Cross, United Way, March of Dimes, and Greenpeace. Freedom from Hunger has operated since 1946 through subsidies.[28]

Gonzalez-Vega contends that "in order to survive, the agricultural development banks must first emphasize their role as financial intermediaries." Even if he is right, why can't that be done as easily by government banks as commercial ones? The doubts about the effectiveness of non-profits seem especially ironic given their source: Most of these writers are employed by public universities, international organizations funded by states, and NGOs! The absence of a bottom line can't be the major problem; if these individuals have managed to somehow produce excellent work despite the nature of their organizations, why can't the same be done in microfinance?

Similarly, Morduch (2000: 619) acknowledges the failures of some past efforts with subsidized credit but draws the lesson that what is required is "efficiency, transparency, and appropriate management incentives," outcomes not exclusively associated with any particular form of MFI. He denies that subsidization, inefficiency, and limited scale go hand-in-hand, and that governments cannot achieve success. Again it is striking that CGAP, an IO, has been a leader in improving functionality, as has the LINKS program of Catholic Relief Services (Dingcong, 2004).

The welfarist perspective is similarly a recreation of an ideological perspective deeply rooted in political economy conceptions. Woller states the case with unusual candor: "In a philosophical sense the fear is that the commercialization of microfinance will divert the industry from its 'spiritual foundation,' which was and is the movement's animating force. The result is a profitable but soulless endeavor." Woller's concern is understandable, but it may be misplaced. The first mistake made by Woller will be hard to see for most welfarists: the 'spiritual foundation' is not necessarily THE animating force for microfinance and it definitely is not the only one. Without the promise of eventual profitability, microfinance is just another form of aid – and interest in aid has been declining, not rising, in recent decades. Welfarists must be more open to accepting multiple goals as legitimate. The second error is the seemingly knee-jerk equation of the market with a soulless endeavor. As we see below, commercial enterprises are not the only entities which feel competition that could drive them away from operations focused on the welfare of the poor: government programs and NGO's also face such competition.

[28]As Rich Rosenberg of CGAP (2006:4) puts it, "The main risk in funding microfinance projects does not come from borrowers' willingness or ability to pay their loans, but rather from uncertainty in predicting the future competence of microfinance managers. "

The emphasis on sustainability and, especially, generating high repayment rates and other performance indicators that would make MFIs attractive to formal financial markets, have developmental implications beyond forcing lenders up the income curve to avoid the poorest and riskiest. It also encourages rapid profitability of enterprises over those with greater developmental potential – low-risk, quick-return trading as opposed to longer-term, asset-deepening goods- or services-production, for example. Small loan sizes may even create the perverse incentive to use cheaper, but less productive, technology, thus eroding productivity.

Woller regards this commitment to a particular form of service delivery to be dangerous to experimentation and diversity in MFI operations because it has become hegemonic through evangelism. The result is that microfinance is moving toward commercialization, larger loan balances, more individual and less group lending – in short, becoming less distinctive from formal financial sectors. This is true in other respects as well. For example, Rosenberg (2006:5) observes that the United Nations Capital Development Fund (UNCDF), which supported microfinance operations for UNDP, used a model called "MicroStart" that produced great success, illustrating that technical competence and good administration can flow as easily from an NGO as a commercial operation. Littlefield and Rosenberg, 2004 observe that "Most leading MFIs operate today on a commercial basis using the techniques and disciplines of commercial finance. They are investing in more sophisticated management and information systems, applying international accounting standards, contracting annual audits from mainstream auditing firms, and seeking ratings from commercial rating agencies. Last year, rating agencies, including industry leaders Standard & Poor's and Moody's Investors Service, carried out over 100 credit ratings of MFIs."

There are no shortage of writers arguing for a middle ground in creating effective MFIs, an approach which would be made much easier if we could call off the ideological war between the market and the state. Padhi (2003) suggests marrying the capacity of NGOs as "change agents" defined broadly with that of banks as financial intermediaries. NGOs have a crucial role in group formation, capacity building, credit absorption capacity, social intermediation (making the poor more productive and better risks), skill development, etc. Littlefield and Rosenberg (2004) detail a range of models of cooperation. Lapenu (2000) offers a description of the appropriate state role.

Two developments may make a cease fire between opposing camps a little easier to achieve. First, between the classic political economy division of state vs. market, which corresponds to a left/right ideological cleavage, lies civil society and the actor which exemplifies it at the global level, the international non-governmental organization (NGO). The controversial position of NGOs, which have been extremely active in microfinance, disturbs the neat symmetry of a state vs. market dichotomy (Bornstein, 2004). Second, the boundary between state, market, and civil society – between state-run agency, commercial bank, and international NGO – are rapidly eroding.

Civil society has occupied an important role in development discourse at least since Putnam's famous popularization of "social capital" as a significant resource for development. "Social capital" is to civil society what "power" is to politics or "wealth" is to markets.

> "Social capital refers to the institutions, relationships, and norms that shape the quality and quantity of a society's social interactions. Increasing evidence shows that social cohesion is critical for societies to prosper economically and for development to be sustainable. Social capital is not just the sum of the institutions which underpin a society – it is the glue that holds them together." (World Bank 2001)

In the latter sense, social capital reminds one of the "dark matter" in recent theories of the universe after the Big Bang. While it cannot be seen, attempts to make sense of certain visible movements are made much easier by assuming that it is present. Putnam argues that a vibrant civil society populated by institutions that bind the population together contribute to development as fully as do the stocks of land, labor, and capital emphasized by economists or the good governance and policy environments championed by political scientists. These ideas have been widely adopted in microfinance particularly, serving as an important conduit for earlier concepts from various political economy literatures. Rankin's (2002) discussion of social capital in the form of trust emphasizes the norm of reciprocity which Polanyi poses as an alternative to the market (or charity) as a means of gaining cooperation. The "social collateral" championed by Grameen – one's social standing when failure to repay would lead to its loss and even ostracism – follows directly from Polanyi's discussion of social standing. "Social capital" has been applied by Dowla (2006) to Grameen Bank's creation of trust, norms and networks. Rankin (2002: 4) describes its adoption this way:

> Among economists in particular, social capital has been embraced as something of a " magic bullet" with the power to correct state and market failure (Michael Edwards n.d.). This view underlies the recent worldwide, nearly evangelical, faith in nongovernmental organizations (NGOs) and non- profits – rooted in civil society and mobilizing social capital – as the most appropriate institutions to carry out development."

The nature of NGOs themselves are contested terrain and efforts to place them in the left-right ideological space that defines political economy are problematic. This is especially true of microfinance NGOs. One common view holds that NGOs belong to the progressive camp that anchors the left pole of the political spectrum on behalf of the interests of civil society. The right pole is defined by the market, while the state occupies the center position which is the arena of conflict over important social values as well as tangible resources. NGOs "criticized the state from a 'left' perspective defending civil society, while the 'right' did so in the name of the market." (Petras,1997: 11). Of course, NGOs were active in various humanitarian causes that commanded the respect of the left as well – just as microfinance today has many leftist advocates.

The other view emphasizes the role of NGOs in displacing the traditional left as a source of resistance to neo-liberalism, not least by converting ex-Marxists to the NGO formula. As Petras (1997: 12) colorfully expresses it: "Anti-statism was the ideological transit ticket from class politics to 'community development', from Marxism to the NGOs." "NGOs became the 'community face' of neo-liberalism" by emphasizing the local amelioration of problems and distracting from the global, structural causes of those problems. Neo-liberal regimes are thereby strengthened, and the opportunity to utilize NGOs as a tool has not been lost on either rich or poor states and IGOs representing DC interests."

The emphasis on social capital by economists no doubt reflects their quite simple view of social and political interactions (that they must all be positive).This is the "dark side" of social capital. But as Bourdieu (1977) reminds us, not all social interaction should be considered social capital (or "symbolic capital" in his phrase) and not all social capital is benign – gestures of giving and kindness can also create domination and "symbolic violence". As Rankin, 2002:8-9 notes "The key point for our purpose is to acknowledge that common moral frameworks are not *in themselves* desirable planning objectives, so long as they serve to entrench dominant cultural ideologies and undermine the potential for critical awareness on the part of the oppressed. To the extent that development programs nourish local forms of association underpinned by common moral frameworks, they risk exacerbating already existing lines of hierarchy, coercion, and exclusion." :10 " Social capital thus offers a " governmental strategy " for shifting the onus of development from the state to civil society and to third- sector agencies working on its behalf."

> "In reality non-governmental organizations are *not* non-governmental," (Petras, 1997: 13), because so much of their funding comes from states; instead they are merely subcontractors of states and IGOs. NGOs depoliticize and demobilize sectors of the population and ignore struggles of teachers, public employees, and other progressives. By partially substituting for what a progressive set of welfare programs would provide, they leave states off the hook. The NGO ideology of 'private voluntaristic activity' undermines the sense of the 'public': the idea that the government has an obligation to look after its citizens and provide them with life, liberty, and the pursuit of happiness; that the political responsibility of the state is essential for the well-being of citizens. Against this notion of public responsibility, the NGOs foster the neo-liberal idea of private responsibility for social problems and the importance of private resources to solve those problems."
> (Petras, 1997: 14)[29]

While the above discussion makes clear that the introduction of NGOs has not by itself dissolved ideological rigidities, they may be easier to break down because the categories that define this schism are themselves disintegrating. Not only are NGOs and state-run banks adopting business principles in their operations, and regulated commercial banks emulating the social goals of non-profits, but hybrids are everywhere. It is no longer easy to construct a typology of the organizational forms adopted by MFIs. It is even harder to fit individuals into the categories. Since Banco Sol (Bolivia) became the first NGO to transform into a Regulated Financial Institution (RFI) in 1992, the lines have been blurred.[30] At least 39 had followed as of 2003 (Fernando, 2003). Hishigsuren (2006) places the number at 43.

Partnerships of sorts between all three institutional forms are represented in India, where a

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[29]Interestingly, critics of NGOs from the left seem to agree with their critics from the right, the advocates of market institutions, especially commercialized banks. Both see NGOs as too small and not sufficiently sustainable to accomplish what more permanent organizations - be they governments or firms - can do.

[30] An RFI may be a commercial bank or a non-bank financial intermediary. Mersland and Strom (2007) contrast NGOs with share holding firms (SHF).

state requirement that 18% of the net credit of commercial banks must be given to the agricultural sector, including microfinance has caused commercial banks without rural branch operations to partner with NGOs, which do (Meehan, 2004: 13). The microfinance program of India's National Bank of Agriculture and Rural Development (NABARD) – the Self Help Group - Bank Linkage Program (SBLP) – is a partnership between development NGOs and commercial banks that is the largest in the world, with more than a million and a half SHG's with an average of 15 clients per group (90% women) (El-Mahdi, 2005). The microfinancing operations of Thailand's BAAC has long been financed by the requirement that all state agencies utilize state banks, including BAAC, for their banking operations, providing a subsidy of sorts to their operations. In addition to NGOs, commercial banks, government rural development banks, and traditional moneylenders, there are credit unions, and cooperatives of various sorts and lots of amalgams. NGOs often evolve into regulated institutions. BAAC is a state-run bank that operates heavily through cooperatives. One wonders if a typology so complex, neither mutually exclusive nor mutually encompassing, deserves to be the focal point of such ideological controversy.[31]

Finally, analyses have found little difference in performance among the categories.[32] Mersland and Strom (2007) analyze the performance differences between 132 NGO's and 68 SHF's (13 banks, 55 NBFIs) in 53 countries, seeking to test Schreiner's (2002) assumptions (Mersland and Strom, 2007:6) "that more socially oriented MFIs trade off narrow breadth, short length and limited scope with greater depth, while less socially oriented MFOs trade off shallow depth with wide breadth, long length and ample scope." No difference in cost-effectiveness is found (operating expense ratio) or on ROE. Also (Mersland and Strom, 2007:16) "NGOs are not more social oriented than SHFs." (Mersland and Strom, 2007:18) "although costs and risk are higher in the NGO, this type of organization has developed a business model that has a ROA on par or better than the SHF. This indicates that the NGO should be sustainable in the long term, contrary to our hypothesis derived from Schneider's framework."

Perhaps it should not be so surprising that differences are hard to find since, as they observe (Mersland and Strom, 2007:5), "Most equity holders in SHFs are NGOs, donors or social oriented investors (Ivatury and Abrams, 2005, Ivatury and Reille, 2004, Goodman, 2005)." The vehemence of the belief that microfinance MUST be commercialized is odd given the dearth of studies that ask whether performance varies across different kinds of MFIs – not to mention the small differences found when the question *is* asked. Woller and Schreiner (ud) look only at village banks (none commercial). Cull et al. (2006) find various differences between group- and individual-lending MFIs, but not much difference based on ownership remains after lending and

[31]There are many regional variations. NGOs remain the dominant mode of delivery in Asia; in Latin America, following Banco Sol, microfinance is more urban and informal sector, "less concerned with poverty and more focused on microenterprise", oriented to existing businesses (Montgomery and Weiss, 2005). For a breakdown of institutional forms by region, see Helms (2006)."In Bangladesh, the organized NGO sector and Grameen account for 86% of microfinance lending and commercial banks for just 14%." (Khandker, 2005: 265) Grameen is a chartered bank. Differences in technique also involve individual lending, revolving fund (without professional management), self-help groups, and savings-based groups.

[32]Chavan and Ramakumar (2002) generally find better performance from NGO MFIs than government programs, specifically India's Integrated Rural Development Programme (IRPD) and regional rural banks (RRBs).

various other covariates are introduced. The most usual correlates of financial self sufficiency are the administrative expense ratio (driven by salary and productivity) and the real portfolio yield (interest rate charged on loans). Cull (2006) is the most elaborate study. Hartarska and Nadolnyak (2007) find little difference in the performance of regulated and non-regulated MFIs, although better capitalized organizations and those that take deposits do better, so there may be some indirect effect of regulation.

Holdouts remain. Gonzalez-Vega grants that a wide variety of institutional forms are included on a list of best practice examples, yet somehow insists that there are organizational deficiencies that have been overcome only by exceptional individuals: "There are serious questions, however, about the ability of organizations with diffused property rights structures, such as most NGOs, or with conflicting governance constitutions and weak mechanisms for internal control, such as credit cooperatives and client-owned village banks, to engender sustainable financial intermediation (Chaves, 1994). Organizations that are not disciplined by market forces and have not clearly defined owners may act in ways that serve the interests of their employees or managers and ignore those of their so-called beneficiaries or the sustainability of the institution (Adams, 1994)."

More important than the form of the MFI is the clientele that they target, the priorities they set, and the diagnosis of poverty and poverty alleviation that is implicit in those choices. We discuss these inter-related considerations in the next three sections.

Diagnoses of poverty

The conviction of its many proponents that microfinance can help alleviate poverty is hardly absent theoretical support. Indeed, the variety of theoretical justifications that have been offered for microfinance is a greater problem than the dearth of them. Skeptics of microfinance operations face a slippery opponent as any challenge to the theoretical underpinnings of a program can be met with a shift of theoretical focus. "No income growth? OK, but women are empowered."

Advances in microfinance as a research area – and improvements in microfinance's effectiveness as a poverty tool – must begin with a more rigorous stipulation of the underlying theory and a more careful probe of the match between theory and the theory-relevant conditions found in any particular case. Currently, donors and investors fear a bait-and-switch ploy, and evaluation researchers miss the opportunities presented by measurable intermediate targets that are suggested by theoretical accounts of poverty and poverty alleviation.

A number of channels through which microfinance could help alleviate poverty have been proposed, and nearly all are both plausible and easily illustrated with anecdotes. The channel most responsible for the allure of microfinance involves the unleashing of microenterprise previously blocked by the absence of available capital. This story is represented in the glossy presentation of nearly every microfinance institution – and it is a compelling one. FINCA's home page features a

Tanzanian woman who needed money for bicycle repairs to take her tomatoes to market. Pro Mujer's has a Mexican woman in her sewing studio financed with a loan. The second paragraph of Muhammad Yunus's autobiography tells of the Bengali woman whose profit in her bamboo stool business was eroded by usury (Yunus, 1999). Robinson (2001) goes only 14 pages before describing an Indonesian man who expanded his business making stoves from scrap metal.

By this theoretical account, the role of capital is critical to poverty alleviation and the creation of new microenterprises is the central goal of microfinance. The argument is not only clear and compelling for donor audiences but also well-grounded in accepted economic theory for academics. It is also supported by empirical research that establishes the importance of business ownership: Even for modest microenterprises, the income of owners is far higher than that of those who do not own or operate a business (Felkner and Townsend, 2007). Unfortunately, the poverty diagnosis embodied in the theory is often inconsistent with either the facts on the ground or the operations of MFIs or both (Cohen, 2002).

The poverty diagnosis is lodged squarely in standard microeconomic treatments of the firm: Productive potential is a function of available stocks of land, labor, and capital, and the efficient combination of these factors of production through entrepreneurial and management skills. Aggregated to the macro level in the form of Solow growth theory, this conception underlies much of modern development theory (Solow, 1956; Swann, 1956). It has spawned direct empirical application in the form of growth accounting for national economies (Bosworth and Collins, 2003). It has energized the policy debate over the relative importance of capital accumulation vs. policy change in the success stories of the newly industrializing countries of East Asia (Dollar, 1992; Edwards, 1998; Cline, 1982). The scramble to interpret the net factor productivity that appears in the residual term of its regression estimates has yielded the theoretical innovation of the new growth theory (Romer, 1986; Mankiw et al., 1992). And it has led to a focus on financial structures, both micro- and macro (Levine, 1997).

Growth theory translates into a theory of poverty by treating shortfalls in factors of production as a blockage to growth, especially when one factor is noticeably missing. Such is the case in Lipton's (1977) classic of political economy *Why Poor People Stay Poor*, whose answer to the title question implicates the market failure whereby capital does not find its most productive use. In the absence of extensive policy interventions, rural areas do not receive adequate inflows of capital.

In the Solow account, the marginal productivity of each factor of production is a function of the relative stock of the others: The marginal return to capital, for example, is highest when capital is scarce but the other factors are already present in relatively large quantities. Lipton then alerts us to the very high returns which must follow from the massive imbalances of the factors of production present in poor rural areas, where capital is both difficult and expensive to acquire. Enter microfinance – and the argument of institutionists that the poor can afford to pay very high rates of interest because the marginal return to capital is higher yet under these circumstances of capital scarcity via market failure.

The common image of microfinance is an entrepreneurial woman with marketable skills and a sound business plan, but no capital to finance the creation of a microenterprise. Of course, without those other elements, the marginal return to capital and the debt tolerance of the prospective borrower may be closer to zero than the high interest rate usually associated with sustainable microfinance. We explore below the implications of this formula for the client selection processes and the location decisions of MFIs – and our doubts that MFIs are currently as attentive as they need to be of the match between the assumptions of the theory and both their financial products and the conditions under which they are offered.

A related goal is to enhance the profitability of existing businesses through reducing financing costs, which may not even involve output expansion. This is made possible by replacing high cost informal finance, especially by local moneylenders who have a reputation as exploiters of their near-monopoly position in local capital markets. Interestingly, Muhammad Yunus cites as the inspiration for his innovation this scenario of high capital costs that erode profitability of existing enterprises, not the absence of capital which prevents the creation of new ones. Despite the similarity of the underlying logic, the practical implications of the differences are significant. Here the bottom line orientation of institutionists assumes critical importance, because the ability to better the competition is both the raison d'etre of the MFI and a condition of its sustainability. Lehigh explorations of microfinance operations in Latin America (Watkins and Wuerth in Honduras and Peru; Aach in Ecuador) suggest that the behavior of MFIs in highly competitive environments is quite different than elsewhere. And ought to be. Yet MFIs commonly believe "that they are 'the only game in town.'" (Wright, 2001)

Existing literature has not given much attention to either the role of competition or the effect of existing as opposed to prospective microenterprises.[33] Yet, there is good reason to believe that the model case used in microfinance public relations – the total absence of financial services – is actually quite rare. Armendáriz de Aghion and Morduch (2005: chapter 3) sketch the alternative sources often available and cite one study in which a third of borrowers are engaged in more than ten different credit arrangements at any one time.

Most development scholars doubt the fundamental implicit assumption in the institutionist approach – that access to credit is the sole (and many doubt that it is even the main) bottleneck to development. Surely it varies, a point elaborated in the following section, and so must the operational assumptions of MFIs. Consider the provision of capital to potential entrepreneurs with the skills profile of a typical woman in Bangladesh, where the average education level is less than two years of schooling. If such people are good management prospects, why do we have MBAs? If they are not, then finance must be packaged with other programs, which probably implies a different institutional form. The existing literature does not appear to recognize that building capacity in business operations, skills development, new technologies, and marketing support are vital in some environments and unnecessary in others. Instead, fixed ideologies still prevail, as

[33] Exceptions include Goldberg's (2005) plausible suggestion that Coleman's (1999) finding of no poverty impact for marginal provisions of microfinance in northeast Thailand was due to the prior saturation of credit markets by BAAC.

when Robinson (2001: 72-73) cited the reflections of Adams and Von Pischke (1992), who note that early efforts at linking credit and training failed, to justify a contention that finance must always be separated from other development programs.[34] On the other hand, the recognition of the multiplicity of needs implicit in the evolution from micro-credit to micro-finance (adding savings and insurance) seems a hopeful sign.

In response to poverty diagnoses not centered on capital shortfalls, many NGOs use microfinance as an entry point for other social interventions, just as sovereign debt has been the mechanism by which international lenders from the IMF, World Bank, and national aid programs have gained leverage on the macro-economic policies of poor states (). Pro Mujer and Freedom from Hunger use weekly meetings to provide education on health issues, for example, and Bangladesh's BRAC is often identified as the most thorough in this respect.

Multiple goals are frequently at work in microfinance, but it is seldom clear exactly what theory of poverty justifies some financial interventions, namely those that do not translate into investment which yields future returns large enough to repay the debt while securing long-term growth. Even Marguerite Robinson, an ardent champion of the financial services approach, acknowledges the alternative goal of building the self-confidence of the poor. A particular manifestation of that goal is women's empowerment, which is mentioned by most MFIs. Such a goal need not involve a new productive enterprise and may be built on an understanding that the exclusion of the poor from other aspects of social life due to deep-rooted structural inequalities is at least as important as their inability to access financial markets. Group-based approaches are especially likely to be tailored to these kinds of social outcomes because they create networking opportunities that are otherwise blocked by local power constellations, cultural norms, or geographic considerations.[35] That said, it is still not clear through what channel loans generate the capacity to repay them.

Even where microfinance does translate "small pay-ins" into "large take-outs" (Rutherford, 1999), the "take-out" may not be for a productive investment. Lump sums may finance income shortfalls that result from temporary emergencies (crop failures, illness), life cycle events (such as births, marriages, and burials), or consumer durables (houses, transportation, appliances). Here, the underlying economic theory that anticipates enhanced standard of living as a consequence of microfinance is not at all clear. That the time discount rate is greater than the interest rate is one clear boundary condition, but even that assumes an ability to pay which cannot be assumed as a matter of course. For these uses, the challenge is to prove that alternative

[34] Robinson commits the error of comparing the actual to the possible, because the recognition that business skills training has sometimes been done poorly does not mean that better training programs cannot be constructed nor that training is more appropriate in programs for new entrepreneurs rather than experienced ones, as was the case in the Adams and Von Pischke study. It is also a bit disingenuous of her not to mention that they find microcredit programs *in general* ineffective, not just state-run ones: (: 1468): "In our opinion, debt is not an effective tool for helping most poor people enhance their economic condition – be they operators of small farms or microenterprises, or poor women. In most cases lack of formal loans is not the most pressing problem faced by these individuals."

[35] Social capital in the form of trust is also a major determinant of the success of group lending practices for microfinance (Cassar et al., 2006).

financing devices, such as rotating savings and credit associations or cooperatives, cannot do the job with lower overhead costs. Here, as in many other questions dealing with microfinance, the issue seems to be how universal the claims of microfinance proponents are entitled to be and how flexible our studies should be in evaluating MFIs. This consideration is especially critical because of the importance placed on questions of scale, especially by institutionists. If needs are varied and efforts to meet them necessarily disaggregated, scaling up may be more difficult and less important than often argued.

Universalism and scale

Institutionists emphasize the importance of achieving scale in microfinance operations, both to lower operating costs through efficiency and to extend the benefits to more recipients. However, both welfarists and critics of microfinance have doubts that entrepreneurship is for everyone, especially given the types of business opportunities available in poor areas and the limited skill sets of potential borrowers.

> "Are all of these urban, mobile, savvy young people going to want to be micro-entrepreneurs? Are they going to want to sell bananas and tomatoes on a little handkerchief on the side of the street like their mothers did? Or are they going to want jobs? I think they may want jobs" (Littlefield, 2007)[36]

If so, it is not obvious that microfinance can "shift its focus from self-employment to jobs" – or that it should. Jobs creation, which by definition involves enterprises larger than those typically involve in microenterprise start-ups, is a mission far removed from the central story of microfinance, and its underlying poverty theory does not match that of microfinance. Better tools are probably available.

One limitation on microenterprise is the prevalence of entrepreneurial and business skills, especially among people with limited education and experience. Another is the absence of easy opportunities in poor economic environments. Littlefield herself questions whether "the world can absorb that many self-employed micro-entrepreneurs." If the low-hanging fruit has already been picked (and the tallest pickers already employed), the remaining niches where microenterprise/ microfinance can succeed may be very hard to find.

Meanwhile, microfinance proponents continue to promote it as capable of limitless expansion to fill what may be a wild overstatement of need. Meehan (2004: 5) suggests that "market demand for microfinance services is estimated at more than US$300 billion, while market supply is just US$4 billion." Is this estimate derived from the existence of 2.8 billion people living on less than $2 per day? If so, it seems to rest on the assumption that every poor man, woman, and child can be a successful entrepreneur who requires a loan of around $100 per

[36] It is ironic that these doubts about universalism and scale have actually been expressed most clearly by Elizabeth Littlefield, the CEO of CGAP which embodies the institutionist perspective that emphasizes the necessity of scale.

person. Robinson (2001:10-13) is explicit in estimating microfinance demand exactly that way – by working backwards from the number of poor people – and she thereby estimates that "the quality of life of 1.8 billion people could be improved by providing them with local access to formal commercial microfinance."

Is it a realistic diagnosis of poverty to assume that the productivity of all poor households is constrained solely by credit (even if the destitute poor are excluded)? The actual demand for microfinance is extremely important because the scale of the unmet challenge is so prominent in the arguments of the "financial systems" approach.[37] Greater outreach may not be good if credit is extended to people who can't use it effectively – or for whom alternative development programs would work better. Risk aversion as well as a lack of skills, other inputs, a reliable market, and an adequate business plan are among other factors which limit demand for microfinance. Paulson and Townsend (2004) suggest interest in entrepreneurship is high but far from universal. As Schreiner and Woller (2003: 1567) put it, "Micro enterprise is good choice for a few extraordinary poor people, but wage jobs, additional education, and job training are still the most common paths out of poverty". To assume otherwise is to create a myth of "entrepreneurs as decathletes", skilled in multiple areas. That may be less offensive, but hardly more helpful, than the traditional view of the poor as helpless objects of development planning unable to contribute meaningfully to their own futures.

There is some irony here, because some advocates of the financial systems approach seem more realistic than the poverty lending school in this sense: They would explicitly limit microfinance to the economically active poor, not the extremely poor who are of greater interest to welfarists. There is some evidence that this targeting is sound. In one of the first impact studies, Hulme and Mosely (1996) find that the benefits to those borrowers above the poverty line was substantial, but to those below the line minimal. The explanation is found in the pattern of funds use: Nearly 70% of loans were used for consumption by those borrowers with incomes less than 80% of the poverty line, while it was about 14% for richer borrowers (who also had larger loan sizes). As noted above, the theoretical case for loaning money for investment purposes is clear, while the net long-term benefits of consumption loans is decidedly more murky.

The universalism espoused by microfinance cheerleaders and characterized elsewhere as a search for "the magic bullet" is also found in the reliance on a "best practices" philosophy. The symbol usually cited is "The Pine Book" (CGAP, 2004), which emphasizes the regular reporting of core performance indicators to improve information and incentives.[38] By contrast, "Seibel (1998) challenges the use of the adjective 'best' and its implication that there is only one optimal

[37] Littlefield: "If microfinance institutions are to close the significant supply-demand gap, vast external resources will need to be tapped. In the long-term, only the financial markets5 have the resources readily available to allow for optimal growth."

[38] The indicators are outreach (number and economic status of clients), cost-recovery, loan collection, and efficiency (reasonable administrative costs). Guidance on calculating and interpreting these indicators can be found at www.microfinancegateway.org/content/article/detail/32627. The list of indicators an MFI ought to report to its stakeholders, including a funding agency, is fairly long—cf. www.cgap.org/docs/Guideline_ disclosure.pdf.

way of doing things. Instead, '[g]iven the great diversity of microfinance organizations, strategies and situations, there cannot possibly be a unitary set of best practices, only diverse sets of sound practices.'" (Dunford, 2000: 7)

Furthermore, a more cautious approach to universalism would encourage the adaptation to particular circumstances, which seems warranted given that microfinance has worked better in some places than others. It seems likely that this results at least as much from different environmental circumstances as from different practices by MFIs. Exploring that possibility would require greater participation by development economists, sociologists, anthropologists, and other social scientists attuned both to development problems and to the variance in their appearance across different settings. An emphasis upon cultural effects might help explain why group lending works better in some environments than others, for example (Tapella, 2002; Gine et al., 2006). It would also require that institutionists relax their attitude toward universal prescriptions and unlimited scale.

The multiple goals of microfinance

The microfinance literature is curiously inconsistent with respect to the multiple goals associated with microfinance. On the one hand, the case for microfinance is almost defined by the duality contained in the "win-win" proposition (Morduch, 2000), the goal of a "double bottom line" (), and the mantra of "doing well by doing good" (Robinson?). The tension between sustainability/profitability and poverty outreach goals is a major theme of much of the literature.

On the other hand, there is little recognition of the lessons found elsewhere in political economy literature, such as the "one target – one tool" maxim of Keynesian macroeconomics that would discourage the use of one approach (microfinance) or one microfinance product to reach multiple goals. Most individuals in developed countries hold mortgage debt, credit card debt, auto loan debt, revolving debt, education loans, and others. Many have checking, savings, and brokerage accounts and hold life, home, and health insurance. These different products are relevant to different needs, are issued by different firms or institutions, and are evaluated in different ways. To meet all these needs in poor countries with a particular institutional form, let alone the same product, seems needlessly parsimonious and, perhaps, reminiscent of Gilpin's earlier characterization of schools of thought in political economy, "imperialistic". Microfinance is trying to be all things to all people.

The most obvious divide in goals has already been alluded to. The "promotional" model is based on a loan that enables profitable entrepreneurship, which empowers the (female?) owner and increases her income. Or it develops better social ties through cooperative business strategies, which may involve creating, expanding, or diversifying an agricultural, manufacturing, or services business. Different loan products – which may imply different institutional forms – are needed. For example, agricultural loans usually require a seasonal term of up to one year, with lump sum repayment, whereas others may tolerate only a minimal grace period and regular weekly repayments. A mismatch between goals and loan terms is frequently visible, as when repayment begins within a week of the original loan, long before substantial returns could be earned by most productive investments capable of generating sustainable welfare improvements. A more client-led agenda would be preferable (Cohen, 2002).

Alternatively, the goal of the "protectional" model can be achieved by income smoothing, which may raise welfare without increasing long-run income (or even while diminishing it marginally), without inducing investment, and without changing the productive profile of the borrower or her community. In developed countries, such a mission is filled by insurance, not loans, or, in the language of Rutherford (1999), by a "saving through" rather than "saving down" structure. That seems a more prudent strategy which should be encouraged by a goals-explicit microfinance provider.

Between the protectional and promotional models is the channel of risk promotion, in which the known availability of credit in the event of enterprise failure (such as crop loss) allows potential borrowers to be less risk averse in their production decisions and thus achieve greater growth. This consideration encourages impact assessments to distinguish access to credit programs from actual participation in those credit programs (Diagne and Zeller, 2001).[39]

The goal of income-smoothing should be distinguished from that of income-advancing or asset-acquisition loans (like home improvement loans or mortgages), because it implies a very different assumption about time-series trends in the ability of borrowers to pay. Income smoothing loans offered in non-emergency environments invite borrowing beyond capacity to service the loan, because the target income is above the long-term average. Parallel to the concerns of institutionists that borrowers will acquire a "grant mentality" that makes default cognitively easy are the concerns of welfarists that they will acquire a "debt mentality" that easily accepts more-or-less constant and permanent insolvency that makes default inevitable. Asset-acquisition loans are different: They are very long term in their return structure, like borrowing to educate a child or to capture house or land appreciation, but they do not burden a borrower without compensating gains, as do pure consumption loans. While asset-acquisition loans may not be collateralized from the standpoint of the lender, they induce a semi-liquid trade-off of income and wealth from the viewpoint of the borrower.

Welfarists from the political economy tradition are likely to feel that a socially responsible lender committed to the "creation of value" (Woller and Schreiner, ud) should avoid loans unsuited to the goal, but this implies that both fund usage and the liquidity of the borrower be more closely monitored than is usually possible. For example, income-smoothing loans should be offered only during income troughs. Income-advancing loans should be made only when justified by life event timing or visible capacity to repay. To offer "protectional" consumption loans at all also requires the acknowledgment that MFIs must forego those loans that appear to encourage consumption at an unsustainable target. My experience with the loan products of most MFIs

[39] Many will benefit from access without actually using that access. The benefits of participating in a credit program also are difficult to distinguish from the benefits of other programs tied to credit (e.g. literacy classes, business training, family planning education).

suggest that a lot more self-conscious exploration of the multiple and sometimes competing goals of microfinance is required to maintain prudential responsibility.

However, following this advice bumps up against the universalistic assumptions common to the financial services camp as well as the basic commitment of MFIs to limit overhead costs of compliance. Economists schooled in the neo-classical tradition are likely to find judging the value of a transaction to a willing participant unnecessary, uncomfortable, an/or impossible. Instead, their deep philosophical commitment to individual autonomy in utility maximization (such as consumer sovereignty) makes it natural for them to assume that actual behavior "reveals preferences". If a peasant takes out a loan, it is an indication that it is in his interest to do so, at least as far as he – or anyone else – can tell.

Two consequences follow. First, it is inappropriate for a potential lender to refuse a loan on the grounds that it would not benefit the borrower (provided that the borrower is not a minor, mentally incompetent, or too desperate to be expected to eschew income from any source). Second, the success of a lending program can be judged by whether or not a demand exists for it. For example, microfinance advocates, especially those who oppose subsidization, generally dismiss concerns about usurious interest rates by showing that high rates do not prevent borrowers from lining up.

To the contrary, political economists and behavioral economists do not regard the proposition that individuals act in their self interest as a truism that should stand as an unexamined assumption. Instead, they treat it as either a hypothesis to be tested empirically or as a poetic abstraction based upon the myth of humans as unitary, consistent, integrated, and rational actors. If the latter view is accepted (or the above desperation condition is met), poor people will frequently borrow money against their own interests. They will often incur too much debt and use its proceeds unwisely. In the formal economy of developed countries, it is the state that intervenes to protect the foolish or the misled, but in the poorly regulated environment of microfinance the responsibility should fall to the provider, especially when they are self-defined as agents of the poor.

Other goals are defined at the village or community level: creating successful role models, introducing business practices, creating mobility, building social capital in the form of village-level institutions or the trust of self-help groups.[40] Even the employment of loan officers from the community itself spurs development, for example. From an evaluation standpoint, we notice that none of these goals require increased personal income in the short-run to be met. We also observe that if goals are defined at these higher levels of aggregation, evaluation studies can be defined there also, which opens up some space for more creative approaches to validating the claims of microfinance advocates.

[40] They may also be defined at the household level, as when frequent repayment of debt transfers control of family finances to the most responsible member of the household.

Evaluation studies

The discussion thus far emphasizes the importance of empirical assessments of the arguments that roil the field. It is widely acknowledged that relatively little is known . As Zeller and Meyer (2002) put it:

> MFI field operations have far surpassed the research capacity to analyze them, so excitement about the use of microfinance for poverty alleviation is not backed up with sound facts derived from rigorous research. Given the current state of knowledge, it is difficult to allocate confidently public resources to microfinance development. (Zeller and Meyer 2002 as quoted by Montgomery and Weiss, 2005:1)).

Yet agreement on the necessity of filling that gap (and how thoroughly) is far from universal (Copestake et al., 2001). Adams (2001) argues, for example, that "[impact assessment studies] are fraught with insurmountable methodological problems and the costs of doing them usually exceed any benefits they might provide." He is certainly right about the problems: From the point of view of practitioners and most donors, the marginal dollar of revenue is better allocated to providing loans than to doing studies and writing reports that are properly appreciated mostly by academic methodologists.

However, the value of the benefits of impact studies depends centrally on how seriously one takes the goal of cost-efficient poverty reduction. There is some skepticism among welfarists about the commitment of many commercial MFIs to really achieving the "double bottom line". If the operation is profitable, targeting the poor and a handful of anecdotes may be thought good enough. Financial services analysts and others do not question the determination of welfarists to alleviate poverty, but they are not necessarily convinced of their dedication to achieving it through non-aid channels. They sense, correctly in my judgment, that many microfinance NGOs are not dismayed by the prospect of microfinance as disguised aid. In neither case is a "bang for the buck" assessment really essential.

Among those committed to impact analysis, the most fundamental question is whether microfinance actually produces the outcomes claimed for it.[41] Beyond that, theorists will want to know whether those outcomes, when successful, are achieved through the expected channels or by other mechanisms. Practitioners will focus on whether differential success can be explained by variables under the control of MFIs, such as products and procedures, or by other factors which are not. Both will be concerned with the role of environmental conditions, though for somewhat different reasons. Practitioners seek guidance on location choices for their interventions; theorists hope for new clues to the eternal question of why development occurs in some places and not others.

Most evaluations conducted thus far are about internal performance measures rather than

[41] Of course, this is only the first step in a broader analysis that considers the costs at which the results are achieved and whether alternative uses of those resources might produce better outcomes. Conceptually, this essay considers the narrow text question a stand-in for the broader ones, which seem at the moment far less answerable.

external outcomes (Rosenberg, 2006; CRS, 2005). Chavan and Ramakumar (2002: 957) summarize the consensus: "Most of the available studies narrowly focus on their "programmatic success" [Rahman 1999: 67], where the principal variables studied are the number of beneficiaries, amount of credit disbursed, recovery rate, and profit flows among others." Such business criteria as the default rate, administrative costs, and subsidy dependence will be monitored routinely and at low cost by the MFIs themselves, whereas external impact measures will usually require a skilled outside methodologist to conduct carefully controlled (and expensive) studies, which face a more sophisticated and skeptical audience.

The next advance beyond business criteria usually involves an analysis of targeting success, such as the percentage of loans given to a target market (e.g. for Grameen, women with less than .5 acres of land). That target is usually related to income or wealth, with some programs explicitly directed to the "working poor" or "entrepreneurial poor" whereas others are declared to be focused on the poorest of the poor. Some misdirection of loans to those outside the defined target group is inevitable, of course. Some programs are most concerned that loans will reach richer customers that do not need microfinance services because they already have access to formal credit arrangements. This is a particular problem where loans are subsidized and therefore available at below market rates. Others are anxious to avoid loans to those too poor to enjoy their benefits, as when the absence of other resources makes microenterprise unattainable even with adequate credit. Since income data may be difficult to gather (or to interpret and compare), the size of the average loan in relation to the poverty line is a frequent proxy for the targeting of the overall loan portfolio, under the assumption that the relatively well off will be unmotivated to seek small loans and the poor will be unable to service large ones.[42] Such data are much more easily collected by the MFI, but clearly the fit between measure (loan size) and concept (income of the borrower) is poor.[43]

By emphasizing outreach (through targeting studies) and sustainability (via business criteria analysis), most analysts have assumed away the critical question of outcomes: are poor people really made better off by microfinance? Concerning welfare benefits, poverty reduction, and other social changes, there have been more *surveys* of evaluation studies (Goldberg, 2005; Montgomery and Weiss, 2005; Weiss et al., 2003; Kabeer, 2005; Littlefield et al., 2003; Amendariz de Aghion and Murdoch, 2005; Meyer 2002;Sebstad and Cohen, 2000) than there have been really rigorous evaluation studies. And more guidelines concerning how to evaluate

[42]Default rates tend to be higher for larger loan sizes, especially when they result from sequential escalating loans, as is common with Grameen. The most timely payments come not from successful investment but from cross-financing by borrowers, which can create debt cycles very quickly.

[43]Welfare levels can be estimated via income (cash or total, including in-kind and imputed), expenditures, or asset-holding (Little, 1997). (:2): "Assets can be financial, material--either productive (e.g., farm machinery) or consumptive (kitchen appliances)– human, and/or social. Human and social assets reflect the fact that non-material resources (e.g., levels of knowledge and education) and networks--the social relations that individuals and households maintain for support--are important assets to entrepreneurs and other economic actors." Net worth, which subtracts liabilities from assets, isn't usually worth doing. Use of income (i.e. expenditures) are somewhat more reliable than income; educational expenditures are especially good. Little (1997) emphasizes how difficult it is to get good data and suggests ways of doing it.

(Hulme, 1997; Westley, 2002; Simanowitz, 2004; Copestake et al., 2005) than actual evaluations. That pattern reflects the complex of evaluation problems, many of which apply to most policy evaluation studies, but some of which are unique to the kind of intervention represented by microfinance.[44]

There is no simple way around these difficulties, especially the dual endogeneity issues of program location and borrower participation. Both problems threaten to conflate the actual impact of microfinance with the effect of unmeasured variables that are correlated with program participation. It is usually assumed that these patterns are most likely to bias upward the apparent effect of microfinance, exaggerating the impact. For example, simple comparisons between the growth rates of villages that have hosted microfinance programs and those which have not will show a spurious positive effect if MFIs chose their locations wisely. In the logic of practitioners, limited funds should be disbursed where they are most likely to have a positive impact – such as in villages with good transportation and communication to facilitate the program itself and where economic opportunity abounds for the borrowers. But in the logic of evaluators, this non-random selection constitutes a placement bias that makes it impossible to distinguish the impact of microfinance from the unmeasured effect of location. The endogeneity of project placement may also reflect the tendency to place projects in areas where poverty is worse, so the bias could be either positive or negative.

Perhaps even more disruptive is the self-selection or participation bias: those who choose to borrow are probably the most entrepreneurial, best educated, and most well endowed in the other attributes that predict success (such as wealth, health, and access to social, political, and economic networks). Where group lending formats make participation contingent on acceptance by those who will be jointly liable for the loans, the tendency for participation to occur only among those most likely to be successful is accentuated. Therefore, borrowers will usually increase their incomes more rapidly than non-borrowers, but this may be a consequence of their other pre-existing attributes, not the microfinance loan itself.

The participation bias can be eased with a control group as close as possible to the treatment group in the relevant attributes. Identifying a control group of those who *wish to* participate is one possibility. These could consist of future borrowers, as when a program interviews and accepts clients but does not begin the program immediately, like the BIDS studies referenced below and the start-up MFI Common Cause International in Thailand. Comparing older borrowers to newer ones is another possibility, recommended by AIMS (Cohen and Gaile, 1998), but attrition levels are typically high enough to make old borrowers a large (and non-random) subset of the original borrowers, among other biases which are generally thought to overstate impact (Karlan, 2001; Armendariz de Aghion and Morduch, 2005: 208-210; Alexander-

[44] Among the former is the long lag between the provision of credit and poverty outcomes. Consider, for example, that microfinance may increase school enrollment and the empowerment of women, which will carry developmental consequences for decades (Honohan, 2004). More fundamentally, loan recipients will usually show both immediate consumption gains and a decline in net assets because of the debt liability. Welfare judgments will be driven by the time frame and breadth of the analysis.

Tedeschi and Karlan, 2007).[45] A useful primer on the difficulties of dealing with these biases can be assembled from the reports of the joint research project of the Bangladeshi Institute of Development Studies (BIDS) and the World Bank (Khandker, 1998, 2005; Pitt and Khandker, 1998) together with critiques of it (Armendariz de Aghion and Morduch, 2005: chapter 8).[46]

The problem of participation bias can be ducked entirely by measuring outcomes at the village level, so that the availability of credit (not the use of credit) becomes the independent variable and no distinction is made between participants and non-participants. While mitigating some of the usual econometric problems that undermine clean interpretation, such studies would also deal with the possibility that aggregate effects may be smaller than individual ones because microfinance may redistribute income rather than increase it.[47]

Even without estimation complications, the challenge of impact evaluation is formidable. Data on either social or income outcomes is likely to be pretty poor, and, where multiple sources of finance are available, so too will be the data on credit use. The most straightforward way of identifying benefit is to simply ask the recipient, but, as Coleman (2001: 5) reports

> participants will generally tell evaluators (who are generally hired by the program itself) that the program is helping them, even if it is not. To do otherwise could be viewed as rude or ungrateful. ... Villagers who had worked themselves into a vicious circle of debt told a visiting program sponsor that the program had greatly benefitted them. Later, and privately, some of those same clients asked me how they could extract themselves from the program and have their debts forgiven.

Deliberate misrepresentations are probably less severe than recall errors, which are likely to be quite large especially when borrowers are unmotivated to take the evaluation seriously. Aach reported great difficulty in securing the cooperation of borrowers, a problem that probably could have been eased by greater participation in the survey by MFI officials but at the cost of Coleman's warning above. Alternatives to self-reporting range from direct observation of asset holding, which invites mammoth measurement error, to reliance on aggregate social indicators such as education levels or health measures, which may be quite insensitive to the relatively small and short-term changes that would be the most easily mapped to loan operations.

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[45] For example, these results do not address generalizability since they include only those who are eligible for, have chosen to participate in, and have been accepted by microfinance programs. Whether the results would be similar if microfinance were to expand is anybody's guess.

[46] Montgomery & Weiss, 2005: 9 summarizes: "Best-practice approaches to resolving these problems employ a form of "difference-in-difference" (two-stage least squares instrumental variables) analysis that compares participants and a similar control group and between locations or sectors with and without access to the program. Where exogenous eligibility criteria exist, Impact = (Yep - Yip) - (Yen - Yin)where Y is change in an outcome measure, e and i stand for eligible and ineligible households, respectively, and p and n stand for program and non-program villages, respectively."

[47] Whether the benefits are an externality to communities or contained by borrowers is an interesting theoretical question that has not been addressed.

With such large measurement error – even if it is random (itself a heroic assumption) – standard errors would be so inflated that showing a positive effect may be quite difficult. The actual impact would have to be quite high in order to get statistically significant parameter estimates, yet there is good reason to believe that actual impacts of microfinance may be rather small. Since interest rates are high, even quite good returns on investment yield relatively small net income improvements. Indeed, Brett's (2006) ethnographic account cites net losses because interest rates are higher than productivity gains, a constant fear expressed by many others. Similarly, Coleman (1999, 2006) finds that virtually all the effects of microfinance on rank-and-file borrowers are erased by using the proper controls, with only members of the village bank committee receive significant benefits.

Furthermore, microfinance inherently produces small gains because it is dealing with poor people and only a portion of their income. As discussed in the section on scale and universality above, benefits accrue only to those with sufficient skill and a favorable market, so only a minority may experience a positive impact. This would account for the tendency of anecdotal, qualitative interviews to suggest big improvements for some individuals whereas quantitative surveys of all participants usually show much much less.[48]

Consider Pitt and Khandker's (1998) well known study which shows (controversially, see Morduch, 1999 and below) a marginal improvement in consumption of 18 percent from loans to women and 11% from those to men. By any standard – certainly that of formal evaluation studies of microfinance or any other poverty alleviation program – this is a strong and noteworthy result. Indeed, practitioners are likely to be giddy with such an outcome – after all, if it could be reproduced over time, 5% of borrowers could lift themselves out of poverty each year. With about a quarter of the population in Bangladesh actually covered by microfinance, that means about 1% of the population per year would cross the poverty threshold. However, given that poverty declined by about 1% a year over the last decade throughout Bangladesh, would the signal be loud enough to be heard over the noise? (Khandker, 2005) Doubtful, it would seem, but Khandker's (2005) study shows a clear effect in what appears to be the most theoretically sophisticated study. But this later study recalculates the much-cited benefit described above, reducing the gains to 8% or less and notes that there is no return at all to loans to men.

From the above section on goals, we recall that other outcome measures of interest beyond income include skills development, gains in production or sales, cost reduction, technological progress, reductions in labor time, improvements in health and education, and various types of asset accumulation (land, livestock, productive or working assets, household assets, consumer durables, etc.) Problems include under-reporting, recall bias, and inaccurate evaluations of income in kind.

To add plausibility to positive findings and also to document the channels through which microfinance has its impact, a process tracing method would focus on these and other

[48] Honohan (2004) is less kind. He sees a great deal of "cherry-picking" as analysts emphasize the findings that support their point and ignore the others. He is not wrong.

intermediate outcomes. For example, Coleman (2006) finds that access to and use of microfinance does not reduce the volume of high interest loans outstanding from moneylenders, a key channel through which microfinance was presumed to augment net income. An internal study by BRAC (Kabeer and Matin, 2005) claimed to have found an impact of BRAC membership on trust, political participation, and political awareness, other mechanisms of social capital thought to carry the effect of microfinance on participant welfare. However, it is hard to find much evidence of differences between new (less than 2 years) members and old members (more than five years, on average more than eight), so the effects seem quite small.

Good studies would have to investigate negative effects as well as positive ones, because there could be a trade-off. Even with respect to the usually presumed benefits of microfinance – on income and food security – studies find negative or null effects. Diagne and Zeller (2001) find a negative (but statistically insignificant) impact of credit usage on net crop incomes, per capita income, food security, and nutritional status.

Negative aspects of microfinance also include the loss of privacy inherent in group processes, which often had negative economic consequences when public knowledge of the financial affairs of the poor weakened their bargaining ability in dealing with moneylenders and others (Marcus and Acharya, 2005). Also fears of debt peonage and the resulting personal responsibility are deemed real by participants, though it would seem to outsiders that reliance on MFIs would be less damaging than using moneylenders. In fact, many borrowers don't see a very significant difference between newer MFIs on the one hand and traditional moneylenders and local elites on the other. Small farmer cooperatives and village banks often become a political tool for the more powerful local families. Local powers gain control over more resources, sometimes defaulting their way to greater wealth and other times securing the lion's share of loans and then loaning them, in turn, at the higher rates associated with traditional moneylenders.

If the key issue is the nature of local political structures, surely the design of MFIs and their success must be analyzed by taking into account the variable nature of these relations in different locales. Both the prospects for microfinance and the design of programs should be sensitive to variations in levels of inequality, the incidence of participation in political and social structures; the amount of trust endemic to social relations, and the degree of communitarianism found in local cultures, etc. Of course, these variables should also be considered as potential outcomes of microfinance as well (:10): "development should be about escaping the oppressive predictability and grinding social relations of local lived experience in the country and enter into new and hopefully better, but at least different, relationships with the state, the international economy, and people outside their locale. "

The most sophisticated impact analyses derive from the BIDS studies of Bangladesh cited above, the series of studies of Thailand by Robert Townsend and his associates (Kaboski and Townsend, 2002, 2005, 2006)[49]; and the Coleman (1999, 2006) studies of northeast Thailand. To

[49] "We find that institutions, particularly those with good policies, can promote asset growth, consumption smoothing and occupational mobility, and can decrease moneylender reliance. Specifically, cash-lending

greatly simplify, the BIDS studies show a positive impact, the Coleman studies do not, and the Townsend studies are mixed. Many other impact studies have been conducted, but their statistical analyses are generally insufficient in dealing with the estimation biases discussed above. The known list of others that have achieved the imprimatur of well-known peer-reviewed journals is surprisingly short (Goetz and Gupta, 1996; Pitt et al., 1998; Hashemi et al., 1996; Panjaitan-Drioadisuryo et al., 1999). Other notable impact studies include Chavan and Ramakumar (2002); Smith, 2002 (see Morduch), McNernan (2002),and Wydick (2001).

Can a conclusion be reached in light of the weaknesses of existing studies? The leading surveys of microfinance impact studies offer two.

> "There is no study yet that has achieved wide consensus as to its reliability.... Having one very reliable evaluation is more valuable than having one hundred flawed evaluations." Armendáriz de Aghion and Morduch, 2005: 222

> "Various studies, both quantitative and qualitative, document increases in income and assets and decreases in vulnerability of microfinance clients. A few studies have failed to find positive impacts from microfinance and in rare cases have identified a negative impact. However, the frequency of such outcomes has been too low to cast much doubt on the generally favorable conclusion indicated by the bulk of the evidence." Littlefield et al., 2003: 2.

This last judgment, by well-respected scholars and practitioners, would be more persuasive were it not that their first two examples (MkNelly and Dunford, 1998, 1999) come from studies identified by Holohan (2004: 25) as best exhibiting the phenomena of reviews that "cherry-pick" a few positive findings from a sea of negative or null ones.

Conclusion

Finally, Honohan (2004: 29) offers a summary of summaries:

> "A poll of unbiased observers reading the evidence—both the positive reported experience of practitioners as documented in countless reports and the relatively ambivalent or weak econometric evidence—would at present likely return a cautiously optimistic verdict."

While fair-minded, this judgment barely touches our real need for rigorous impact assessment, which must go far beyond the increasingly banal question of whether microfinance "works" or not. After all, we have known intuitively for a long time what these studies have demonstrated more systematically in recent years: Microfinance produces benefits in some places at some times for some people, and not others. We need to know more about those variations and

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institutions—production credit groups and especially women's groups—are successful in providing intermediation and its benefits to members, while buffalo banks and rice banks are not. The policies identified as important to intermediation and benefits: the provision of savings services, especially pledged savings accounts; emergency services; and training and advice. Surprisingly, much publicized policies such as joint liability, default consequences, or repayment frequency had no measured impacts."

we also must evaluate microfinance against other well established programs so as to identify cost effectiveness in poverty alleviation.[50]

[50] In comparing alternative uses for donor funds, Heifer International would be an excellent alternative since it involves (1) direct investment in productive resources rather than a less accurately targeted infusion and (2) a “pay it forward” philosophy that mimics the repayment of loans as a way of getting multiplier effects. http://www.cipav.org.co/lrrd/ See Rutherford (1999) for three alternative ways of swapping small periodic savings for a one-time large investment: saving up, saving down, and saving through.

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