THE GREAT DIVIDE IN MICROFINANCE: POLITICAL ECONOMY IN MICROCOSM

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A scholar trained in international political economy (IPE) cannot encounter the Great Divide in microfinance (Morduch, 2000) without noting strong parallels to IPE's own grand chasm (Gilpin, 1987). The classical schools of thought in political economy make the same ideological arguments, accept the same gross assumptions, and commit the same errors as their newer microfinance counterparts. 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 chapter discusses those commonalities, identifies several issues central to the microfinance literature anticipated by the IPE literature of a generation earlier, and sketches components of a microfinance research agenda appropriate for IPE and development scholars.

1. THE GREAT DIVIDE IN MICROFINANCE

Woller, Dunford, and Woodworth (1999) and Morduch (2000) were among the first to discuss the existence of a "schism" in the study of microfinance. Although the exact dimensions of this divide are stated differently by various authors, the existence of alternative schools of thought is widely

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accepted (Brett, 2006; Bhatt & Tang, 2001; Mitlin, 2002; Robinson, 2001; Rhyne, 1998).

Morduch's (2000, p. 618) schism "between rhetoric and action" is defined narrowly around the necessity of subsidies. On the one hand, exponents of commercialized microfinance – such as the Consultative Group to Assist the Poor (CGAP) – associate subsidies with inefficiency, impermanence, and a limited scale of operations. Thus, the compilation of "best practices" by CGAP eschews subsidy and embraces commercialization. Those commercialized MFIs that operate without subsidies are able to grow in scale to meet widespread unmet demand for access to financial services. 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 to the billions of poor is through the quintessential market participant, the for-profit enterprise.

On the other hand, many practitioners who aim primarily at reducing poverty doubt that unsubsidized services delivered through the market can be cheap enough to benefit the very poorest, who they often conceive as the target of microfinance. These practitioners interpret the unavailability of financial services for the poor as an instance of "market failure" that 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). Morduch (1999, p. 1587), for example, estimates that no more than 5% of all MFIs are profitable without subsidies. Without them, 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. The trade-offs include serving urban over rural areas to cut costs, emphasizing account volume over portfolio quality, keeping field staff salaries low and work levels high, dealing mostly with clients in retail trade and services with high cash flow, de-emphasizing manufacturing, agriculture, and fixed asset loans, and an upward creep in the prosperity of clients.

Woller et al. (1999) see a broader schism between "welfarist" vs. "institutionalist" perspectives, which encompasses 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 non-governmental organizations (NGOs), community-based credit unions and banks, commercial banks and finance companies, and state programs including rural development banks). 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 development. Consequently, the practitioners and development-oriented scholars who make up this school of thought naturally compare the performance of microfinance against other humanitarian programs that seek developmental outcomes. In an interview, 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 exemplify the welfarist approach's principled commitment to poverty alleviation and various other development goals. They support MFIs to the extent that they succeed in promoting those goals, but they frequently combine microfinance with other programs to do so.

The "institutionist" approach instead views microfinance from the perspective of banking practices and the potential of microfinance to surmount the four great problems of small-scale finance: high transaction costs, the difficulty of measuring risk, the cost of monitoring clients, and the absence of collateral. Adherents to this approach are committed in principle to commercialized microfinance, and 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 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 & 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. 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 innovations likely to achieve the various goals embraced by government programs.

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

> 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 mirrors the broader neo-classical economic literature in holding that any goal other than profit maximization erodes systemic efficiency. Thus, the best guarantee of welfare maximization is a free market among modern corporations that embody that goal-oriented behavior. In response, the early institutionist approach narrowed the programmatic focus to finance itself, with market interest rates, a smaller role for the state, and de-emphasis of the other elements of development to focus more narrowly and effectively on finance.

In the words of Rhyne and Otero (1994, p. 11), "The principles behind the emerging techniques for offering financial services to the poor are the same as those found *in any financial system*" (italics added). A welfarist would 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 designed to help the poor*. In effect, microfinance is less the arena in which finance and development *converge* than where they *collide*. Whereas Littlefield and Rosenberg (2004) have written on "breaking down walls between microfinance and formal finance," a welfarist seeks to break down walls between microfinance and development.

For example, one of Gonzalez-Vega's four problems with state-owned rural banks is that they are reliant on agriculture, an inherently precarious sector. From the standpoint of running a successful bank, this critique is accurate: 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 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, 2007). If you run away from agriculture, you are running away from a majority of the problem.

These microfinance approaches mirror political economy concerns over how human interactions should be ordered, especially with respect to the allocation of things of value. The Great Divide in Microfinance is often defined as a clash over whether financial services for the poor should be provided by market-oriented private firms, state-run development banks, or NGOs that represent broader societal interests and values. However, this choice reflects deeper disagreements that have ideological counterparts in the political economy literature, discussed in the next section. More troubling yet, as discussed later, there remains remarkably limited empirical basis for arguing one way or another.

2. 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 conflict over mechanisms of allocation, especially between the state and market (Best & Connolly, 1982). The iconic formulation of Robert Gilpin (1987, p. 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."

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 institutionist approach to microfinance can be seen as one expression of the (neo-) liberal perspective embodied in orthodox economics. Markets should be largely 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 Adam Smith's "invisible hand" that individual pursuit of self-interest yields maximization of aggregate welfare. If these premises are accepted, the case for commercialization of microfinance follows. The Great Divide in microfinance exists precisely because mainstream economics starts from those premises, whereas one must look long and hard to find a political scientist, sociologist, or anthropologist who does not instinctively reject them (Fallows, 1993; Polanyi, 1944; Rodrick, 1997).

In political economy traditions, the strongest competitor to the market is the state. Its advocates doubt the normative foundations and actual performance of markets and then note the special strengths of the state. In standard democratic theory the state represents the broad interests of all citizens (by implication more or less equally) and is the only institution to do so (Dahl, 1998). Often, an implicit "social contract" mythologizes a necessary link between the needs of society and the behavior of the state, as in Hobbes, Locke, and Rousseau. More pluralist views expect the state to operate in the public interest via the leverage "the people" have over politicians competing for their vote with good policy.

Such pluralist perspectives form the core of development theories that emphasize 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 due consideration, especially where markets regularly fail. Even where markets work, the center-left hopes for a more expansive state as a check on market power that inevitably benefits the wealthy. The center-right, by contrast, fears that state efforts to be "fair" will degenerate into populist redistribution, compromising efficiency and growth.

Although the early, predominantly centrist, political economy literature was dominated by such "state vs. market" clashes, the left constructed not only the most theoretically sophisticated critique of the state but also the most vehement attack on the market (Gold, Lo, & Wright, 1975). The same appears to be true of the critical literature in microfinance. At the left's most extreme, the instrumentalist Marxist contends that the state is the "executive committee for managing the common affairs of the whole bourgeoisie" (Marx & Engels, 1998[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 microfinance (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. Commercialization'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 (1952, p. 80) 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." This more empirical perspective underlines the absence of any good reason to expect such governments to advance the interest of the mass public against more powerful actors.

If no pluralist-democratic state exists, some other agency to avoid the limitations of markets must be found. These limitations include the "market failure" acknowledged by neo-classicals as well as the more extensive "ravages of the satanic mill" Polanyi (1944) associates with unregulated markets.

In the modern era, this role is fulfilled by the various institutions of civil society, represented at the international level by values-oriented NGOs, the vaunted "third force" (Florini, 2000). As a practical matter, NGOs are growing exponentially because they are wildly popular among non-ideological reformists, but they remain under-theorized by their supporters and viewed with great suspicion by both ideological wings. Neoliberal theories, with their basic conviction that "markets function most efficiently when drained of social content and encumbrances" (Skidmore, 2001), are little more tolerant of NGOs than states. Critics from the left question the ability of NGOs to avoid the limitations of all organizations lodged within capitalist structures (Petras, 1997; Cooley & Ron, 2002). Such a structural understanding informs critics of microfinance who see it as a thinly disguised effort to co-opt those who would otherwise direct their rage about development failures toward a more radical and system-threatening critique.

Gilpin (1987) argues that political economy is the struggle between these alternative methods of social organization – the state, the market, and civil society. Each tries to organize the world according to its own principles. Each has theories and ideologies to support its case as a superior form of organization. Each supports some values and opposes others. Each benefits some groups and harms others. Political economy is the study of the struggle between these imperialistic forces. So is the Great Divide in microfinance.

3. WHAT LESSONS CAN MICROFINANCE LEARN FROM POLITICAL ECONOMY?

There are at least four, 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 for simplicity in the face of complex arguments. But reducing multiple controversies into a single rigid ideological division impedes conversation and progress.
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 sources of funds.
3) *We must place the diagnosis of poverty before the solution to poverty.* A proper diagnosis is logically before 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) *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," which identifies the mechanisms or channels through which effects are conducted. Moreover, research should seek explanations for variance rather than universality in microfinance experiences.

3.1. The Dangers of Over-Simplification and Polarization

The construction of schools of thought can help organize a wide-ranging literature, but should not be taken too seriously for at least two reasons. First, such gross simplifications 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 underlying questions and potentially cross-fertilizing ideas. This is especially damaging in an area like microfinance where different intellectual traditions and academic specializations must meet. In IPE the economics vs. politics divide has never really

narrowed and continues to impose real constraints on intellectual progress (Rao & Woolcock, 2007). Indeed, fighting ideological and disciplinary battles often appears more important than solving the underlying problems. For studies of microfinance to fulfill the rich potential of energizing disciplinary intersections in the social sciences, we need to de-emphasize ideological divisions or actively seek to bridge them.

One pole is defined by CGAP (1996), in which Richard Rosenberg lays out financial sustainability "best practices" that allow "win-win" optimism for institutionists (Morduch, 2000, p. 619). Similarly, "The Pine Book" (CGAP, 2004) emphasizes the regular reporting of core performance indicators to improve information and incentives. Key indicators are outreach (number and economic status of clients), cost-recovery, loan collection, and efficiency (reasonable administrative costs). Those best practices are served on a bed of pure neo-liberalism: financially sustainable programs can make the greatest dent in poverty thanks to scale obtainable only by attracting commercial finance, which in turn requires a minimal level of profitability.

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 recurrent theme in the remainder of this essay. According to Dunford (2000, p. 7), "Seibel (1998) challenges the use of the adjective 'best' and its implication that there is only one optimal 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'." So too, the focus on financial self-sufficiency is seen as overly narrow and suspiciously in tune with neo-liberal perspectives. Motivations are questioned in a way that stilts conversation where it occurs at all. Consider Woller et al.'s (1999, p. 53) skepticism:

> According to Elisabeth Rhyne (1998, p. 7), for example, "Sustainability is but a means to achieve [outreach]…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 complex social phenomena and the theoretical ideas surrounding them have been reduced to comic books. One example concerns the famous "Washington consensus," a compilation of neoliberal development

policy best practices established by the IMF, World Bank, and U.S. Treasury early in the Reagan years and still the dominant paradigm in many circles (Gore, 2000).

John Williamson (1993, p. 1329), who coined the phrase, 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 acknowledged that "none of the ideas spawned by the development literature…plays any essential role in motivating the Washington 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 IPE textbook (Lairson & Skidmore, 2003, p. 12) observes that "the arguments of (neo)liberals sometimes extend beyond respecting to worshiping markets." Nor is it surprising that Fallows (1993, p. 65) 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.

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

First, we must avoid critiquing microfinance institutions by false counterfactual comparison with strictly theoretical archetypes. The IPE literature is full of descriptions, for example, of the failures of import substitution policies in Latin America, which are then compared to what

liberal theory predicts from hypothetical free trade. On the other side, the dismal record of stabilization policies through the IMF is paired against the theoretical benefits of a hypothetical program more sensitive to state concerns. The lesson is clear: actual 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 actual 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-to-oranges comparison occurs when evaluation criteria do not match up with 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), reducing the chest-thumping might produce dialogue with more satisfying outcomes. Similarly, it cannot be a surprise that commercial banks structured to achieve profit are closer to profitability than NGO programs structured to empower individuals or alleviate poverty.

Third, we must acknowledge that many debates in microfinance entail differing levels of analysis (Singer, 1961). In effect, the "double bottom line" contains one set of goals – sustainability or profitability – expressed at the level of the program or firm and a second set – poverty alleviation, empowerment and the like – that makes sense mainly at the level of the community. This implies that evaluations must encompass both levels. For example, microfinance proponents often attribute its success in part to joint liability schemes that reduce the costs of evaluating and monitoring clients. However, Marr (2004) argues that such functions remain and are still costly, but that the burden shifts from the bank to civil society, with costs in the form of lost social capital rather than money. Monitoring takes time, and imposing social sanctions on neighbors undermines trust and affects social interactions. Friendship patterns are disrupted by selection or non-selection into a group and by failures to repay. Nor do joint liability groups necessarily perform these functions well, because participants' motives are divided between microfinance-related incentives and other factors, including structural power relationships and social status. We cannot ignore social

psychology and non-economic effects in our zeal to achieve income gains. That requires a conscious balancing of effects that arise at both the firm and societal level of analysis.

3.2. 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. Although plausible arguments support each main form – for-profit firms, states, and NGOs – there are theoretical, empirical, and practical reasons to doubt that any such generalized answer is possible. Mitlin (2002, p. 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."

Institutionist arguments 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, p. 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 four times that size. The highest penetration of the poor reached by microfinance occurs in Thailand, largely through the efforts of the state-run BAAC. The findings of Rosenberg (2006, p. 6) – that the projects involving the most government involvement perform the worst – deserve greater scrutiny, particularly in light of his conclusion that "In the final analysis, the quality of technical input and management…is more important than project structure."

Why can't government programs work? Good microfinance is said to be difficult for governments because the soundest principles (higher 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 forgiveness. Woller et al. (1999, p. 40) 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.

However, it is not at all obvious why we should attribute these failures to "stateness" when the alternative explanation is just that they were first attempts, from which we have subsequently learned. Barry (1995, p. 3) 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. On both grounds, we have reason to doubt that the institutionist perspective relies on anything more than what Mitlin (2002, p. 175) refers to as "somewhat incredulous faith in markets."

Morduch (2000, p. 619) denies that subsidized programs will necessarily fail, because he questions "the belief that funding will be pulled away from programs, even those able to demonstrate sustained social effectiveness." Donors are as rational as any other investors and will value efficiency in "bang for the buck" terms even if measured in outcomes other than profitability. As a result, subsidized programs are not inherently inefficient or short-lived. Robinson (2001, p. 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 subsidies enjoyed by Grameen seems to establish that they *are* sustainable by the soundest possible empirical criteria: they have actually been sustained! The Grameen family now consists of more than two dozen organizations and its microlending program has reached more than five million borrowers (Grameen, 2007).

Moreover, non-profit organizations are ubiquitous outside of microfinance, and it is not obvious why their success in other development areas cannot be duplicated in microfinance. Many NGOs are revealed as highly

efficient by the well-developed theory of shadow prices computed in connection with net social gain, transaction prices, and the like (Thys, Tulchin, & Ohri, 2005). Among them are familiar names that operate at large scale and over a long period of time: 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.

Gonzalez-Vega and Graham (1995, p. 15) contends that "in order to survive, the agricultural development banks must first emphasize their role as financial intermediaries." Even if he is right, 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 cannot be the major problem; if these individuals have managed somehow to produce excellent work despite the nature of their organizations, can't the same be done in microfinance?

Similarly, Morduch (2000, p. 619) acknowledges some failed 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 or NGOs cannot achieve success. Indeed, Rich Rosenberg of CGAP (2006, p. 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. It is striking that CGAP, an international organization, has been a leader in improving functionality, as has the LINKS program of Catholic Relief Services (Dingcong, 2004).

The welfarist perspective similarly re-creates an ideological perspective deeply rooted in political economy. Woller states the case with unusual candor: "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 may be misplaced. The first mistake will be hard to see for most welfarists: the 'spiritual foundation' is not necessarily THE animating force for microfinance and definitely 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 markets with soulless endeavors. Commercial enterprises are not the only entities facing competition that could divert focus from the welfare of the poor: government programs and NGOs face it too.

The emphasis on sustainability and, especially, high repayment rates and other performance indicators attractive to commercial finance have developmental implications beyond forcing MFIs up the income curve to avoid the poorest and riskiest. It also encourages low-risk, quick-return enterprises over those with greater long-term developmental potential, such as production of asset-deepening goods or services. Small loan sizes may even create the perverse incentive to use cheaper, but less productive, technology, thus eroding productivity.

Similarly troubled, Woller regards evangelistic commitment to a particular hegemonic form of service delivery as dangerous to experimentation and diversity in MFI operations. As microfinance moves toward commercialization and larger loan balances, more individual and less group lending, it is in short becoming less distinctive. Littlefield and Rosenberg (2004, p. 39) 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."

There is no shortage of writers arguing for a middle ground in creating effective MFIs, an approach that would be made much easier by calling off the ideological war between market and state. Padhi (2003) suggests marrying the capacity of NGOs as "change agents" with 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) describes an appropriate state role.

Three developments may make a cease fire a little easier to achieve. First, between the classic political economy division of state vs. market lies civil society and the actor that exemplifies it at the global level, the international NGO. That NGOs 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. Third, empirical studies have so far found little evidence of MFI performance differences among the categories.

Civil society has occupied an important role in development discourse at least since Putnam's famous popularization of "social capital" as a significant productive resource. 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, 1998, p. 1)

Putnam argues that a vibrant civil society populated by institutions that bind the population together contributes to development as fully as do the 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 IPE concepts. Rankin's (2002) discussion of social capital in the form of trust emphasizes the norm of reciprocity which Polanyi posed as an alternative to the market (or charity) as a means of gaining cooperation. The "social collateral" championed by Grameen – one's social standing, which failure to repay puts at risk – follows directly from Polanyi's discussion of social standing. Dowla (2006) similarly applies "social capital" to Grameen Bank's creation of trust, norms, and networks.

Interestingly, critics of NGOs from the left seem to agree with critics from the right who advocate 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. Petras (1997, pp. 13–14), for example, warns that 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."

Although the earlier 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 also hybrids are everywhere. It is no longer easy to construct a typology of MFI organizational forms. "In reality, non-governmental organizations are not non-governmental" (Petras, 1997, p. 13), because so much of their funding comes from states; instead they are merely subcontractors of states and IGOs. 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. Differences in technique also involve individual lending, revolving funds (without professional management), self-help groups, and savings-based groups.

It is even harder to fit individuals into the categories. Despite its image as the quintessential response to the failure of the market, Grameen is a chartered bank. Since Banco Sol (Bolivia) became the first NGO to transform into a Regulated Financial Institution (RFI) in 1992, lines have increasingly blurred. At least 39 had followed as of 2003 (Fernando, 2003) and many more have since. Similarly blurred partnerships between all three institutional forms are represented in India. A state requirement that 18% of the net credit of commercial banks must go to agriculture has caused commercial banks without rural branches to partner with NGOs (Meehan, 2004, p. 13). The microfinance program of India's National Bank of Agriculture and Rural Development – the Self-Help Group–Bank Linkage Program (SBLP) – is the world's largest partnership between development NGOs and commercial banks, with more than 1.5 million groups averaging 15 clients per group (El-Mahdi, 2005). Thailand's BAAC is a state-run bank that operates heavily through cooperatives and its microfinance operations have long been financed by a subsidy of sorts from the requirement that all state agencies use state banks for any banking activities. One wonders if a typology neither mutually exclusive nor mutually encompassing deserves to be the focal point of such ideological controversy.

Finally, 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 few differences found when the question is asked. 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 regulatory effect. 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). Cull, Demiguc-Kunt, and Morduch (2006) is the most elaborate study. They find various differences between group- and individual-lending MFIs, but little difference remains based on ownership after controlling for lending and various other covariates. Similarly, Mersland and Strom (2007) analyze the performance differences between 132 NGOs and 68 shareholder-owned

firms (SHFs, 13 banks, 55 non-bank financial institutions) in 53 countries and find no difference in cost-effectiveness or return. Nor were NGOs more socially oriented. "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…" (Mersland & Strom, 2007, p. 18). Perhaps it should not be so surprising that differences are hard to find since, as they observe (p. 5), "Most equity holders in SHFs are NGOs, donors or social oriented investors."

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

3.3. Diagnoses of Poverty

The conviction that microfinance can help alleviate poverty is hardly absent theoretical support. Indeed, the variety of theoretical justifications offered for microfinance is a greater problem than the dearth of them. Skeptics 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 research – 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 conditions in any particular case. Currently, donors and investors fear a bait-and-switch ploy, and evaluation researchers miss opportunities presented by measurable intermediate targets suggested by theories of poverty and poverty alleviation.

The number of proposed channels through which microfinance could help alleviate poverty are nearly all both plausible and easily illustrated with anecdotes. The channel most responsible for the allure of microfinance involves unleashing microenterprise previously blocked by the absence of capital. This story is in the glossy presentation of nearly every microfinance institution – and it is compelling. 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). Even Robinson's (2001) multi-volume academic treatise goes only 14 pages before describing an Indonesian man who expanded his business making stoves from scrap metal.

By this theory, capital is critical to poverty alleviation and the creation of new microenterprises is a 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. The diagnosis is lodged squarely in standard microeconomics of the firm: productive potential is a function of available land, labor, and capital, and their efficient combination 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; Swan, 1956). 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. Lipton's (1977) classic of political economy *Why Poor People Stay Poor* answers the title question by implicating 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 return to capital is highest when capital is scarce but the other factors are present in relatively large quantities. Lipton then alerts us to the very high returns that must follow from the massive factor imbalances in poor rural areas, where capital is both difficult and expensive to acquire. Enter microcredit – and the market failure argument of institutionists that the poor can afford to pay very high interest rates because the marginal return to capital is higher yet. 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. This theory is supported by empirical research that establishes the importance of business ownership: even for modest microenterprises, the income of owners is far higher than those who do not own a business (Felkner & Townsend, 2007).

Unfortunately, the poverty diagnosis embodied in this micro-enterprise-centered story is often inconsistent with either the facts on the ground or the operations of MFIs or both (Cohen, 2002). In the absence of business opportunities in poor economic environments and the entrepreneurial skills to take advantage of them, the marginal return to capital and the debt tolerance of the borrower may be closer to zero than the high interest rates usually associated with sustainable microfinance. Indeed, many microfinance proponents and critics alike doubt that entrepreneurship is for everyone (Paulson & Townsend, 2004). CGAP CEO Elizabeth Littlefield

(2007) herself questions whether "the world can absorb that many self-employed micro-entrepreneurs" and

> 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.

If so, it is not obvious that microfinance can "shift its focus from self-employment to jobs" – or that it should. Job creation, which by definition involves expanding and managing enterprises significantly larger than typical 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. As Schreiner and Woller (2003, p. 1567) put it, "Microenterprise is a 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 stereotype of the poor as helpless objects of development planning unable to contribute meaningfully to their own futures.

A related goal is to enhance profits in existing businesses by reducing financing costs, which may not even involve output expansion. This is possible by replacing high cost informal finance, especially from local moneylenders who have a reputation for exploiting near-monopolies in local capital markets. Interestingly, Muhammad Yunus cites this scenario as the inspiration for his innovation, not the absence of capital preventing the creation of new enterprises. Despite similar underlying logic, the practical implications of the differences are significant. Yet, existing literature has not given much attention to either the role of competition or the effect of existing as opposed to prospective microenterprises. Exceptions include Goldberg's (2005) plausible suggestion that Coleman's (1999) finding of no poverty impact for marginal provisions of microcredit in northeast Thailand was due to the prior saturation of credit markets by BAAC. Indeed, 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) 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 and increasing numbers of leading MFI practitioners doubt that access to credit is the sole (and many doubt that it is even the main) bottleneck to development. Surely it varies, 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 have MBAs? If they are not, then finance must be packaged with other programs. Much existing literature does not recognize that building skills and capacity in business operations, new technologies, and marketing are vital in some environments and unnecessary in others. On the contrary, the recognition of the multiplicity of needs implicit in the recent evolution from microcredit to microfinance (adding savings, insurance and other financial services) is a hopeful trend.

In response to poverty diagnoses not centered on capital, many NGOs use microfinance as an entry point for other social interventions, just as the sovereign debt mechanism enables international lenders from the IMF, World Bank, and national aid programs to gain leverage on the macroeconomic 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 debt while securing long-term growth. Even Marguerite Robinson, an ardent champion of the financial services approach, points to the alternative goal of building the self-confidence of the poor. A particular manifestation of that goal is women's empowerment, mentioned by many MFIs. Such a goal need not involve new enterprises, but rather 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 limited financial access. Group-based approaches are especially likely to be tailored to these kinds of social outcomes because they create networking opportunities otherwise blocked by local power constellations, cultural norms, or geographic considerations. That said, it is still not clear through what channel loans generate the capacity to repay them.

This gap makes microfinance critics very nervous. Although the theoretical case for loaning money for investment purposes is clear, the underlying economic theory suggesting net long-term benefits of consumption loans is decidedly more murky. That the time discount rate exceeds 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. The greater outreach sought by institutionists may not be good if credit is extended to

people who cannot use it effectively – or for whom alternative programs might work better. The challenge is to prove that alternatives to MFIs, such as rotating savings and credit associations or cooperatives, cannot do the job with lower overhead costs.

In this respect, advocates of the financial systems approach seem more realistic than the poverty lending school in arguing for explicitly limiting 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, whereas it was about 14% for richer borrowers (who also had larger loan sizes).

The goal of income smoothing that underlies most consumption loans implies a very different assumption about time-series trends in the ability of borrowers to pay. Critics note that 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 critics that they will acquire a "debt mentality" that easily accepts more-or-less constant and permanent insolvency that makes default inevitable. Welfarists from the political economy tradition are likely to feel that a socially responsible lender committed to the "creation of value" (Woller & Schreiner, 2002) should avoid unsuitable loans, but this implies that both fund usage and the liquidity of the borrower be more closely monitored than is usually possible.

Moreover, economists schooled in the neo-classical tradition are likely to find judging the value of a transaction to a willing participant unnecessary, uncomfortable, and/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.

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 a poetic abstraction based upon the myth of humans as unitary, consistent, integrated, and rational actors. They accept that poor people will frequently borrow money against their own interests. 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.

3.4. 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, as quoted in Weiss, Montgomery, & Kurmanalieva, 2003; p. 1) 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.

Yet agreement on the necessity of filling that gap (and how thoroughly) is far from universal (Copestake, Bhalotra, & Johnson, 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 studies and reports appreciated mostly by academics.

However, the value 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 good enough. Financial services analysts and others do not question welfarists' determination to alleviate poverty but may doubt their dedication to achieving it through non-aid channels. They sense that many microfinance NGOs are comfortable with 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. Beyond that, theorists will want to know whether successful outcomes develop through expected channels or other mechanisms. Practitioners will focus on whether differential success can be explained by variables MFIs

can control, such as products and procedures, or by external factors. Both will be concerned with environmental conditions: practitioners for guidance on location choices; theorists for new clues to the eternal question of why development occurs in some places and not others. It is clear 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 scale or different practices by MFIs. For example, cultural effects might help explain why group lending works better in some environments (Tapella, 2002; Gine, Jakiela, Karlan, & Morduch, 2006). Evaluation studies exploring such complex socially embedded sources of variance require greater participation by development economists, sociologists, anthropologists, and other social scientists attuned both to development problems and to their diversity across different settings.

Most evaluations thus far explore internal performance measures rather than external outcomes (Rosenberg, 2006; Dingcong, 2004). Chavan and Ramakumar (2002, p. 957) summarize the consensus: "Most of the available studies narrowly focus on their 'programmatic success' (Rahman, 1999, p. 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 default rates, 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 methodologically demanding and skeptical audience.

The next advance beyond business criteria usually analyzes targeting success, such as the percentage of clients in a target segment, usually defined by income or wealth (e.g., for Grameen, women with less than .5 acres of land). Some programs explicitly aim for the "working poor" or "entrepreneurial poor," whereas others declare focus on the poorest of the poor. Some microcredit programs worry that loans may reach richer customers who already have access to formal credit arrangements and so do not need microfinance services. 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 portfolio, under the assumption that the relatively better off will seek larger loans. Such data

are readily collected by the MFI, but clearly the fit between measure (loan size) and concept (income of the borrower) is weak.

By emphasizing outreach (via targeting studies) and sustainability (business criteria), most analysts have assumed away the more fundamental question: 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 & Weiss, 2005; Weiss et al., 2003; Kabeer, 2005; Littlefield, Morduch, & Hashemi, 2003; Armendáriz de Aghion & Morduch, 2005; Meyer, 2002; Sebstad & Cohen, 2000) than really rigorous evaluation studies. And more guidelines concerning how to evaluate (Hulme, 1997; Westley, 2002; Simanowitz, 2004; Copestake, Dawson, Fanning, McKay, & Wright-Revolledo, 2005) than actual evaluations. That pattern reflects a complex of methodological challenges, most of which apply to policy evaluations in general, but some of which are unique to microfinance.

Among the former is the long lag between the provision of services 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). Similarly problematic, loan recipients can show both immediate consumption gains and a decline in net assets due to debt liability. Welfare judgments then depend on the time frame and breadth of the analysis.

There is no simple way around such difficulties, especially the dual endogeneity issues of program location and client self-selection. Both problems threaten to conflate the actual impact of microfinance with the effect of unmeasured variables correlated with program participation. These patterns may bias upward the apparent effect of microfinance, exaggerating the impact. For example, simple comparisons between the growth rates of villages with microfinance programs and those without will show a spurious positive effect if MFIs chose their locations wisely. Practitioners aim limited resources where they are most likely to have a positive impact – such as in villages with good transportation and communication and where economic opportunity abounds. But in the logic of evaluators, this non-random selection 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 bias: those who choose to participate are probably the most entrepreneurial, best educated, and most well endowed in other attributes that predict success (such as wealth, health,

and access to social, political, and economic networks). Group banking formats that restrict participation to those accepted by others accentuate the tendency toward those most likely to be successful. Therefore, if participants increase incomes more rapidly than non-participants it may be a consequence of pre-existing attributes, not microfinance itself.

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. Karlan and Zinman (2008), for example, identified those initially rejected for loans but just below qualifying thresholds and randomly assigned some to a treatment group approved for loans and others to a control group. Alternatively, the control group could consist of future borrowers, as when a program interviews and accepts clients but does not begin the program immediately, like the joint studies by the Bangladeshi Institute of Development Studies (BIDS) and the World Bank (Khandker, 1998, 2005; Pitt & Khandker, 1998). Comparing older borrowers to newer ones is another possibility, recommended in Cohen and Gaile (1998). However, attrition levels are typically high enough to make old borrowers a nonrandom subset of the original borrowers, among other biases generally thought to overstate impact (Karlan, 2001; Armendáriz de Aghion & Morduch, 2005, pp. 208–210; Alexander-Tedeschi & Karlan, 2007). A useful primer on the difficulties of dealing with these biases can be assembled from the BIDS-World Bank reports together with their critiques (Armendáriz de Aghion & Morduch, 2005).

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. Indeed, many explicit 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. Even the employment of loan officers from the community itself spurs development. 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. From an evaluation standpoint, none of these goals require increased personal income in the short-run. Moreover, if goals are defined at these higher levels of aggregation, evaluation studies can be defined there also, inviting more creative approaches to validating the claims of microfinance advocates. While mitigating some of the usual econometric problems, such studies would also deal with the possibility that aggregate

effects may be smaller than individual ones if microfinance redistributes income rather than increases it.

On the contrary, aggregate effects could be higher than for individual clients if, for example, substantial numbers of potential borrowers simply know credit would be available in the event of enterprise failure (such as crop loss). They could then be less risk averse in production decisions and thus achieve greater growth. Impact assessments would need to distinguish access to programs from actual participation (Diagne & Zeller, 2001). Many may benefit without actually using that access. Whether the majority of benefits stems from externalities to communities or is contained by borrowers is an interesting related theoretical question yet unaddressed.

Even without estimation complications, the challenge of impact evaluation is formidable. Data on either social or income outcomes are 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 simply to ask the recipient, but, as Coleman (2001, p. 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, especially when borrowers are unmotivated to take the evaluation seriously. Problems include under-reporting, recall bias, and inaccurate evaluations of income in kind. Aach (2008) reported great difficulty in securing the cooperation of borrowers, a problem that probably could have been eased by greater participation 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 substantial 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 microfinance operations.

With large measurement error – even if random (itself a heroic assumption) – standard errors would be so inflated that the actual impact would have to be quite high to show statistically significant results. 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 after using controls, with only members of the village bank committee receiving significant benefits.

Furthermore, microfinance inherently produces small gains because it is dealing with poor people and only a portion of their income. As discussed earlier, benefits accrue mainly to those with sufficient skill and a favorable market, so only a minority may experience much 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 less. Honohan (2004) is less kind. He sees a great deal of "cherry-picking" as analysts emphasize findings that support their point and ignore others.

Consider Pitt and Khandker's (1998) well-known study that shows (controversially, see Morduch, 1999) a marginal improvement in consumption of 18% from loans to women and 11% for men. By any standard – certainly for any poverty alleviation program – this is a strong and noteworthy result. 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 heard over the noise? (Khandker, 2005) Doubtful, it would seem, but Khandker's (2005) study shows a clear effect in what appears to be among the most theoretically sophisticated studies. But this later study recalculates the much-cited benefit described earlier, reducing the gains to 8% or less and notes no return at all to loans to men.

Another set of evaluation challenges arise in the form of measuring outcomes of interest beyond income, including 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.). To add plausibility to positive findings and also to document more fully the channels through which microfinance could have impact, process tracing methods would focus on these as well as on other intermediate outcomes. As an example of the latter, 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 & 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 two years) members and old members (more than five years, on average more than eight), so the effects seem quite small.

Furthermore, good studies would also 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 – some 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 & Acharya, 2005). Also fears of debt peonage and the resulting personal responsibility are deemed real by participants. Although it would seem to outsiders that reliance on MFIs would be less damaging than moneylenders, small farmer cooperatives and village banks can become political tools for 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 local political structures are a key issue, surely the prospects for microfinance and the design and analysis of programs should be sensitive to variations in different locales: for example, 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. Of course, these variables are potential outcomes of microfinance as well (Marcus & Acharya, 2005, p. 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."

4. CONCLUSIONS

In light of all these potential pitfalls, the fundamental question remains: can we say that microfinance helps alleviate poverty? The most sophisticated

impact analyses derive from the BIDS-World Bank studies of Bangladesh noted above, the series in Thailand by Robert Townsend and his associates (Kaboski and Townsend, 2005, 2006); the Coleman (1999, 2006) studies of northeast Thailand, and Karlan and Zinman (2008) in South Africa. To simplify greatly, the BIDS studies and Karlan and Zinman show a positive impact, the Coleman studies do not, and the Townsend studies are mixed. Kaboski and Townsend (2005) summarize:

> We find that institutions, particularly those with good policies, can promote asset growth, consumption smoothing and occupational mobility, and can decrease money-lender reliance. Specifically, cash-lending 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.

Many other impact studies have been conducted, but their statistical analyses are generally insufficient in dealing with the estimation biases discussed earlier. The known list of others that have achieved the imprimatur of well-known peer-reviewed journals is surprisingly short (Goetz & Sen Gupta, 1996; Pitt et al., 2003; Hashemi, Schuler, & Riley, 1996; Panjaitan-Drioadisuryo & Cloud, 1999). Other notable impact studies include Chavan and Ramakumar (2002), Smith (2002), McKernan (1996), and Kevane 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…." (Armendáriz de Aghion & Morduch, 2005, p. 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, p. 2)

Unfortunately, this last judgment, by well-respected scholars and practitioners, would be more persuasive were it not that their first two examples (MkNelly & Dunford, 1998, 1999) come from studies identified by Honohan (2004, p. 25) as best exhibiting the "cherry-pick" phenomena.

Finally, Honohan (2004, p. 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.

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

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THE NEW MONEYLENDERS: ARE THE POOR BEING EXPLOITED BY HIGH MICROCREDIT INTEREST RATES?☆

Richard Rosenberg, Adrian Gonzalez and Sushma Narain

1. INTRODUCTION

Over the past two decades, institutions that make microloans to low-income borrowers in developing and transition economies have focused increasingly on making their lending operations financially sustainable by charging interest rates that are high enough to cover all their costs. They argue that doing so will best ensure the permanence and expansion of the services they provide. Sustainable (i.e., profitable) microfinance providers can continue to serve their clients without needing ongoing infusions of subsidies and can fund exponential growth of services for new clients by tapping commercial sources, including deposits from the public.

The problem is that administrative costs are inevitably higher for tiny microlending than for normal bank lending. For instance, lending $100,000

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