Socio-economic Perspective of Microfinance as a poverty reduction tool

Ada Jaffery and Dawood Mamoon

University of Management and Technology, University of Islamabad (A Bahria Town Project)

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Socio-economic Perspective of Microfinance as a poverty reduction tool

By
Ada Jaffery
MS Student
University of Management and Technology
Email: jafferyada@gmail.com

And
Dr Dawood Mamoon
Professor and Dean, School of Management and Economics
University of Islamabad (A Bahria Town Project)
Email: dawoodmamoon69@gmail.com
Abstract:

This paper aims to critically evaluate the microfinance approach in social and economic perspective. Critical analysis reveals that microfinance can be used as an efficient tool to reduce poverty, thus contributing towards economic as well as social development. Moreover, paper highlights the role of institutional design and indicates that microfinance institutions working on the lines of non government organizations and following the double bottom line approach performs better than the other institutional frameworks. Joint liability and the role of group leader are eminent in enhancing the performance of these institutions. Poverty can be decreased if microfinance institutions are driven in a more systematic manner keeping in mind primarily the well being of society.

Keywords:

Section 1

Introduction:

Economic development is considered as a process by which policy makers’ work to improve the conditions of a developing state. Development economics covers the financial expansion, economic growth and improvements in the general well being of the people, usually referred as social development. So, in general economic development is an amalgamation of socio-economic improvements. Debate on growth and development has been in the limelight especially in the developing countries and research proves that in certain circumstances growth without development leads us towards poor social conditions. It is important to understand that for a country to do well, all the sectors need proper and equal effort at a national level. Disparities in the sectors takes countries towards coordination failures and poor values of social and economic indicators such as GDP, employment, investment, trade, balance of payments, literacy rate, health facilities, infant mortality, population and access to credit etc. In developing regions around the globe including Latin America, Asia and Sub-Saharan Africa, it is generally observed that socio-economic state of affairs is pitiable. Many international and national agencies are working on these lines so that they can uplift these conditions.

United Nation Organizations and World Bank are the most prestigious institutions working for the well being of people in many prospects in different countries of the world. Poverty, human rights, education, health, finance, security and peace are the major areas where these international bodies are functioning. Operating via their own centers or collaborating with the state governments, or NGO’s these organizations have extensively worked for the well being of communities. Among all the issues being addressed by these associations poverty is a core problem, as it is related to the overall socio-economic development of the society and state. Poverty is a multifaceted problem (Simanowitz, 2002), and that is why its alleviation methods have been discussed by people from all walks of life including economists, sociologists, educationists, as well as psychologists.

Poverty is referred to a state or a situation in which an individual or a community is deficient in its financial resources and rudiments to have the benefit of minimum standards of living and well
being that’s considered acceptable in society. As explained in the definition poverty depicts the level of necessities available to the people in the developing countries. In this context microfinance has played a significant role and has been considered as a tool to assuage poverty level. After the success of Grameen Bank of Bangladesh initiated by Doctor Muhammad Youniss and after receiving Nobel Prize by the Norwegian Nobel Committee in 2006, microfinance has been widely considered as a poverty diminution instrument. According to NNC microfinance can be very helpful in shattering the hedge of poverty and can be a prerequisite in establishing global peace.

Microfinance is a hot topic in the present development debates and is defined as “provision of financial services to the underprivileged class of the world”. In developing countries the major reason of poverty is the lack to the access to credit in both rural and urban slums. High interest rates charged by the local money lenders and the formal proceedings majorly leave the poor class with no credit in rural and sub-urban areas respectively. Apart from credit accessibility there are various other social services offered by the microfinance institutions which help their members combating poverty and several other related adversities of their lives. Facilities of micro credits, micro savings, micro insurance, trainings and micro remittances help individuals to break the vicious circle of poverty and services such as investment in health and education smooth out the progress of social development.

These are the major reasons why microfinance programmes have been introduced in many countries around the world particularly during the last three decades. Between 1997 and 2005 the number of microfinance institutions have increased from 618 to 3,133 (Daley-Harris, 2006). To support this new paradigm United Nations declared the year 2005 to be The International Year of Microcredit. UN affirmed that in 2002 almost one fifth of the population of the world were living below the poverty line i.e. their earnings were below 1$ a day, microfinance has helped people in combating poverty. U.N claims that the aims of the Millennium Development Goals (2000), which are substantially eradicating poverty with other human development goals, can be achieved by the noteworthy contribution of microfinance.
There are different types of institutional frameworks found in the microfinance industry (Dunford, 1998). Considering the Charter Type used by Mix Market these institutions can be categorized as Non-government Organizations (NGO’s) or other microfinance institutions (MFI’s) which include banks, rural banks, credit unions and non bank financial institutions (NBFI’s). The performance of every MFI differs from the other because of several reasons. Two major challenges which microfinance institutions face are the financial sustainability and outreach. Both these issues are linked with the impacts of the MFI’s on poverty abolition.

Objective of the paper:

This paper aims to critically analyze firstly, the performance and efficiency of microfinance institutions by exploring which type of institutional design is better to become most effectual in stamping out poverty, secondly the role of microfinance institutions in enhancing general well being of the people in context to social development and thirdly impacts of microfinance on the socio-economic development and growth of developing countries.

The paper is further organized in the following manner: Section 2 of the paper builds the conceptual framework useful for understanding the microfinance approach, Section 3 examines the types of institutional design of the MFI’s and flaws associated with them, Section 4 helps to establish a link between MFI’s, poverty alleviation and socio-economic development, Section 5 provides concluding remarks and policy prescriptions on the debate under consideration.

Section 2

Conceptual Framework:

Poverty is a multidimensional trend which covers an individual’s economic and social capabilities. Eradicating poverty is a difficult task for both United Nation Organizations and World Bank. The process of poverty alleviation requires a coordinated effort for purpose of
Microfinance; A poverty reduction tool, Socio-economic prospective empowering people economically as well as socially, so that the human capital can be made more productive (World Bank, 2006). Poverty is considered as the divest of general well being of individuals. Low income level, poor health conditions, meager access to education facilities, insufficient capacity and lack of security, less facilities to improve one’s life and lack in freedom of speech encompasses poverty. (World Bank, 2010). So poverty is not just an economic issue it is related to many other things which affects the social well being of communities.

Microfinance institutions work as poverty eliminating tools but on the double bottom line approach which means they have two objectives financial and social (Christen et al, 2004). These objectives of the MFI’s have been widely debated by two different schools of thoughts known as Intitutionalists and Welfarists. Intitutionalists are the advocates of self-sufficiency in terms of finances so that MFI’s can survive without any external help from donor agencies (Adam and Von Pischke, 1992) and Welfarists are of the view that social development and helping the poor should be the primary goal of MFI’s (Hulme and Mosley, 1996). There exists another segregation of opinions in credit deliverance in context with the poverty reduction. The Income generation approach which believes in providing credit only to those poor who can use these finances for business purposes or such activities by which revenue can be generated. In contrast to this is the New Minimalist approach, which supports providing loans to needy people without taking into account the issues of one’s economic state and risk of default and repayments (Mustafa and Gill, 2006).

There are two major international bodies related to the microfinance industry. First one is “The Consultative Group to Assist the Poor” which follows the financial approach and second is the” Microfinance Summit Campaign’ aligned with the NGO’s Integrated Approach to uplift the general well being of the people and improving the social capital of the society.

Different methodologies are there to check the efficiency and performance of the MFI’s .The paper would discuss only the ones which are related to the poverty and social subject matter. Social Performance Indicator (SPI) deals with the socio-political capital of clients and measures the level of responsibility of MFI’s. The Poverty Assessment Tool (PAT) measures poverty outreach by separating clients from non-clients .It has been developed by the CGAP. International Action Research programme (IMP-ACT) examines the excellence of such
Section 3

Institutional Design:

The subject of institutional design is of great importance in microfinance, it is a crucial factor because of MFI’s dual role in the society. Informal credit facility is not a new concept; it has been in practice since late 1950’s in various parts of the world to break the monopolies of local money lenders. Small rural support programmes and cooperatives have been providing loans at subsidized rates. In this perspective economists play a major role in realizing the importance of these programmes. Efforts of Ohio School (Adam Smith, Gonzalez Vega, Von Pischke and others) are worth mentioning, as they did their best in making policy makers of developing countries understand the reasons of underdevelopment as a result of high interest rates. Their contributions provoked most of the developing economies like Bangladesh, Sri Lanka, Pakistan and Indonesia etc during late 1980’s to minimize the rates as well as the cost related to the procedures involved in rural lending. (Senenayake and Premaretne, 2006).

There are different kinds of organizations and institutions working in the microfinance industry:

FFI’s are the formal financial institutions

CFI’s are the cooperative financial institutions

NGO’s are the non-government organizations

CBFO’s are the community based microfinance institutions

All these categorizes of the microfinance agencies further have variety of diverse bodies such as FFI’s includes commercial and state owned banks, CFI’s covers multidimensional cooperatives, NGO’s are either only microfinance organizations or have various other social assignments,
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CBFO’s are mostly based on village organizations. (Munoz, 2010). Two approaches are concerned with the working MFI’s. Few follow the Financial System Approach and while others follow the Poverty Lending Approach (Robinson, 2001). Financial approach emphasis on the financial sustainability of microfinance institutions and poverty lending promotes credit financing on subsidized interest rates. Generally speaking all formal and informal institutions working in this industry go with the first approach as sustainability is one of the most important factors in measuring the efficiency as well as the performance of an organization. The Poverty Lending Approach is mainly followed by NGO’s. Non government organizations are the private institutes working to enhance the welfare of the people, they pursue with the Integrated Mechanism in which along with the finances individual’s general well being is also improved. NGO’s provides path out of poverty by helping in the field of education, health and trainings (Barclay O’Brien, 2008). They have a better understanding of the clients because they offer a range of social and economic services. In a research conducted by CGAP in 2004 it was concluded that among 24 Network Support Organizations under consideration, the performance of those were outstanding who have their implementing partners worldwide. Interestingly Asia has the largest number of partners amounting to 704 after Sub Saharan Africa with 532 partners.

As discussed earlier that poverty is a socio-economic issue, and the NGO’s working for the microfinance covers the economic and social issues of the community which makes microfinance an efficient tool to eradicate poverty under this organizational structure.

Policy makers and academic circles debate on another strand related to the theoretical framework of MFI’s. It is related to the way of lending which is either joint or individual. Joint liability lending is like a group lending which is very helpful in resolving various social issues attached with the microfinance paradigm. Whereas individual-based lending is giving credit to a specific person on personal terms and conditions. Literature on this subject strongly recommends joint liability lending as it helps in minimizing the information asymmetries associated with the Imperfect Information Paradigm (Hoff and Stigiz, 1993). This concept was concerned with the information asymmetries such adverse selection, moral hazards and enforcement. There are many arguments which support the joint liability lending. Firstly it reduces the risk of defaults as all the group members are jointly responsible for the repayment of loan. Secondly, it reduces the
Microfinance; A poverty reduction tool, Socio-economic prospective lenders efforts in the process of screening and monitoring (Chowdhry, 2005), repayments performance becomes better when members are allowed to choose their group partners (Sharma and Zeller, 1997). Thirdly, social ties play a crucial role in the success of joint liability programmes. Lending loans to groups help people in understanding each other’s social problems and they try to find solutions for these problems (Wydick, 2001). By developing social ties and refining existing relationships members help each other in elevating their general well being. Another very important factor involved in this type of lending is the role of group leader. In a study conducted on almost 102 groups from Eritrean, Africa it was concluded that group leader has the capacity to enhance social ties, reduce moral hazards, hence making the repayment structure of the group better (Hermes & Lensink, 2007).

Non government organizations and other multidimensional bodies usually follow joint liability lending as their basic aim is to serve and not earn. Whereas most of the bank type microfinance institutions takes individual lending, as they are as such not concerned with the society’s overall well being.

Section 4

Socio-economic development and effectiveness of microfinance institutions:

The microfinance wave shows relevance in its growth and expansion with the international development. In early stages the process of development was concerned with the creation of the pie and was considered as economic growth only as the availability of credit in case of MFI’s. Later on the subject was the distribution of the pie when international bodies realized the fact that social development is also important along with the economic rearing, the point where role of NGO’s comes into limelight for improving the social capital of communities in microfinance industry. Now is the time which emphasizes on the sustainability and development of the pie apart from the environmental issues there are certain other matters such as culture, politics and institutional development to create appropriate policies (Tavanti, 2010).
Microfinance movement has developed its links with the economic and social development in many ways. It alleviates poverty by establishing relationships with clients, solving their financial problems by easy and subsidized loans. Availability of such credit helps the poor in smoothening their consumption pattern also it increases the household income level. MFI facilitate people to fight poverty by providing access to the social and human capital. Most of the NGO’s while working for finances in terms of MFI’s also establish schools, dispensaries and clinics, vocational trainings and counseling centers etc. By doing all this these institutions minimize the vulnerability of the poor. At a macro level extended credit availability increases the investment and gross domestic product ratio and reduces income inequalities (Senenayake and Premaretne, 2006). MFI’s have contributed in creating employment opportunities. Most of the commercially successful microfinance institutions have created jobs for thousands of people. It is anticipated that these jobs can have a multiplier effect (Roodman and Qureshi, 2006).

Concept of social capital is considered as a missing link in the development strategy of many states (Grootaert, 1997). Social capital as defined by the World Bank “The norms and traditions which exist in societies and facilitate people in developing coordination for their goal achievement” (World Bank, 2000). Literature provides a wider scope of the term social capital, as suggested by various researchers it covers social as well as political aspects of society, in organizing the institutional framework of a society the role of social capital is worth mentioning (Olson, 1982). The performance of the MFI’s in eradicating poverty is greatly dependant on already existing social ties among clients. In a study conducted among 146 groups in Madagascar it was concluded that stronger social ties shows a high repayment rate in MFI’s (Zellar, 1998). In another study a data set of 140 groups was taken from Burkina Faso to analyze the role of social ties in efficiency of MFI’s. It was concluded that social pressure among the group members are positively related with the repayment rate (Paxton et al., 2000).

Microfinance industry has a vital role in enhancing the human capital. The term human capital was first defined as “the increase in the productive capacities of humans through different
Microfinance; A poverty reduction tool, Socio-economic prospective channels such as education and training so that maximum benefit can be attained for raising the level of production” (Schultz, 1960). Mostly all those MFI’s which are working on the poverty lending approach focuses on the social and human capital development. In any community, wherever they are working by developing social ties among clients, investing in Education, Health, Awareness programs and other trainings such agencies are improving human capacities. Especially in developing countries where these facilities are not adequate microfinance act as a safety net.

As discussed earlier such institutions help smoothening the consumption pattern of the poor. This increased consumption and raised level of income leaves a long run impact on this class in different ways, they can improve their diet and can send their children to schools (Dasgupta, 1995). This has been observed in many countries that by improving health conditions labor productivity is improved. A study conducted in Indonesia on same lines showed that by raising the level of fish, fruits and vegetables in the diet by 10%, the chances of illness can decrease by 9, 3 and 6 percent respectively (Pitt and Rozenweig, 1985). Various NGO’s are also working to decrease infant mortality rate. Apart from health sector these organizations have contributed towards education by increasing the ratio of school enrollment in various communities. Freedom of speech and human rights are the main agenda’s of many non government organizations. MFI’s working as partners of various international NGO’s spread such awareness programs which help people to understand their basic rights.

It is seen in the microfinance debate that women clients have always been privileged because of the fact that their rights are usually commanded by men in rural areas. Getting a chance to work and contribute in enhancing the well being of the family gives them respect and equal status. In a study on social efficiency in microfinance institutions a strong relationship was found in women empowerment and effectiveness of poverty eradication. Data envelopment analysis has been used to show a significant relationship among these two indicators. Another finding of the same study is the more socially efficient role of NGO’s in microfinance industry (Gutierrez, et al., 2009).
Section 5

Conclusion:

This paper is an attempt to critically evaluate the microfinance approach in social and economic perspective and the way it can be used as an efficient tool to reduce poverty in developing as well as underdeveloped world around the globe. Discussion reveals the fact that the scope of microfinance is quite wide and it cannot be restricted to the financial services only. Microfinance institutions are playing important role in developing human and social capital and uplifting the well being of communities. Thus acts as a major contributor in increasing the welfare of communities by reducing poverty and providing other services.

As far as the framework of design is concerned non government organizations are performing far better as compared to other institutional bodies in this sector. Only non-government organizations are able to work under the integrated approach. Following the double bottom line, NGO’s are able to provide their clients both social and economic benefits.

The impacts of microfinance can be maximized in long run if the industry is driven in a systematic manner, understanding the fact that these institutions are different from the commercial and profit oriented financial institutions of economies. Paper explores that microfinance institutions can work efficiently with joint liability programmes where group leaders play important role. Moreover, limitations are required so that efficiency can be enhanced. Microfinance schemes running solely on the welfare lines can help the underprivileged class to become active member of society and then they can pool in the economic prosperity of states.
References:


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