

## **Who should Microfinance help: the 'poor' or the 'poorest of the poor'?**

### Introduction

Should there be a requirement that American aid for international microcredit programs go to the very poorest of people? Researchers have found that people near the poverty line are more likely to take advantage of microfinance programs and are more likely to get bigger loans and ultimately build successful microenterprises. At the same time, those much further below the poverty line are more likely to drop out of microcredit programs. The United States Congress, along with numerous organizations, is pushing for greater inclusion of the poorest people in these programs – yet this is likely a difficult task to achieve absent new methodologies. An additional problem raised is how to monitor the progress toward this objective.

This paper will begin with a brief background of microfinance, including a general overview of its programs and of the U.S. government's involvement with this initiative. I will then analyze the growing concern over including the poorest of the poor in microfinance programs. Finally, I will propose a number of solutions for broadening the impact of microfinance, including a lending program that would first alleviate the quality of life for the very poor and another program that would expand the membership of “solidarity groups” to include more who fall below the poverty line.

### Background

#### *Overview of Microfinance*

Microfinance programs aim to alleviate poverty by strengthening the ability for economic development, income growth, and entrepreneurship in much of the developing world. Microfinance institutions began to emerge in large numbers in the late 1970s.

Today, loans of \$1,000 or less in Europe and Eurasia, \$400 or less in Latin America, and \$300 or less in the rest of the world are allotted for local small businesses made up of ten or less employees.

Before the emergence of microlenders, many of the world's poor became deeply indebted to moneylenders who charged exorbitant yearly interest rates of up to 120 percent. Microfinance programs have helped to lessen much of this burden by charging interest rates that generally range from 20 to 50 percent. Because the poor cannot provide collateral, many lending institutions require microenterprises to form solidarity groups to take on the debt obligations of each other, which has resulted in a repayment rate that is often over 97 percent. This is where I believe the strength of the microfinance program lies. Existing studies found that microenterprises have “positive impacts on business and household income, education and employment, especially among women (making up 69 percent of the program participants).”<sup>1</sup> As the microfinance industry continues to grow with more than 500 institutions worldwide and large commercial financial institutions such as Citigroup and Deutsche Bank expressing interest, the United Nations declared 2005 as the International Year of Microcredit.

### *U.S. Governmental Involvement*

Since 1988, Congress has continued to strongly support microfinance through a variety of measures including appropriation bills and other legislative means.<sup>2</sup> The Agency for International Development (USAID) receives annual appropriated funding for microfinance programs totaling over \$2 billion, with 3.7 million microenterprises

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<sup>1</sup> Curt Tarnoff, *Microenterprise and U.S. Foreign Assistance*: Congressional Research Service Report for Congress, April 12, 2001, p.1.

<sup>2</sup> E.g. the Microenterprise for Self-Reliance Act of 2000 and Bipartisan Congressional groups geared towards strengthening microcredit efforts.

reached worldwide.<sup>3</sup> Although other governments and private entities contribute to microfinance institutions, USAID is the primary financier and developer of such programs. The U.S. government averages annual funding support of approximately \$155 million.<sup>4</sup> While the current Bush Administration supports international microcredit programs, it proposed to cut all federal funding to U.S. microfinance organizations.

### Growing Concern Regarding Who Microfinance Ultimately Helps

Many of the 50 million people who take part in microcredit programs hover at the upper fringe of poverty. “[E]ntrepreneurial people do well with microcredit. But others who are less skilled and trained, how do they do? Can very poor households get decent returns or not? That’s the big question policy-wise.”<sup>5</sup> Supporters of microenterprise development have a variety of priorities and objectives regarding the people they lend to. Some believe that the industry should focus on alleviating poverty in developing countries. Others find that priority should go towards methods that will effectively stimulate economic growth.

There is a growing push for the nonprofit organizations and banks who take part in microfinance programs to “reach deeper into the ranks of the poor, though there is little rigorous evidence judging whether the very poor [actually] benefit from microcredit, economists say.”<sup>6</sup> In 1987, some Members of Congress, backed largely by charitable organizations, began a campaign to ensure that funding would benefit the very poorest

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<sup>3</sup> Celia W. Dugger, *Debate Stirs Over Tiny Loans for World’s Poorest*: New York Times, April 29, 2004, A1, A8.

<sup>4</sup> Stacey Young, *Microenterprise: Laying the Foundation for Economic Development*: USAID/Bureau for Economic Growth, Agriculture and Trade/Microenterprise Development Division, August 19, 2004, p. 1.

<sup>5</sup> Celia W. Dugger, quoting Jonthan Morduck, associate professor of public policy and economics, New York University, *Debate Stirs Over Tiny Loans for World’s Poorest*: New York Times, April 29, 2004, A1, A8.

<sup>6</sup> Celia W. Dugger, *Debate Stirs Over Tiny Loans for World’s Poorest*: New York Times, April 29, 2004, A1, A8.

members of the population – an approach known as “poverty lending,” which would increase loans under \$300. In more recent years, Congress has responded to this concern by including language in their foreign aid appropriations bills<sup>7</sup> urging USAID to require that half of American aid for these loans go to the poorest sector – those who make less than \$1 a day.<sup>8</sup>

The new rules have been met by strong opposition from many donors and various microfinance institutions who contend that their current initiatives are, in fact, helping countless people in need who would not otherwise be progressing without these loans. While admittedly not focusing on the very neediest, they insist that forcing those in the microfinance industry to serve the poorest is a distraction from a much broader issue of trying to reach the billions of people who have no access to credit or to a secure place to save their money. They note that microfinance programs are indeed still assisting “the poor” in developing business ventures and in obtaining subsequent financial success, because the people they are helping are at the poverty line, making not much more than \$1 dollar a day.<sup>9</sup> Further, many institutions project that without the new rules, the industry will continue to grow at a fast pace, which will ultimately help more people, including those further down the economic ladder.

This is countered by the argument that it would be possible to include the very poor in microenterprise initiatives if the international lending community would experiment with new ways to include them in microfinance. For example, the

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<sup>7</sup> See, e.g. H.R. 1950, 108<sup>th</sup> Congress and Committee Report 108-459.

<sup>8</sup> Congress defines the “very poor” by less than \$1 per day or the bottom 50% of those living below their country’s poverty line.

<sup>9</sup> *Methodology – Measuring Poverty*, The World Bank Group Website:  
[http://www4.worldbank.org/afr/poverty/measuring/methodology\\_measuring\\_en.htm](http://www4.worldbank.org/afr/poverty/measuring/methodology_measuring_en.htm).

Bangladesh Rural Action Committee (BRAC), one of the largest microlenders and advocates of expanding the industry to those well under the poverty line, has offered some poor women free wheat and skills training along with their microloans.

Yet one reason why the very poor have not utilized microfinance programs as much as others do is that despite lower interest rates, many fear they are too impoverished to repay any loan. Even organizations such as BRAC have found it difficult to broaden their base. BRAC was forced to end a pilot loan program for “ultrapoor” women because the minimal debt repayment burden was still too high.

Thus, most agree that the industry must continue to work at developing new approaches in order to help the poorest people. In addition to experimenting with coupling small loans and skills training, organizations such as BRAC have even decided in some cases to leave out lending completely, providing women with training, health care, and animals such as cows and goats rather than loans with which to buy the animals.

## Solutions

### Overview

While microfinance has proven to be a valuable program by assisting the needy in small business ventures and in achieving financial security, it has not reached all of the poor in areas where it exists. However, the current microcredit system is often an unrealistic and impractical way of addressing the problems of the destitute. Therefore, I propose that the microfinance industry remain largely what it is today with governments, nonprofits, and financial institutions continuing to use existing support programs, while more aggressively developing new methods to financially assist the poorest of the poor.

*Proposed New Approaches:*

*Proposal #1. Initiatives to First Alleviate the Critical Problems of the Very Poor*

Those who are destitute have unique and critical needs that must arguably be addressed before they can benefit from a microenterprise program. Further, after borrowing money, those at the very bottom of the economic ladder could end up even more vulnerable than they were before.

Thus, in order for many of the very poor to be able to successfully participate in a microfinance program, they must first be provided with food, clothing, shelter, and health care. This approach calls for the development of a two-step program that would first address a person's basic needs, and then provide resources and training to begin a microenterprise, which could ultimately lead to a successful business and loan repayment.

This type of initiative would likely involve more socially-conscious microfinance institutions, donors, and government programs such as USAID, should the majority of microfinance institutions be reluctant to participate. Donors, however, have been providing financial and technical assistance essential to the development of microenterprises from the very beginning. “[D]onors as well as...private foundations have provided the initial capital for loans, funds to cover operating losses, equipment such as computers to track loans...instructors to provide training...and other skills.”<sup>10</sup> In 1995, a number of prominent organizations such as the World Bank, USAID, and the U.N. Development Program formed the Consultative Group to Assist the Poorest (CGAP). CGAP has received well over \$60 million in funds and commitments for its

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<sup>10</sup> Curt Tarnoff, *Microenterprise and U.S. Foreign Assistance*: Congressional Research Service Report for Congress, April 12, 2001, p.4.

activities and continues to operate on a \$10 million annual budget. My proposed program would have to seek donations or government sanctions for the first step to help pull the destitute out of their dire situation. Step two could follow with the involvement of lenders confident that those being helped by the program can start a business and pay back their loans.

*Proposal #2. Expansion of Solidarity Groups*

As discussed above, in order to eliminate frivolous loans and encourage timely repayment, some microfinance institutions require that entrepreneurs form solidarity groups consisting of five or more loan seekers, all of whom agree to take on each other's loans as a collective obligation.<sup>11</sup> This collective obligation leads to group peer pressure on its individual members to repay their loans so as not to risk losing microcredit as a financial opportunity for their community. By expanding group requirements to include one or two group members who fall well below the poverty line, solidarity groups are a potential way to include the very poor in microenterprise initiatives.

One problem in implementing this policy is that not all institutions have solidarity groups to begin with. Since this is a policy that has proven to work and boasts very high repayment rates, around 97 percent, more institutions could be convinced to include solidarity group programs. Congress, as well as groups and institutions that advocate broadening microfinance to all sectors, would have to create an aggressive campaign to raise lenders' usage of these groups.

There is the further problem of naturally increasing the chances of loan defaults within solidarity groups that take on poorer members. In order to make it fair for others

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<sup>11</sup> Curt Tarnoff, *Microenterprise and U.S. Foreign Assistance*: Congressional Research Service Report for Congress, April 12, 2001, p.3.

in the group, there should be a careful screening process to ensure that the extremely impoverished member (or members) has a viable business plan and is absolutely willing to repay his or her loan. Additionally, other group members should be afforded some type of protection and/or incentive for participating in the new type of group. This will enable those with the entrepreneurial spirit and skills to assist those less fortunate than them while simultaneously ensuring that the solidarity of the group provides the means to repay the loan. Congress should include an account in the Foreign Operations appropriations bill to help these new kinds of solidarity groups have lower interest rates and guaranteed assistance for loans that a very destitute member could not repay.

This leads to another potential difficulty – funding. Congress would have to agree to add money to a program that already receives \$155 million per year (see above). Considering the war in Iraq, massive tax cuts, and growing deficit, the government is more and more reluctant to add programmatic funding. Thus, resources to support this effort would likely have to come from traditional USAID funding, which is already limited.

Although it will not be easy to achieve, increased assistance for solidarity groups is not an impossible option. In addition to the high repayment returns, studies have found that these groups have helped in generating new employment, in raising the income of others, and in directly benefiting the families of entrepreneurs.<sup>12</sup> Additionally, when solidarity groups are formed, an opportunity is created for borrowers to be educated in finance, and - if the lender is socially oriented - education in family planning and health care are provided as well. For example, the Grameen Bank in Bangladesh lends

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<sup>12</sup> Curt Tarnoff, *Microenterprise and U.S. Foreign Assistance*: Congressional Research Service Report for Congress, April 12, 2001, p.4.

exclusively to women and provides vaccinations through its groups, while other groups have been motivated to organize day care centers and clinics in response to problem solving discussions. These examples of social change through solidarity groups, coupled with the elevated rates of repayment, indicate that solidarity groups can be an effective option for broadening the base of those benefiting from microenterprises.

### Conclusion

There are several variations of microenterprise throughout the world. Microenterprise in one area is not necessarily “micro” in another area. As seen in this paper, a microenterprise loan in Europe may be \$1000, where as in Africa it may be \$300. Yet regardless of the amount of the loan, it is important to note the fact that these programs help those who are extremely poor, especially relative to United States quality of life standards.

United States aid to foreign countries, specifically through USAID, is substantial. With the continued assistance to microenterprise, the amount of aid to these foreign countries could be lessened because as these small entrepreneurs begin to succeed in their businesses, their quality of life increases as does the economic vitality of their countries.

While I believe that the methodology governing how foreign aid is given to the entrepreneurs in these poor countries will be debated for some time to come, the fact that we are helping people will make a world of difference. If we can come together, not just the United States, but all countries and organizations providing support for microenterprise, on how to best fund this program, it will slowly begin to end poverty and hunger throughout the world.

There are numerous ideas and approaches about how to include the very poorest people in microfinance, if at all. The best way to support microenterprise will not be the same for every situation. For instance, in Bangladesh, BRAC found that lending to women only was the best way to implement the program. And when it attempted to expand its program and help the “ultrapoor,” BRAC failed because the minimum debt burden was still too high. In other situations where the lending institutions require the loan recipients to form solidarity groups, loan repayment rates have been as high as 97 percent. This is why one of my own proposals concluded that financial stability for the very poor could be achieved by supporting greater funding for solidarity groups.

The wide variety of solutions and goals shows that in order to effectively continue a microfinance program that helps people pull themselves from the depths of poverty, those funding it should take an open-minded approach and a patient attitude as the program expands.