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The New Economy

Microfinance works, even without a Hollywood ending

Contrary to the hype, microfinance doesn't help everyone – and microfinance loans sometimes go for personal needs, not a business. But that's OK.

Tairabi Pathan, who took a loan of rupees 10,000 ($220) from a microfinance company to start her own business, arranges her goods for sale at the side of a road in a slum area in Mumbai Oct. 26, 2010. India's microfinance industry, which surged to prominence when George Soros-backed SKS Microfinance raised $358 million in an IPO, faces a regulatory clampdown that could erode profits and hurt growth. Reports of dozens of suicides by poor borrowers in the southern state of Andhra Pradesh, the hub of India's microfinance sector, prompted the state to enact an rules against aggressive recovery practices by lenders who make loans that average about $150 to poor customers at interest rates that can top 30 percent.
(Danish Siddiqui/Reuters/File)

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If you've seen a promotional pamphlet from a microcredit organization, then you've probably heard this one before: a poor seamstress takes a $100 microloan, buys a sewing machine, quadruples her output of skirts, raises the profits of her one-woman business, and so pulls herself and her family out of poverty.

It's a compelling story. It means giving borrowers a hand up – not a handout. Maybe the story is so powerful because it appeals to America's reverence for the self-made entrepreneur. In any case, it has raised millions in donations for microlending charities.

Unfortunately, much of real-world microcredit does not follow this Hollywood story line. Many clients don't invest in their businesses, even if they're supposed to. In a study with a major entrepreneurial microlender in Peru, 32 percent of borrowers revealed they had spent at least some of their loan money on household goods, 33 percent on their children's education, and 23 percent on health care.

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This does not mean microcredit is bad. The real picture is mixed. Microloans have generated some positive impacts for some people, but not for everybody, and not always through entrepreneurial activities, according to the first three major rigorous evaluations of microcredit. One reason: Not everybody is a born entrepreneur.

When economists partnered with an entrepreneurial microlender in India to study welfare impacts on borrowers, they found that likely entrepreneurs tended to invest their loans in durable goods that could be used in business. Unlikely entrepreneurs simply consumed more – particularly "temptation goods," such as alcohol, lottery tickets, and cigarettes. That's not the story microcredit advocates like to tell.

Fortunately, we need not throw up our hands. Even if we have to step outside the Hollywood version of microcredit, there are still many stories with happy endings. One comes from South Africa, where Jonathan Zinman of Innovations for Poverty Action and I (Dean Karlan) studied a for-profit lender that made expensive, unrestricted cash loans to clients who had jobs. The firm didn't care what clients did with their loans, provided they made their payments on time. It didn't have any fancy rhetoric about entrepreneurship, and didn't offer any extras like business training or health education.

What it *did* have was a positive impact: A year after the start of the study, in a randomized trial, borrowers of the for-profit lender were more likely to be employed and had higher incomes than their nonborrowing counterparts. And not thanks to the familiar tale: Many borrowers had used their loans for consumption (as opposed to business investments), but in a good way. Their loans helped them recover from unexpected shocks – like sickness or damage to personal transport – that otherwise would have forced them to stop working (and presumably risk losing their jobs).

The take-away from all this is simple: We don't need the Hollywood version of microcredit. The first three major studies found some substantive positive impacts, but not always through the celebrated entrepreneurial mechanism. More broadly, we need to think harder about micro*finance*, not just micro*credit*.

Some of the most promising evidence – especially regarding women's empowerment – is coming from evaluations of savings programs. It's an exciting frontier, where providing simple and secure ways to store money empowers people to make better choices about how to use their resources and better their lives.

•Dean Karlan and Jacob Appel co-wrote a new book, "More Than Good Intentions: How a New Economics Is Helping to Solve Global Poverty.

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