Microfinance Subsidy: What we have Learnt so Far?

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Abstract

Microfinance (MF) had been functioning in many parts of the world for several centuries. However, it comes into greater attention and started to get outstanding growth only from 1970s, since when MF has perceived as an effective tool for poverty alleviation. Thus various donors as well as governments started to subsidise micro finance institutions' (MFIs) heavily. But after decades of heavy support, recentimpact studies on MFIs have been exhibiting lower than expected performance of the sector.In practice, three major procedures of experiment has commonly been followed for impact study, namely, experimental design, quasi-experimental design and non-experimental design. None of these procedures comes up with any conclusive evidence of poverty alleviation directly brought by the MFIs. Moreover, by relying on subsidy many MFIs remain non-resilient and inefficient. However, depending on impact studies solely to justify MFI subsidy is not sufficient as MFI supposedly play a great role in developing financial system and inclusion where traditional financial institutions are not viable.This paper dealt with these extended roles of MFI based on the extensive literature review.It is evident that for sustainable development in financial system of the developing countries, heavy subsidy to MFI industry should be revised and minimized, rather a more market-based framework should be implemented to bring efficiency, innovation and accountability. Among various market-based financing source, general equity and socially responsible equity investment could be the viable alternative for MFIs. Because equity investment eventually transfers the low-cost fund (needed for sustainability) as well as control (essential for achieving efficiency and innovation) over the MFIs. This research can be extended to empirical study of financial viability of MFIs without subsidy in the future.

Key Words: Micro Finance Institution (MFI), MFI subsidy, Life Cycle of MFI, MFIs efficiency.

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Introduction

History of 'Microfinance' is much older than people usually assume. Even many of the microfinance community consider that the micro-lending invented in Bangladesh around 30 odd years ago (Seibel, 2003). Nevertheless, small saving and credit groups have functioned in many parts of the world for several centuries. Even most of the developed countries (e.g. European countries) have its own history of microfinance throughout their development pathway. In developing countries, microfinance industry started to get its breakthrough growth from the 1970s when donor countries and agencies extend their hand towards microfinance program (Hudon and Traca, 2011). Initially donors' assumed that extended financial inclusion through microfinance in low-income countries will reduce poverty through creation of employment (largely self-employed) and human capital development (Khandker, 1998). Over the last four decades, using donors' favour and subsidies along with national government funding in some cases, the microfinance industry has grown considerably. According to Microfinance Summit 2015, more than 3700 microfinance institutions (MFIs) working around the world to serve over 210 million clients of which approximately 60 percent clients are extremely poor (Microcredit Summit, 2015). Despite this rapid expansion of the sector very few empirical research has found the systematic effect of microfinance on poverty alleviation (Epstein and Yuthas, 2011). But poverty impact of MFIs is particularly important as billions of dollar from development fund are invested in this sector as subsidy with the hope of sustainable poverty reduction. In this paper, MFI subsidization will be revisited in light of various recent literature to evaluate the justification of subsidy and prospective alternatives strategies. This paper is divided into few sections: the next part will present impact of MFIs in reducing poverty followed by a discussion on subsidy and financial system, reasons for heavy subsidization, funding policy and conclusion in the last segment.

Literature Review: Impact of MFIs

As mentioned earlier, microfinance is not a new idea. However, it came into the attention of international agencies, professionals and policy makers when microfinance poses poverty alleviation through an institutional framework as its central idea (Khalily, 2004). For that reason, unlike conventional financial institutions, microfinance is always scrutinized based on the level of poverty alleviation (end-outcome) along with savings, asset accumulation, child education, women empowerment, health and nutrition intake (intermediate-outcome), etc. It is aquite compelling idea as historically MFIs rely heavily on donors' fund to finance their growth. In this section, some key researches have been reviewed to explore the social and economic impact of microfinance program on people's life.

However, measuring impact of microfinance, especially from thedemand side, is immensely difficult because of its counterfactual nature. According to Odell (2010), researchers around the world broadly use three different research designs in answering this impact, such as experimental design, quasi-experimental design, and non-experimental design. Among experimental (randomized) research, Banerjee et al. (2009) have conducted one of the most significant studies on Hyderabad (a state of India) in collaboration with a large MFI named 'Spandana'. The research has been conducted over 5 years with one baseline and two end line survey. They have not found any significant impact of microcredit on monthly expenditure, average consumption, loan take-up rate and social development. Meanwhile, they have reported a reduction in informal borrowing though the total borrowing remains the same and increase in nondurable consumption. However, research design has some major flaws like chances of general equilibrium and spill over effect was very high for the locale of the study and the separation line between control group and treatment group was too narrow to reach a conclusion.

Another significant study conducted by Angelucci et al. (2014) using randomized trial has also found similar neutrality of microfinance. They did not find any transformative effect like some other previous study done by Coleman (1999); Karlan and Zinman (2009), which also did not find any conclusive evidence of positive effect of microlending. In another study conducted by Crépon et al. (2014) in Morocco using randomized evaluation, authors found very low loan take up in the treatment area, only 13 percent. Access to microcredit leads to increase in investment and profit from self-employed activities but the increase actually offset by the decrease in casual labour. Eventually, microfinance does not lead to any overall gain in income and consumption. It is important to note that these researchers mainly focused on the economic impact of microfinance. Tarozzi et al. (2015) have conducted a study in rural Ethiopia by taking a number of social indicators into consideration and also have failed to reject the hypothesis of no impact for most of the outcomes.

On the contrary, some experimental research reported a positive impact of microfinance in eradicating poverty and social advancement. Some authors have found a microcredit exhibits positive effect for those who started their loan take-up from moderately poor status while leaving severe poor unaffected (Morduch, 1998; Dugger, 2004). Over the years, the microfinance industry has broadened their focus by incorporating saving and insurance with its traditional lending program. In a randomized impact study in Kenya, Dupas and Robinson (2009) has shown that micro-enterprises constrained with savings facility, especially women entrepreneurs and access to MFI significantly affect the savings which lead to a higher investment and consumption expenditure. By and large, most of the experimental research on microfinance reports its neutrality in poverty alleviation though it has various interim impacts. It isworth noting that all of these research findings are not transparent because of possible selection bias, endogeneity of program placement and fungibility of the fund (Hulme, 2000). Hulme argues that apart from fungibility, selection bias and endogeneity problem of experimental research can be tackled by judgemental selection of sample in control groups. So, this literature review has to extend by including other research approaches like quasi-experimental or non-experimental based studies.

One of the first serious economic studies that dealt with selection bias has been conducted by Pitt and Khandker (1998) to assess the effect of microfinance in Bangladesh. They have found the largely positive effect of microfinance in income, girls' school enrolment and improvement of physical health. But in response to this paper, Morduch (1998) has conducted a counter study using the same data set and concluded that the method used by Pitt and Khandker to tackle the selection bias actually exacerbate the problem rather correcting it. Morduch (2000) has found, using a different method, very little evidence of consumption increase, instead, he reported microfinance helped to smoothen the consumption. In the following year, Pitt (1999) replied Morduch's argument and suggested that the problem posed by Morduch was wrong. In 2005, Khandker extended his research by using more data those had become available by that time and found stronger than theprevious positive impact of microfinance. However, Roodman and Morduch (2009) have expressed their doubt about the statistical accuracy of the study. Ultimately, they concluded by explaining the difficulty of nonrandomized examination method but did not suggest any particular approach to impact evaluation.

This classic academic debate about impact assessment methodologies at least illustrates that several other approaches have to use for a better understanding of microcredit intervention, like a case study, household economic portfolio and anthropological studies (Khalily, 2004). Nawaz (2010) has conducted a case study based research in Bangladesh and found out that microfinance moderately reduces poverty of the borrowers but failed to reach extreme poor of the village. Another case study based research in the Philippines by Kondo et al. (2007) has found several positive effects of microlending participation, per capita income, and expenditure including food expenditure have been increased. Dunn and Arbuckle Jr (2001) have conducted a research using household economic portfolio analysis to tackle the problem of fungibility. They have conducted three research in Peru, India, and Zimbabwe using the same methodology and found microfinance matters for poverty alleviation although the magnitude of the findings was mixed in different locale and variables. Few other non-experimental studies have reported a positive impact of MFI in improving the socio-economic scenario of the participants (Mustafa, 1996; Husain, 1998; Zohir et al., 2001). As a matter of fact, all of these three studies were internal research and used a very simple analytical process which did not capture the issue of fungibility, general equilibrium effect etc. One of the major anthropological studies brought a completely new viewpoint of microfinance analysis. Rahman (1999) has reported, after conducting a study on Grameen Bank's client, for making timely repayment bank's worker usually creates an immense pressure on its clients which leads to increased tension and frustration among the households, and creates a new form of violence and dominance over women.

Unlike experimental research, a larger portion of quasi-experimental and non-experimental studies (as discussed earlier) show MFIs' success in intervening poverty and other social problems. But much of these literature have failed to meet a rigorous level of statistical analysis. Moreover, those studies have come up with a conclusion, using qualitative methods, single case and non-random sampling, that cannot be easily replicated nor generalized for other programs' in a different context (Westover, 2008). Till date, research using best available methodology nullify the old impact studies and make the microfinance community confused about the earlier perception of the robust impact of microfinance in changing the lives of the poor. On the contrary, many professionals (e.g. Morduch and

Haley) argue about the necessity of impact assessment of microfinance as finance has an obvious positive impact on the household or individual if it practiced in the well maintained environment. Khalily (2004) has also criticized impact assessment as it is mainly donor driven act to justify their investment to their taxpayers. Regardless of these arguments, impact assessment is necessary to ensure efficient use of money compared to other intervention alternatives. In the next section, justifications of subsidizing MFI programs have discussed.

Microfinance Subsidy and Financial System

'Impact approach', i.e. poverty lending, of assessing microfinance institution is probably too narrow as this approach fails to recognize the necessity of microfinance industry for creating a financial system for the marginalized people in developing countries. Therefore Robinson (2001)emphasisto use both impact (poverty lending) approach and financial system approach to assessing microfinance industry. The latter approach mainly focuses on the institutional development, sustainability, cost-effectiveness, financial inclusion etc. However, advocates of impact approach argue that over-emphasis on sustainability undermine the poverty focus of the MFIs. Especially when donors and governments of developing countries investing substantial amount on the MFI even after having other development alternatives, the amount of subsidy should have a considerable direct impact in changing the life of the poor. Moreover, asignificant portion of the subsidy invested in the MFIs for the sake of poverty lending.

In the previous section, impact approach based literature mainly reviewed and it is evident that most of the newer results pose a doubt regarding the effectiveness of MFIs in poverty reduction. In response to those findings, MFIs commonly argue that subsidy is still required to achieve sustainability, efficiency, and overall financial sector development etc. Thus for an unbiased judgmentabout the continued subsidization in MFIs based on only impact approach might not be justified. In the following few paragraphs, the effect of the subsidy on these selected issues related to the development of financial system through of MFI are discussed.

Subsidies and Efficiency

Probably efficiency of MFIs is more robust and reliable criterion than the impact assessment based on financial and social performance (Balkenhol, 2007). Because only the higher efficiency of MFIs could lead to the expansion of the industry as well as improve the profitability that eventually brings down the existing high-interest rate. Hudon and Traca (2011) have found that subsidies play a positive role in improving the efficiency up to a certain threshold level. Beyond that threshold point, they have found negative marginal effect which conforms to the earlier argument posed by Morduch (2005). He has argued that over-reliance on subsidy limits the scale and innovation for building strong MFI. Probably subsidy up to a certain level allows MFI some breathing space to invest in human capital and infrastructure that leads to efficiency. Still hard budget is preferred than the soft budget for bailing out poor MFIs as the hard budget push the MFI managers' more seriously to perform well (Morduch, 2000). It is noteworthy to discuss here, relying on efficiency solely is not also be very much convincing as efficiency is negatively related to theoutreach of MFIs (Hermes et al., 2011). Outreach criterion is also very meaningful measure as ahigh rate of financial inclusion is considered as the long run goal of the policy makers.

Subsidies and Recovery Rate

The concluding sentence of thelast paragraph posted an anti-thesis in favour of outreach over efficiency. However, outreach measured by the number of client only can also be questioned. Chakravarty and Pylypiv (2015) have conducted a study by evaluating data gathered from 947 MFIs to find the effect of subsidies and donation on the loan recovery performance. They have found that on an average MFIs with higher private fund are more successful in terms of client selection, portfolio risk, and loan recovery compare to the institutions with high subsidies or donations. This finding indicates that subsidization might result to higher adverse selection which poses a threat to the sector.

Subsidies, Operating Cost and Sustainability

Subsidies have an adverse effect on the operating cost of MFI. Borrowers of MFIs pay higher amount of interest, therefore, MFIs themselves are being subsidized. Most of the subsidized MFIs are non-equity based organizations. It is well researched and established that management of non-equity based entity has expense preferences (Khalily, 2004). Thus, cheap funds through subsidies usually lead to over expenditure and distort efficient allocation of the fund. Moreover, reliance on subsidy creates an inertia in most of the cases and reduces the push to become self-sustainable (Hudon and Traca, 2006b). It will be an overwhelming expectation that MFIs could able to earn all of its cost overnight, still, donors have to push the MFIs harder for innovation in business process and product development so that they can expand their revenue.

Subsidies and Life Cycle of MFI

Another key question has remained unanswered that how long MFIs should be subsidised. Most of the donors usually disburse their subsidy to well-established MFIs rather investing in new risky ventures. Due to this consistency, MFIs openly put the subsidy projection in their financial planning and remain subsidy dependent. Moreover, lack of new start-up keeps the competition low and limits the amount of innovation (Hudon and Traca, 2006a). In this process, probably, donors are supporting some well-established MFIs those have achieved sustainability already.

Why is Subsidy Very Common in MFIs?

In the previous section, few drawback of over subsidization in MFIs are discussed. Even with these ambiguities, there is still a trend of giving subsidy to the MFIs. Hudon and Traca (2006b) exhibits that MFIs with intense subsidy have lower sustainability. However, they have further exhibited that those MFIs tend to more focus on the poorest. This tendency of MFIs might keep the donors in favour of subsidizing. Moreover, theoretically, MFIs should work in absence of large bank to capture the informal financial market and provide an institutional framework. This might be another motivation for subsidizing MFIs. Apart from these, there is a common notion about MFIs prevails that these institutions are not capable of recovering the cost of conventional funds due to high administrative cost, tiny amount of loan, and poorest client base.

However, from the newer research findings, there is sufficient amount of doubt raises regarding the poverty effect of micro-lending. Unfortunately, there is no substantial and conclusive research available on the effects of MFIs in creating or improving the formal financial sector. Though researchers (e.g. Khalily, 2004) claim that formal sector development effect of MFIs is very fundamental and obvious, in few researches such effect were note vident. In the context of Bangladesh, MFIs shows a positive impact in improving savings scenario (Khandker, 1998). But later research by Mia and Chandran (2016) revealed that growth of the savings scenario through MFI is not growing significantly. Authors have accused lack of innovation in product offering as the main reason for this weak performance. In an another research Islam et al (2015) have found that household's access to microfinancereduces the incidence of borrowing from informal sources, but not the amount of borrowing in the case of Bangladesh. This result confirms with the notable study conducted by Banerjee et al (2009). Besides the poor impact in creating formal financial sector, the need of MFIs in doing so is also declining. In many developing countries (e.g Bangladesh, Kenya), technologies such as mobile banking are now playing a great role in financial inclusion. Many large FIs are now approaching to thetiny client using this technology (Kumar and McKay, 2010). These findings and changed reality further questioned the quantum and flow of subsidy in MFI industry.

Subsidies or no Subsides: What Should be done?

The over-excitement about the impact of MFIs has diminished after several decades of practice. There is no conclusive evidence exist about the MFIs impact on poverty alleviation. In the meantime, MFIs have achieved robust growth partly due to the heavy subsidy. Furthermore, overall financial sector development through microfinance is also not a very compelling argument for subsidy. In many instances, it is evident that subsidy is making MFIs reluctant to innovate financial product and to minimize operating cost, negligent to avoid unnecessary risks and to achieve efficiency. Obviously, it cannot be ascertained that microfinance program has lost its appeal or necessity. Both of the institution as well as funding might be essential in the context of developing countries. But donors' choice of heavy subsidization might make the industry subsidy-fatigue rather making efficient and sustainable.

Now the question arises, 'what might be the alternative of subsidy?' Hudon and Traca (2006b) suggest that donors should gradually increase their focus on equity-based funding rather giving easy subsidy. Equity investment eventually transfers the low-cost fund as well as control over the MFIs. In addition to that, socially responsible investors might be a new funding source for the MFIs. By mixing low-cost fund in the invested capital with the other conventional sources such as a loan, market-based equity etc., MFIs could significantly lower the average cost of capital (Fehr and Hishigsuren 2006). Moreover, this equity funding method might also push the MFIs to become more efficient through innovation, technology use and eventually to achieve long-term sustainability.

Conclusion

In recent time, donors have to defy their MFIs' subsidy policy as concerns regarding the impact, both social and economic, have increased substantially due to newer research results as well as the success of few private investment based MFIs, notably Compartamos Banco in Mexico.Though these results cannot be replicated or generalized, it has been confirmed that MFIs have failed to achieve its poverty goals as perceived thus subsidization for poverty reduction is also become doubtful. Yet, MFI does not lose its ground due to some fundamental reasons i.e. financial inclusion, mobilizing micro savings, institutionalization etc. Thus low-cost funding is still required to flow in this sector. As research suggest that over subsidization is making MFIs inefficient and unsustainable, equity and socially responsible commercial investment might be the new source of inexpensive and more efficiency-driven funding. Largely MFIs should become self-sustainable gradually rather focusing on the growth through subsidized financing. This paper contributes the academia by raising the question regarding over-reliance of MFIs in subsidy funding based on some recent literature. However, this review does not provide any analytical inquiry about the alternative of subsidy. In further study financial viability of MFIs without subsidy might be addressed.

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