Is microfinance an ethical way to provide financial services to the poor? Microfinance: Are its promises ethically justified?

A. Vanroose

Microfinance is increasingly seen as a major development tool. Its promise to help the poor by providing financial services is seen as the major reason for its support. Nevertheless, its effectiveness on actual poverty reduction is not yet clear and therefore it generates some unresolved ethical questions. These become even more prominent in the process of commercialization. The impact on poverty is usually measured in financial terms. In this paper, poverty is defined in a broader sense to include deficiency in financial as well as human and social capital. The article shows that, in this broad sense, microfinance may have negative as well as positive effects on poverty.

JEL Classifications: A13, D63, I32
Keywords: Ethics, microfinance, commercialization, poverty

CEB Working Paper № 07/014
June 2007
Is microfinance an ethical way to provide financial services to the poor?

Microfinance: Are its promises ethically justified?

Annabel Vanroose

Abstract: Microfinance is increasingly seen as a major development tool. Its promise to help the poor by providing financial services is seen as the major reason for its support. Nevertheless, its effectiveness on actual poverty reduction is not yet clear and therefore it generates some unresolved ethical questions. These become even more prominent in the process of commercialization. The impact on poverty is usually measured in financial terms. In this paper, poverty is defined in a broader sense to include deficiency in financial as well as human and social capital. The article shows that, in this broad sense, microfinance may have negative as well as positive effects on poverty.

Key words: Ethics, microfinance, commercialization, poverty

JEL-codes: A13, D63, I32

* Section for Economic, Monetary and Financial Policy, Vrije Universteit Brussel and Solvay Business School, Centre Emile Bernheim, Université Libre de Bruxelles. I would like to thank Bernard Lietaer for his contribution while writing this article. I thank Eric Baert, Marek Hudon and Kim Oosterlinck for comments on an earlier version.
Introduction
Since the 1990s microfinance has become an important development tool. The successful experiences of different private institutions in providing small-scale financial services to the poor have attracted the attention of an increasing range of players. Donors, social investors as well as for-profit foundations have shown an ever-growing interest in the development and promotion of these organizations. The consideration that microfinance could help the poor and generate some profit for the involved institutions seemed promising. It entailed a win-win situation. From an ethical point of view, the motivation behind the actions undertaken gets however blurred by this fact: if the driver to act is poverty alleviation, can it simultaneously be profit oriented?

Most actors use the argument of poverty reduction as a manner to obtain support for the movement. For example, Mohammed Yunus claims that microfinance will make poverty history. Equally, the decision to award the Nobel Peace Price to Mohammed Yunus and his Grameen Bank was based on the claim that microfinance “plays a major part in poverty reduction” and thereby enhances peace. Another school of microfinance institutions (e.g. Accion in Bolivia) states that they are developing a “new market segment for financial services”; but even such commercially driven institutions still claim on their website that they are “reducing poverty”.

However, it is indistinct what is here meant by poverty reduction. This creates a first problem. Namely, how can one assess whether microfinance institutions do what they say so? This article proposes a broad measure of poverty and shows that it is not clear how microfinance impacts it. Even more, in a lot of cases, the promise of microfinance is reduced to transforming subsidy-dependent institutions into financial sustainable ones that serve the poor. The effect on poverty reduction then becomes not a goal as such, but

---
4 www.accion.org (Consulted: April, 2007)
a possible side effect. As we will see this raises a couple of ethical questions. First, by creating a solution to an unethical situation one has to be careful not to create a new one. Second, it is not ethical claiming to reduce poverty while pursuing other objectives. This is particularly so because other people’s money is involved. I consequently argue for the fact that real objectives should be made explicit. To be ethical, institutions should act as they pretend to and their promises should be carefully defined. Evaluation of their efficiency should also be consistent with this measure. If poverty alleviation is the real objective, then the objective in terms of profits should be consistent with it. In addition, a clear definition of poverty should be given.

In what follows, the emergence of microfinance institutions as an answer to an unethical situation is addressed. Hereafter, a broad definition of poverty is given. Henceforth the effect on the three different forms of capital is assessed. The article ends with some concluding remarks.

**Financial Markets Failure and Ethical Solutions**

According to Wilber, there are three ways in which ethics enters economics. First, economists have ethical values that help shape the way they do economics. Second, economic actors have ethical values that help shape their behavior. Third, economic institutions and policies impact people differentially and thus ethical evaluations, in addition to economic evaluations, are important.

There are a couple of intrinsic ethical questions related to providing financial services. One of the main issues originates from the imbalance of power between the lender and the borrower. Stiglitz argues that credit markets are imperfect and that borrowers have traditionally access to only a limited amount of lenders, while lenders face a lot of borrowers. Borrowers are also typically poorer than lenders. All this leads to possible

---

5 Most of these institutions have received some kind of financial support in the pace of their existence. Especially, international donor institutions have supported these organizations because one of the main objectives of these institutions is to help eradicate poverty through lending to the poor.


abuse. Traditionally there exist high market failures in developing countries and poor people often do not have access to formal financial services. To obtain financial services they often have to turn to moneylenders, which ask usury high interest rates.

It is as an answer to this unethical situation that private actors created microfinance institutions that focus particularly on the poor. This way, the poorer parts of a population could gain access to financial services. We could suppose that the first pioneers were guided by their ethical values and concerns. Nevertheless, traditionally microfinance institutions also ask high interest rates as they bear high costs. This seems to be especially the case with institutions that want to become financially sustainable. These institutions, though, should take care that they do not become the new moneylenders in town.\(^8\)

Economic theory predicts that people self-select, and thus calculate the costs and benefits of a good before they buy it. Consequently, proponents\(^9\) use the huge demand for credit by poor people and the fact that moneylenders are omnipresent in poor societies as a proof that access to financial services is more important than the cost. However, if this is so, this intrinsically comprises that, to be ethically justified, ‘to be good’, access to financial services ‘as such’ should have a positive impact on the poor. Nevertheless, until now, it is far from clear how microfinance impacts poverty. In what follows, the effect of microfinance is analyzed.

---

**Poverty, the lack of wealth and microfinance’s effectiveness in affecting it**

Poverty is commonly measured as an income below a certain level. For instance, the World Bank uses daily income below a poverty line of US$1, adjusted more recently to US$2. Consequently, policies are constructed to lift people above this poverty line.

---

\(^8\) There is a huge (ethical) discussion going on in the field about Compartamos, a Mexican non-profit microfinance institution that has turned into a real commercial bank and asks already for years around 100% effective interest rates. They reach about 600.000 clients. Their profit was $57 million last year. Are such a high interest rates with such a profit ethically justified? [http://www.reuters.com/article/newIssuesNews/idUSN2025193920070420?pageNumber=1](http://www.reuters.com/article/newIssuesNews/idUSN2025193920070420?pageNumber=1) (Consulted: April 2007).

Poverty reduction is here thus effective only when it increases income. Nevertheless, poverty has many dimensions and can be seen as a deprivation of different forms of wealth\(^{10}\). Consequently, for the purpose of this article I propose to use a broad measure of wealth. This definition of wealth integrates stocks of three different forms of capital, namely: financial capital, human capital and social capital. Financial capital is the net amount of financial assets a person possesses. It is measured in monetary terms and thus the easiest to gauge precisely. Human capital can be defined as the stock of skills accumulated, allowing someone to receive a flow of income.\(^{11}\) It is obviously a lot more difficult to quantify human capital than financial capital, but various proxies are used. For instance, a typical proxy for human capital is the amount of retained learning accumulated, the measure of which is typically further simplified to the level of education attained. Finally, social capital is classically defined as "the collective value of all 'social networks' and the inclinations that arise from participants in these networks to do things for each other."\(^{12}\)

An implication of the above is that all three forms of capital should be taken into account to evaluate whether someone’s wealth has increased or not. For instance, is someone’s wealth really growing when she increases its financial capital at the cost of a significant drop in social capital? When analyzing whether microfinance is ethical, the total effect of the program should be evaluated. Eventually, to be ethical the action of microfinance should not harm or decrease any form of capital or the total position of a person, while improving another one. In a sense, one may argue that to be ethical the action of microfinance institutions should be Pareto optimal. Several valuable studies evaluate the impact of microfinance on each different form of capital. As far as I know, no study takes into account the interactions among all three forms of capital.

\(^{10}\) The World Institute for Development Economics Research (WIDER) in Helsinki released in December 2006 the first global survey on personal financial wealth (defined as the net value at purchasing power parity of the sum of financial assets, real estate, consumer durables and livestock). Financial wealth is shared much less equitably than income: more than half is held by just 2% of the world’s adults. Many people in the bottom half (including in the developed world) own next-to-nothing.


Is microfinance building financial capital?

The most common microfinance product is micro-credit: ideally a small loan that provides people with the means to invest in an income-generating activity, and thereby have a chance at increasing their financial capital. Hulme and Mosley give limited evidence that microfinance increases income. Nevertheless, they show also that the impact highly depends on the level of income. Specifically, the poorest borrowers seem not to benefit from a sufficient income increase. Contrary, Khandker found that access to microfinance contributes significantly to poverty reduction and that this is especially true for poor women. Not only participants seem to benefit, but the whole local community. However, Armendariz and Morduch, show that measuring impact is not evident. A lot of factors should be taken into account and it is particularly difficult to isolate the effect of ‘only’ micro-credit. They conclude that there is no study yet that has achieved a wide consensus as to its reliability.

In addition, the effectiveness of increasing financial capital through micro-credit depends on the interest rates microfinance institutions charge. Specifically, if the interest rates are high, the net capital accumulation accrues to the lender rather than the borrower. The interest topic has become highly controversial in microfinance, because it raises some difficult ethical questions on making profits on the back of the poor.

Another aspect that should be taken into account is that financial capital is obviously decreased whenever the micro-credit is used for consumption rather than investment. Micro-credit could also be looked at as micro-debt. Whenever micro-credit is not used to invest in an income-generating activity, no additional means are generated to repay the

---

loan. This could make the repayment difficult. Indebtedness is becoming a main issue in microfinance. Especially as increased competition has lead in some cases to irresponsible lending from some institutions, leading to social dramas. Indebtedness also decreases the level of freedom the poor has. It has been Sen’s contribution to development theory to define development as freedom. Although access to financial services could increase the poor’s capabilities and possibilities, once the level of indebtedness is too high and the individual becomes dependent on different institutions, one cannot claim that one has become more free.

In conclusion, we cannot automatically assume that micro-credit improves the financial capital of all borrowers. The result will depend on the income level of the borrowers, the purpose of the loan and on the interest rate charged by microfinance institutions.

**Is microfinance building human capital?**

Some microfinance institutions not only provide credit, but also a set of other programs or services. These programs are generally defined as “microfinance plus” programs and constitute the welfarist approach. Contrary to the minimalist or institutional approach, this vision believes that credit-only is not sufficient. For example ProMujer, a microfinance institution in Bolivia provides not only credit to women, but also educational and even health services. There has been a huge discussion in the microfinance field regarding the two visions. While the institutional approach promotes financial sustainability, the “welfarists” draw attention that massive outreach and thus microfinance ‘as such’ will not solve the entire poverty problem.

While there is much unclenlessness about how micro-credit impacts poverty, there is increasing evidence that “microfinance plus” programs have more apparent impacts.

---


Karlan and Valdivia\textsuperscript{22} provide evidence of such programs benefiting clients. According to them also the institutions gain as repayment rates increases due to increased business profits. Other research has shown that educational services not only influence the level of human capital of the clients, but also of their children.\textsuperscript{23} One could thus carefully conclude that “microfinance plus” programs have the ability to increase the level of human capital.

Maldonado \textit{et al.}\textsuperscript{24} provide also some preliminary proof of the fact that increased financial income leads to better education. Through increasing income, microfinance could thus help improve education levels. Nevertheless, as mentioned above, particularly amid the “poorest of the poor”, the level of income increase resulting from micro-credit may not be sufficient to make a real difference.

\section*{Is microfinance building or exploiting social capital?}

A huge part of microfinance institutions use commitments of groups in absence of collateral. Namely, peer pressure from groups is seen as one of the main reasons why microfinance works.\textsuperscript{25} Supporters claim that the most important issue is to provide the poor with access to capital. By using social relations as collateral a market failure is resolved. Critics, nevertheless, argue that thereby microfinance exploits social relationships to obtain higher repayment rates and to reduce administrative costs.\textsuperscript{26} This is especially true in the minimalist approach, were cost-effective measures are used to become financial sustainable. Rankin\textsuperscript{27} argues that under these circumstances the health of the financial system rather than the welfare of the poor becomes the main objective of microfinance.

\begin{thebibliography}{9}
\bibitem{Ibid} Ibid.
\end{thebibliography}
A recent study shows that social relationships indeed deteriorate in case of default: trusting friends and neighbors can suddenly turn into something negative.\textsuperscript{28} This means that microfinance transactions can actually reduce social capital. The question then becomes: whenever financial capital is generated at the expense of social capital—typically the only capital form that the poor have been able to accumulate - what is the net wealth effect? More importantly: should we consider such an increase of financial capital at the cost of social capital as ethically acceptable?

However, there are also studies that show that microfinance programs can rebuild social capital\textsuperscript{29}. This seems particularly to be the case with programs that use a village bank methodology, a program inspired by the cooperative movement. The authors claim, though, that financial intermediaries ought to recognize the importance of building social capital in their overall programs and not consider it as an indirect benefit of them.

More recently, also an opposite trend has been observed. More and more microfinance institutions start to working with the individual approach as experience shows that the poor are reliable clients\textsuperscript{30}. This way social capital can neither be built, nor exploited.

\textbf{Concluding Remarks}

Microfinance is an interesting case to look at when talking about economics and ethics. Microfinance institutions can be seen as an answer to a market failure, which created ethical concerns. Microfinance institutions claim to fight poverty by providing financial services. Implicitly, this entails that giving access to financial services is the main objective. However, the major reason for the promotion of the movement is poverty reduction. It is unclear how poverty is here defined. The article proposes a broad measure of poverty. As shown, it is far from obvious how microfinance impacts it. Therefore, in

\textsuperscript{28} Karlan, D. (2005), Social Connections and Group Banking, \textit{Center Discussion Paper}, No. 913, Yale University.
creating a solution, additional ethical concerns have emerged. Wilber\textsuperscript{31} is right when arguing for an ethical evaluation of economic policies. Eventually, to be ethical the action of microfinance should not harm or decrease any form of capital, while improving another one. The overall impact of microfinance, though, on the different forms of capital is unclear. Consequently, the argument that access is the most important issue cannot be accepted as an ethical justification of the movement.

Furthermore the transformation of the microfinance movement has encouraged these questions. By transforming into financial institutions, concerns about financial objectives have put the social effects aside. Once these microfinance organizations turn into real financial institutions, becoming financial sustainable or even maximizing profit becomes the main objective and poverty reduction becomes an externality and not a goal as such. If this is the case, the whole purpose of the movement changes. An ethical approach would then entail that this objective is made explicit in order not to deceive the people involved.