The downside -- and surprising upside - of microcredit

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Microcredit, which involves giving small loans to very small businesses in an effort to promote entrepreneurship, has been widely touted as a way to reduce poverty and stimulate economic growth. A multitude of both non- and for-profit institutions are spending billions of dollars each year on microcredit ventures in developing nations around the globe.

But just how effective is microcredit lending? In a new study, researchers find that the practice may not be an efficient tool in promoting business growth or improving the lives of its beneficiaries, but could instead have just the opposite effect. However, they discovered other surprising advantages.

Economists Dean Karlan of Yale University and Jonathan Zinman of Dartmouth College conducted a study of microloans given out to nearly 1,000 small business owners and entrepreneurs in the Philippines. They found that, contrary to widely held beliefs, the loans did not generate bigger businesses, higher income, or greater subjective well-being for the recipients. Instead, the loans led to fewer businesses and a lesser sense of well-being. However, the practice did result in stronger risk management.

"This study suggests that microcredit works through complex mechanisms that are not entirely understood, and it's clear that we can't set policies and make decisions based on our intuition about what microcredit accomplishes," Karlan said. "We need a better understanding of how this strategy works, based on sound data and

analysis."

Karlan and Zinman developed a new method for evaluating the impact of microcredit lending, working in partnership with First Macro Bank, which made loans to 921 men and women in the Manila area. The team randomly approved loans for a subset of applicants who had been pre-selected based on their credit scores and who were considered "marginally creditworthy." These types of people, and especially the women among them, are often cited as the most likely to benefit from microcredit lending.

The team gave loans ranging from about $100 to $500, with an average monthly interest rate of 2.5%. Typical businesses supported by the loans included small grocery/convenience stores, food vendors, auto and tire repair shops, tailors and barbershops/salons.

Researchers conducted follow-up surveys with the loan recipients 11 to 22 months after they had applied for the loans. The surveys showed that the entrepreneurs who received loans actually shrank, rather than grew, their number of business activities, and that their self-reported sense of well-being (including life satisfaction, self-esteem, optimism and stress levels) did not improve, but in fact got slightly worse.

However, they also discovered that the loans did provide a buffer against income fluctuations and unexpected expenses, allowing the recipients to manage risk without relying on formal insurance. The small business owners' access to informal credit, such as financial assistance from friends and family, also increased as a result of the loans.

"Rethinking microcredit as a tool for the household, rather than merely as a tool for enterprise growth, is clearly the first step in the right direction to understanding the impacts of microcredit," Karlan said. "We hope our methodology can provide a model for others to conduct similar

research in other settings and help provide a clearer picture of whether and how microcredit works."

The study appears in the June 10 issue of the journal *Science*.

Provided by Yale University

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