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Microfinance as a Tool to Combat Socio-Economic Inequalities

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I. Introduction:

Speaking at the opening of the Microfinance Symposium organised in Geneva in 2005, Former UN Secretary General Kofi Annan praised the benefits of microfinance in reducing global poverty:

> Microfinance recognizes that poor people are remarkable reservoirs of energy and knowledge. And while the lack of financial services is a sign of poverty, today it is also understood as an untapped opportunity to create markets, bring people in from the margins and give them the tools with which to help themselves.[1]

Microfinance developed rapidly in the second half of the 20th century as a way to support individuals and businesses with limited access to conventional credit. As such, microfinance institutions (MFIs) present the potential of closing the gap of traditional lending by enabling excluded categories of people to access credit. As Koki Annan indicated in 2005, MFIs can help to combat poverty and socio-economic inequalities, as they target vulnerable populations. An important block of microfinance is solidarity lending, which consists in encouraging borrowing within small groups or communities whose members can support each other's repay. The present paper will analyse the relevance of microfinance as an essential component of the social and solidarity economy (SSE) with the goal of answering the following research question: **To what extent has the development of microfinance enabled to reduce socio-economic inequalities in developing countries?**

II. Why microfinance matters?

Microfinance can be defined as the provision of credit and other financial services to marginalised categories of people who are unable to access such services through conventional financial institutions. The targeted populations typically include low-income individuals, women, minorities as well as aspiring entrepreneurs who need funding to launch a business. The strength of microfinance lies in the principle of group lending. As lending is organised within small groups of borrowers, each of them is responsible for screening other borrowers' repayment ability, thereby mitigating the problem of adverse selection. Following the attribution of the funds, borrowers can also monitor one another which reduces moral hazard.

[1] Kofi Annan, "Microfinance, now important factor in poverty eradication, should be expanded", 10 October 2005, Department of Public Information, News and Media Division, New York

For example, group members can ensure that the funds are utilised as intended. In this respect, the model of MFIs effectively alleviates the information asymmetries which banks face. Besides, MFIs offer incentives to their customers to repay their loans by making future credit available to clients who successfully repaid their past loans. By transferring screening and monitoring costs to borrowers while reducing default risks, MFIs seek to charge low interest rates.

Therefore, microfinance is a crucial component of the SSE, permitting disadvantaged populations to access lending at low cost. In a context where traditional financial institutions favour lending to wealthy individuals with sufficient financial resources as well as solid enterprises, microfinance reduces the discriminations which poorer populations experience. By allowing them to access funding for their projects and invest in their future, microfinance could effectively reduce inequalities.

III. Impacts of microfinance on socio-economic inequalities:

1. Microfinance and income inequalities:

Improving access to credit for low-income populations has the effect of reducing income inequalities, by increasing the income of the poor. According to the International Finance Corporation[2], microfinance in Africa has demonstrated some success in helping low-income people start a business and poor farmers buy fertiliser to improve productivity in their fields. These examples can result in an increase in income for the beneficiaries. However, while MFIs are theoretically expected to contribute to reducing income inequalities, empirical evidence is also necessary to assess the impact of microfinance on inequalities.

In a recent paper published in January 2022[3], Miled, Younsi and Landolsi gathered data from 57 countries developing countries over the periods 2000–2006 and 2007–2013 to analyse how efficient MFIs are at reducing income inequalities. They measure income inequalities as the income Gini coefficient whereas gross loan portfolio per capita is used as an estimate of microfinance intensity. In other words, the authors assess the impact of gross loan portfolio per capita on the income Gini coefficient. Given the complexity to isolate the effect of microfinance from other factors, the authors include a wide range of control variables and

[2] International Finance Corporation. (2018) The Unseen Sector: A Report on the MSME Opportunity in South Africa. Washington: World Bank Group

[3] Miled, Kamel Bel Hadj, Moheddine Younsi, et Monia Landolsi. « Does microfinance program innovation reduce income inequality? Cross-country and panel data analysis », Journal of innovation and entrepreneurship. 2022, vol.11 no 1. p. 1-15

regress their data with three different empirical models. First, they run an OLS regression (ordinary least squares) which indicates that a one percent increase in gross loan portfolio per capita results in a 5% fall in the income Gini index. This coefficient, statistically significant at the 1% level, indicates a strong negative effect of microfinance on income inequalities. In order to avoid endogeneity, the authors also employ two instrumental variables, namely the cost of enforcing contracts and the weighted 5-year lag of average gross loan portfolio per capita. Regressing the Gini coefficient on these instruments also produces significant negative coefficients. In sum, empirical evidence from a wide range of developing countries supports the argument that microfinance is an efficient tool in fighting income inequalities.

2. **A way to reduce social disparities**:

In addition to reducing income inequalities, microfinance has the potential to fight against existing social discriminations, as some categories of people tend to be disproportionately excluded from the formal banking system. This includes minorities, as well as women, who are estimated to be 17% less likely to obtain funding compared to their male counterparts[4].

According to Quanda Zhang and Alberto Posso[5], microfinance emerges as an efficient tool to combat gender inequalities. Indeed, they constructed a panel data running from 2003 to 2014 for 64 developing countries. Gender inequality is measured by the Gender Development Index (GDI) and the Gender Inequality Index (GII) while microfinance intensity is measured as the percentage of women borrowers amongst MFIs. Their results indicate that an increase in the percentage of women borrowers translates into an improvement in gender equality. The authors add that such an effect implies a probable rise in overall income equality, as women are relatively poorer than men. This study effectively presents microfinance as a relevant tool to achieve social equality, notably across genders.

3. **Local versus global effects on inequalities**:

Having established that microfinance contributes to improving socio-economic equality, these positive effects can be felt both locally and globally. At the local or national level, MFIs improve access to funding opportunities for low-income individuals, women, and minorities,

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[4] John Isaac (2014). The World Bank, Expanding Women's Access to Financial Services. Washington: World Bank Group

[5] Quanda Zhang, Alberto Posso, Business or Basic Needs? The Impact of Loan Purpose on Social Crowdfunding Platforms, Journal of Business Ethics, 2021, vol. 173, issue 4, No 7, 777-793

with the potential of making these populations better off. This essentially closes the gap between low-income and high-income groups.

Moreover, the positive effects microfinance are likely to be felt internationally, as financial inclusion is an important vector of economic development. Many developing countries have poorly developed financial systems, which hinders their development relative to the rest of the world. MFIs can serve as supplements to traditional financial institutions, with important macroeconomic benefits. Improved lending to households in need and aspiring entrepreneurs can improve productivity, growth and employment while reducing poverty in developing countries. In other words, microfinance also presents the potential to decrease global inequalities, facilitating the development of poor nations with underdeveloped financial systems.

IV. Assessing microfinance through a case study: The Small Enterprise Foundation in South Africa

The Small Enterprise Foundation (SEF) is microfinance institution founded in 1992 in South Africa's northernmost province called Limpopo, the country's poorest. Most economic activity in this province is linked to agricultural production as well as mining operations. However, Limpopo is characterized by extreme levels of poverty and unemployment (43% as of 2019)[6]. It is to help address those challenges that SEF was launched in the town of Tzaneen, with a target population now reaching 65,000 rural inhabitants. Recognizing the lack of interest of large financial institutions in these struggling rural populations, SEF strove to make funding accessible in Limpopo. Since 1991, the MFI has made almost 5 million loans to over 200,000 clients, 99% of those being women. SEF has also expanded its activities into six other South African provinces over the past ten years.

Regarding the selection process, SEF uses the Poverty Probability Index to assess the probability that their applicants live under a certain poverty level (€100 per month for a family of five). Then, they select the most vulnerable households to receive funding. The funds are typically used to help poor women start an enterprise or conduct an existing one, the most common types being small convenience shops, dressmakers, and fruits or vegetables vending stores. Before disbursing the funds, borrowers are required to attend a meeting with SEF

[6] STATSSA, Statistical release, Quarterly Labour Force Survey, Q1 2019, retrieved from: https://www.statssa.gov.za/?p=12115

members and other borrowers. This meeting enables borrowers to exchange ideas and give feedback, providing them with valuable moral support and experience-sharing.

By helping the poorest women, this initiative aims at reducing socio-economic inequalities in South Africa while contributing to the development of the country's least developed provinces. Johanna Hietalahti and Mikael Linden[7] proposed an empirical analysis of the SEF lending programme in 2006. They followed and interviewed 21 randomly selected entrepreneurs. The results illustrate a positive impact of the SEF on women, as 80% of them declared being better off than they were before, thanks to more stable income from their business. As a result, 60% of the interviewed women were able to pay their children school fees following the lending programme. However, some limitations also emerged out of the programme, with some women having repayment difficulty while others complained about the credibility of the group of borrowers. Besides, interest rates charged on SEF loans are high (33.2% on average).

Overall, SEF is a relevant initiative of the social and solidarity economy, which contributes to reducing gender inequality while enhancing economic equality, by moving households out of poverty. SEF can have great effects on the South African economy as whole. Indeed, the South African economy has been marked by sluggish economic growth and high levels employment relative to other Sub-Saharan African countries. One of the main reasons for this unfavourable economic conjecture lies in the country's low business creation and entrepreneurship. It is for this reason that the World Bank writes in a 2018 report: "building small businesses that contribute to the economy and create jobs is one of South Africa's biggest development opportunities"[8]. The World Bank adds that the lack of funding opportunities for aspiring entrepreneurs, particularly amongst the poorest groups, is responsible for South Africa's low levels of entrepreneurship and business creation. Therefore, the SEF initiative effectively addresses the problem of low business creation in South Africa, by improving access to lending for aspiring female entrepreneurs. The development of such microfinance initiatives could bring positive employment and growth prospects in South Africa, and other developing countries.

[7] Johanna Hietalahti, Mikael Linden. « Socio-economic impacts of microfinance and repayment performance: a case study of the Small Enterprise Foundation, South Africa », Progress in development studies. 2006, vol.6 no 3. p. 201-210

[8] International Finance Corporation. (2018) The Unseen Sector: A Report on the MSME Opportunity in South Africa. Washington: World Bank Group

V. **Conclusions and recommendations**:

The present paper discussed the benefits of microfinance in developing nations, which has been growing in recent decades. Microfinance is instrumental in opening credit for low-income individuals, as well as marginalised groups such as women or minorities. Empirical evidence demonstrates that MFIs contribute to reducing income disparities while fostering gender equality. As illustrated with the case of the Small Enterprise Foundation in South Africa, the development of MFIs in developing countries could help achieve equality and promote economic progress. Nonetheless, the efforts of MFIs remain marginal and interest rates are still higher than those charged by well-established financial institutions, limiting the reach of microcredit amongst certain populations.

Looking forward, more international cooperation is necessary to scale up the activities of MFIs. In particular, international organisations, development agencies, national governments along with private corporations have a role to play in channelling more resources to MFIs through loans and donations. Besides, governments could encourage a reduction in the interest rates charged by MFIs by reducing their exposure to risks. A system of public insurance to cover the potential losses of FMIs could be implemented, so as to make lending more affordable to populations in need. Lastly, training should be proposed to borrowers in addition to funding, as basic entrepreneurial skills are likely to make borrowers more successful in their business.

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