Beyond Microfinance: Entrepreneurial Solutions to Poverty Alleviation

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Foreign Currency and Coins
Photo by Philip Brewer (CC).

Although microfinance has become extremely popular as an approach to poverty alleviation, there are still various controversies associated with it. For instance, Thomas Dichter, and others, have argued that microfinance is primarily used for debt and consumption rather than real investment in revenue-generating businesses.[1]

With an estimated 110 million microentrepreneurs around the world, receiving loans through many thousands of organizations, often in remote and impoverished regions, it is unlikely that we will ever have definitive data regarding exactly what percentage of the loans result in investment versus what percentage are used for consumption.

It is fair to assume that insofar as individual borrowers are freely choosing to take loans from microfinance organizations rather than borrowing money at exorbitant rates from local loan sharks, it is likely that microfinance does, in fact, benefit the world's poor, even if much of the money is used for consumption rather than investment. But merely "better than loan sharks" is not quite the beautiful dream that has inspired so many people to support microfinance.

One of the great ironies of global approaches to poverty alleviation is the ambivalent role towards capitalism among many of those—including many NGOs—who seek to alleviate poverty. On the other hand, there is a mainstream position in economics that economic growth is the most effective means of alleviating poverty. Michael Spence, Nobel Laureate and Chair of the UN Commission on Growth and Development, provides a clear statement of this position:

> We chose to focus on growth because we think that it is a necessary condition for the achievement of a wide range of objectives that people and societies care about. One of them is obviously poverty reduction, but there are even deeper ones. Health, productive employment, the opportunity to be creative, all kinds of things that really matter to people seem to depend heavily on the availability of resources and income, so that they don't spend most of their time desperately trying to keep their families alive.[2]

Or, in the blunt words of Nobel Laureate Robert Lucas, "Once you start thinking about growth, it is hard to think of anything else."

And there is abundant evidence that economic growth, which is the only known means of increasing GDP per capita for large populations, is highly correlated with reduced child mortality, increased literacy, and numerous other measures of well-being. Indeed, one economist has discovered that GDP per capita is statistically indistinguishable from the UN's Human Development Index—other metrics of well-being are also closely correlated with increased GDP per capita, especially below about $12,000 annual GDP per capita.[3]

Thus from an economist's perspective, increasing economic growth is the single most effective means of alleviating poverty and improving human well-being in poor nations around the world.

The question then becomes, to what extent does microfinance contribute to economic growth? Dichter, as well as Amar Bhidé and Carl Schramm would respond: Not much.[4]

Developed societies are wealthy because they are efficient. Today a tiny percentage of the U.S. population produces many times as much food as did 40 percent of the U.S. population who were farmers a hundred years ago. Most poor nations remain largely agricultural nations, whereas all wealthy nations experienced a transition from primarily rural to primarily urban, with a corresponding decrease in the percentage of population that are farmers.

Realistically we can expect all poor nations to experience a transition from primarily rural to primarily urban. As agriculture around the world becomes as efficient as U.S. agriculture, a tiny percentage of the world's people will grow far more food than is grown today.

If Dichter, Bhidé, and Schramm are correct, then microfinance is a stop-gap measure that does not accelerate the pace at which economies transition from rural to urban, from populations largely engaged in agriculture to populations largely engaged in manufacturing or IT careers (In the last ten years many in both India and Ireland leaped directly from agriculture to IT careers, skipping the manufacturing stage).

Although technological innovations are part of the reason why some societies are wealthy, now that technology is available around the world at a cost that represents a tiny fraction of its original development cost, it is perfectly clear that technological innovation was a necessary but not sufficient condition for the creation of wealthy, efficient societies. Without entrepreneurs organizing large-scale enterprises, within a society based on secure property rights, contract enforcement, and economic freedom, no nation on earth would be wealthy.

Concrete evidence for this thesis has been provided by the work of Zoltan Acs, research chair of the Global Entrepreneurship Monitor (GEM) project. The GEM project is the world's largest research project studying the impact of entrepreneurship. The research program, based on a harmonized assessment of the level of national entrepreneurial activity for all participating countries, involves exploration of the role of entrepreneurship in national economic growth.

The single most important discovery of the GEM project is that the higher the ratio of "opportunity entrepreneurs" to "necessity entrepreneurs," the less poverty there is in a given country.[5]

"Opportunity entrepreneurs" are those entrepreneurs who create real businesses that grow based on an identified entrepreneurial niche. "Necessity entrepreneurs" are self-employed poor people struggling to survive. Most microentrepreneurs are "necessity entrepreneurs" rather than "opportunity entrepreneurs."

In order to liberate the wealth creation abilities of more "opportunity entrepreneurs" in the developing world, developing world nations need to reduce the obstacles to business formation. Most developing world nations are massively over-regulated, dramatically reducing the rate of business formation. One study estimates that moving from the most highly regulated quartile to the least highly regulated quartile results in a 2.3 percentage point increase in economic growth.[6] Depending on the size of a nation, this translates into millions, tens of millions, or hundreds of millions of additional people being brought out of poverty each year.

Moreover, what most people don't seem to realize is that the developed nations regulate business less than the developing nations. The ten top-ranked nations on the World Bank's Doing Business Index include not only the U.S. and Hong Kong, but also Denmark and Norway—Denmark is ranked fifth in the world. Conversely the most highly regulated nations on earth are mostly African—Niger, Eritrea, Chad, Burundi, the Republic of Congo and the Democratic Congo Republic, the Central African Republic, et cetera.[7]

It is important to realize that the World Bank's Doing Business Index is designed to measure strictly the regulations that prevent domestic entrepreneurs from starting companies. Improving the business climate for local entrepreneurs by means of reducing red tape need not provide any advantage to multinational corporations. In fact, because multinational corporations can afford to pay lawyers to deal with red tape, and use various other forms of influence, legal and illegal, to cut through bureaucratic obstacles, the ones who are most harmed by excessive regulations are not the multinationals, but the local entrepreneurs, especially those who are not already wealthy and well-connected.

Indeed, a case may be made that the reason that poor nations are poor is that the millions of "opportunity entrepreneurs" in these countries have been prevented from creating tens of thousands of legal enterprises that are critical to the wealth creation of a given nation.

The combination of Zoltan Acs's research on the role of "opportunity entrepreneurs" with the extraordinary obstacles to business creation documented by the Doing Business Index provides empirical support to this notion that legal obstacles to indigenous entrepreneurship are the leading cause of global poverty. Further support for this hypothesis comes from the fact that GDP per capita is highly correlated with economic freedom, which measures diverse obstacles to business formation and growth.[8]

Moreover, there is a well-developed theoretical framework, dating from Adam Smith, with refinements continually being added, that articulates the central role of entrepreneurs in the creation of wealth, given secure property rights and adequate economic freedom.[9]

Many NGOs, on the other hand, are less than enthusiastic about economic growth as a means of alleviating poverty, especially insofar as they see economic liberalization, leading to increased economic growth, as support for corporate globalization. Moreover, they point to countless examples of populations within rapidly growing economies, such as those of China and India, who are not receiving any benefits from their nation's economic growth and may not for some decades to come. Because manufacturing-led economic growth takes place in urban areas, rural areas, in particular, are typically left behind.

Microfinance is one approach to this problem of unevenly distributed wealth creation: Help the rural poor directly instead of waiting for the benefits of economic growth to reach them decades later. But some organizations are interested in moving beyond microfinance to create more substantial rural enterprises.

For instance, Vineet Rai is an Ashoka Fellow who has created a socially conscious Social Investment Bank to invest in rural enterprises in India. Although Vineet and his colleagues in Intellecap have enabled various microfinance funds, their organization's primary growth area is in enabling investment in larger enterprises.

Their largest enterprise is a mobile payments system, run as a for-profit enterprise, that currently serves a million clients and is adding several hundred thousand clients each month. The company uses a technological device that allows individual villagers to act as the village banker, who provides access to electronic banking to village members. Villagers are now able to earn interest, make electronic purchases and transfers, store their wealth securely, and develop a formal, electronically recorded credit history.

Intellecap identifies entrepreneurs who are capable of creating substantial enterprises that will benefit rural Indians and provide access to funding as well as business development expertise that result in the creation of substantial companies.[10]

Intellecap is one of the more sophisticated organizations working with large-scale socially-minded entrepreneurial enterprises. It consistently looks for profitable enterprises, and to that extent operates like a conventional investment bank (with a business consulting arm). At the same time, the organization maintains its commitment to a social mission, as it identifies and supports local rural entrepreneurs who can make a real difference.

Without dismissing the benefits that microfinance has brought to millions of women in particular, it is also possible to look beyond microfinance to the importance of discovering and financing those "opportunity entrepreneurs" who can create the efficiencies needed to create a wealthy society. Indeed, some of the opportunity entrepreneurs will come from the ranks of the microentrepreneurs.

Intellecap has shown that it is possible for socially-minded investors as well as conventional mainstream investors to identify "opportunity entrepreneurs" in distinct niches that address underserved populations, such as rural populations.

As developing nations work to reduce the obstacles to legal business formation, and as the microfinance movement seeds the entrepreneurial spirit in the ranks of tens of millions of the poor, we will see larger numbers of "opportunity entrepreneurs."

And as firms such as Intellecap increasingly move beyond microfinance and funding "necessity entrepreneurs", to bringing investment capital for socially-minded venture capital financing of "opportunity entrepreneurs," we will see broad-based prosperity improve the lives of billions of individuals around the world.

NOTES

1 Thomas Dichter, "A Second Look at Microfinance: The Sequence of Growth and Credit in Economic History," Center for Global Liberty & Prosperity, Development Policy Briefing Paper, No. 1, Feb. 15, 2007.
2 Michael Spence, quoted at the "About Us" page of the UN Commission on Growth and Development.
3 Miles Cahill, "Is the Human Development Index Redundant?" *Eastern Economic Journal*, Winter 2005.
4 See also Amar Bhide and Carl Schramm, "Phelp's Prize," *The Wall Street Journal*, Jan. 19, 2007.
5 Zoltan Acs, "How is Entrepreneurship Good for Economic Growth?" MIT Innovations, Winter 2006.
6 Simeon Djankov, Caralee McLiesh, and Rita Maria, "Regulation and Growth," World Bank, available online 24 July 2006.
7 See World Bank Doing Business Rankings.
8 See, for instance, William Easterly, "Freedom vs. Collectivism in Foreign Aid," Economic Freedom of the World Report, 2006, Chapter Two.
9 For a helpful contemporary exposition, see Frederic Sautet, "The Role of Institutions in Entrepreneurship: Implications for Development Policy," Mercaus Policy Series, Policy Primer No. 1.
10 This information is from conversations with Intellecap founders Vineeet Rai and Pawan Mehra. More information on Intellecap may be found at their website.