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TO BORROW

Why the Taxi Driver Didn't Take a Loan

When a European compact sedan dies, I do not know where its soul goes. Often its body goes to Ghana, where it may be reborn as a taxi. In heaven, some believe, we are made whole again; but in Ghana cars are not. Neither their window cranks nor their turn signals have been restored. Instead of being made whole, they are made orange. The government mandates that every licensed taxi have four bright orange panels on its body: one above each wheel well. This makes them especially easy to spot, but more often than not you can identify a taxi without the aid of vision. You know them by the squealing, jostling sound they make as they trundle down the road, and by the acrid smell of exhaust and burning transmission fluid that follows them like an angry ghost.

One such taxi swerved across two lanes of traffic toward the curb where Jake stood. It sailed in with the grace of a misshapen bowling ball. The driver leaned over toward the open window on the passenger side and said, "Good afternoon, sir. Where going?"

Jake told him where and named his price. Then ensued the usual lively joust of lamentations, appeals, and umbrage taking, and soon they had an agreement. They set out toward the Labadi Bypass, which runs along the beach that marks the southern boundary of Accra, the capital city.

As they drove Jake began to ask the driver his usual suite of questions: whether he owns his taxi; who pays for upkeep and

repairs; whether he's married; how many children he has; whether he keeps any formal savings. He also asked Jake about his work. When Jake said he was working with the savings and loans company where he had flagged down the cab, the driver wanted to know more.

The driver's goal was to own his own car, and he felt he would need a loan to buy one. He asked good questions about the process of accessing credit through the bank. Would he have to hold a savings account to be eligible for a loan? (Yes.) What kind of interest rate do they charge? (3.17 percent per month, flat, calculated on the initial balance of the loan.) How often would he have to make repayments? (Monthly.) Could he repay over a year? (No, the maximum tenor of a client's first loan is six months.) Would he need to offer land as collateral for the loan? (No, he would have to provide a guarantor for security—not collateral.)

By the time he eased the car around the traffic circle at Independence Square, he was enthusiastic. "Tomorrow morning I will come straight to the banking hall before I start work," he said. He knew which documents would be needed to open an account, and whom to ask about starting a loan application. The path forward had been illuminated. Here was a man with the will and aptitude to succeed; he had just been unaware of the resources already available to him.

He and Jake shared a few minutes of pleasant silence as they traced an arc around the football stadium and the edge of Osu Cemetery. Jake could tell he was satisfied. As they came closer to the destination the driver asked one more question: "Do you know another *obruni* [foreigner] at that very bank? He is called James." Jake did know James, a member of the bank's executive management team, and told the driver so.

The driver said he remembered picking James up from the

same office and driving him home. This had been some time ago, "at least one year. I think even more than that." The ride had stuck in his memory because it was, like his ride with Jake, relatively eventful. On that evening James had answered "so many questions" about the process of accessing credit at the bank.

Jake asked, "Well, what did you say to James once he told you all of that?"

He said, without so much as a whiff of irony, "I told him I would come tomorrow."

But he didn't come tomorrow. Not a year before, and not this time either. He did say he wanted a loan, athough that alone is a fairly weak signal of intent. An unscientific review of conversations with Ghanaians over two years suggests that the number of people who say they want loans is much, much larger than the number of people who actually do something about it. What makes this case especially puzzling is that the driver's enthusiasm only increased as he learned all the gory details—about account opening, loan features, security requirements, and the like—and that he actually made a plan (albeit a simple one) to follow through. He knew what he had to do and seemed eager to do it. What went wrong?

Getting poor people to borrow money has become one of the best hopes for alleviating global poverty. So should the taxi driver's failure to show up be a cause for puzzlement and regret? The next few chapters are devoted to finding out.

The Miracle of Microcredit

Maybe the taxi driver hadn't read enough of the promotional literature published by microfinance organizations and their advocates. If he had, he would have known that this is life-changing

stuff—not the kind of thing to be casually passed up. Client testimonials practically jump off the pages and grab you by the lapels: "Look! We used to suffer, but now we're prospering thanks to a loan from . . ." Beside the uplifting story is a photograph of a woman dressed in bright clothes, smiling widely. She is standing in front of the stocked shelves of her recently expanded convenience store or opening the door of her new bread oven, her smile full of dignity and satisfaction and her gaze fixed on a point beyond the camera, fixed on a bright future. Have you seen this woman?

If not, check out the Web sites or annual reports of a few microlenders. You won't have to look too hard. Here is an example from FINCA, the organization that introduced me to microcredit:

> María Lucía Potosí Ramírez . . . has spent her lifetime knitting beautiful wool sweaters and selling them in the local market. But the income she earned from selling her handiwork went toward providing daily necessities for her family, which never allowed her to save so she could buy wool in bulk at a lower cost. And, because she had no collateral, she couldn't access a loan from a traditional lending institution. When Mrs. Potosí learned about FINCA in 2001, she took out a loan for two hundred dollars. This allowed her . . . to purchase more wool at a lower price. Now her family eats better and her loans have tripled, allowing her to purchase and save more. Mrs. Potosí says she is grateful to FINCA for things that go beyond the tangible.

To readers in wealthy countries, stories like these are powerful for two reasons. First, they show loans improving borrowers'

material standard of living. Where a family used to have to choose between, say, eating nutritious meals and buying necessary medicines, now it can do both. Second, they suggest profound changes taking place—changes that extend, as Mrs. Potosí says, "beyond the tangible," and into the lofty realms of empowerment and transformation. This is about more than dollars and cents, and donors value that.

Opportunity International, a global microfinance network serving over a million clients, features a testimonial in its quarterly newsletter from an American donor who visited with some Ghanaian borrowers:

> We heard from Marta, who buys and sells palm oil. She uses her Opportunity loans to pay for her products, giving her the funds to set up a kiosk in town. Her children are in secondary school and have a brighter future. She looked at us and said, "Now I am free!" This statement said it all. Without question, the women we met have experienced transformation. We witnessed it directly and felt their incredible spirit. Our trip to Ghana . . . reaffirmed our reasons for supporting Opportunity International and helped us understand the power of microfinance to change lives.

Before we are swept away in the tide of good feeling, let's get our bearings. While the shiny veneer of microcredit is new, debt is old. People in every corner of the world, rich and poor alike, have borrowed money for millennia. We usually think of debt as a burden and an obligation, not as a miracle cure for poverty. There must be something truly alchemical about microcredit to have turned the act of borrowing money into the kind of transformative, life-affirming experience described by Marta.

The heartwarming success stories we hear about microcredit date from 1976, when Muhammad Yunus, then the head of the Economics Department at Chittagong University in Bangladesh, embarked on a research project about the feasibility of delivering formal credit and banking services to the poor.

Yunus made his first loan, of twenty-seven dollars, to a group of forty-two bamboo craftswomen who, up to that point, had financed the purchase of raw bamboo by borrowing from moneylenders at high interest rates. He was interested in poverty alleviation, not profiteering, so he gave the women a better interest rate—low enough so that they could keep a greater share of their profits than before, but high enough to recoup his investment.

The new loan enabled the women to escape from the cycle of moneylender borrowing, and Yunus saw that his lending idea could work. But he had bigger ideas. Unlike the moneylenders he replaced, Yunus had an explicit social agenda—namely, pulling borrowers out of poverty—and he saw the loans themselves as just one arrow in a big quiver. The other arrows were behaviors and habits, like sending children to school, having smaller families, digging sanitary latrines in homes, and growing vegetables to supplement purchased food. These arrows, unfortunately, were not Yunus's to shoot; they were choices that clients would have to make on their own.

What he could do was to encourage them, using the loans as an incentive. Yunus founded the Grameen Bank to make group loans like the one he had made to the bamboo craftswomen. He wove in the behavioral goals directly. Women who wanted to borrow had to commit not just to paying off their debts, but also to a set of Sixteen Decisions (from which the above four are taken), which would contribute to prosperity and progress for

themselves and their families. Suddenly, and for the first time, borrowing money had become a socially redeeming activity.

The rest is history. Since receiving a banking license from the government of Bangladesh in 1983, the Grameen Bank has grown steadily. Today it serves over six million clients with a total loan portfolio approaching $650 million. Along the way, Yunus and the Grameen Bank jointly picked up the 2006 Nobel Peace Prize for their efforts and, more important, inspired millions around the globe to follow their lead. Today, over a thousand microcredit institutions operate on six continents, serving some 155 million borrowers.

As the numbers and accolades attest, people are excited about microcredit. Everyone is singing its praises, from UN secretaries general to rock-star economists to bona fide rock stars. Some see it as the storied "golden bullet"—the singular big idea that will solve poverty once and for all. Jeffrey Sachs, the noted economist and special adviser to the UN on its ambitious Millennium Development Goals antipoverty initiative, whom we mentioned in the introduction, is one of its most influential advocates. He writes, "The key to ending extreme poverty is to enable the poorest of the poor to get their foot on the ladder of development. . . . They lack the amount of capital necessary to get a foothold, and therefore need a boost up to the first rung."

Celebrities from other quarters are on board too. For instance, the actress Natalie Portman serves as Ambassador of Hope for FINCA, the same charity that finances Mrs. Potosí's sweater venture. And antipoverty crusader Bono, lead singer of the rock band U2 and an outspoken ally both of Sachs and of the poor all over the world, adapts a proverb we met earlier: "Give a man a fish, he'll eat for a day. Give a woman microcredit, she,

her husband, her children, and her extended family will eat for a lifetime."

With so much hype about microcredit, what we need to do is drop our preconceptions and take a clear-eyed, unbiased look at the evidence. In this chapter we'll do just that. We'll see that there are real success stories, but that, as with "teach a man to fish," it's not as simple or as universal as we'd all like. In the following two chapters we'll look at evidence for ways that microcredit programs might be improved, and we'll conclude our foray into the world of microfinance by arguing that we should likely be paying a whole lot more attention to micro*savings* instead.

Erlyn Drops Out

Sari sari translates literally from Tagalog, the most widely spoken indigenous language of the Philippines, as "this and that." It's a phrase you will learn quickly if you visit the country, because you'll find it emblazoned on signboards in every city and every village. The signboards will be red and rectangular, with Coca-Cola logos on either side, and in their centers will be white lettering in all caps declaring: SARI SARI STORE.

True to their name, these are stores that contain a grab-bag of goods. Depending on the neighborhood, you might walk down to your local sari sari store to buy a plate of hot stewed pork and rice, some new pencils, a cup of hot coffee, an individual serving of laundry detergent, packs of dried spaghetti, prepaid mobile phone credit, or fresh-picked coriander.

There is a method to the miscellany, though. The principle behind a successful store is simple: What do people want? The answer, of course, is always changing; but on any given day a fair

approximation is written in the products on the narrow shelves and in the display cases.

Jake and I met one particular sari sari store owner, Erlyn, in the summer of 2009. Evidently, the people who shopped in Erlyn's neighborhood wanted pork rinds. Assorted pork rinds, in all different sizes and flavors and levels of crispiness.

Erlyn was happy to oblige. Above the counter in her sari sari store a great waterfall of pork rinds was frozen in midcascade, suspended in plastic bags and in bandoliers of foil pouches, hung from the lintel with binder clips and fishing line. The other popular item was Tang, and it was also well-represented, a kaleidoscope of colored sachets strewn among the shelves.

Erlyn did more than cater to her patrons' tastes. She also found ways to accommodate their budgets so they could buy the things they wanted without breaking the bank. She sold individual cigarettes and half-servings of Coke, which were really just little plastic bags, each filled with a few ounces of soda and tied shut. (I first experienced soda-in-a-bag in Central America. Shopkeepers like the concept because they get to keep the glass bottle for the bottle refund, but an unintended consequence is that the buyer has to drink it almost immediately, as it is hard to put down a bag of liquid! Each bag was about fifty cents. I remember offering a store owner in Honduras a dollar to have the bottle, too, but evidently there simply was no price for such a luxury.)

Through this myriad of goods, sold bit by bit, Erlyn built a successful business.

Just as she had assembled a motley assortment of products to meet her customers' needs, she had cobbled together a financial solution to meet her own. Well, to a point.

At first glance Erlyn might seem like an ideal microcredit client, and for a while she was one, borrowing from one of the largest nonprofit lenders in the Philippines. She had been very successful with her first few microloans, and so her coborrowers and loan officer encouraged her to borrow more. She did. But when she came home with twenty thousand pesos (about four hundred dollars), her largest loan yet, she found she couldn't put it all into the business at once. There simply was not enough room in the store for that many pork rinds. They would have been spilling out into the street. So she invested what she could in inventory, and the rest commenced to burn a hole in her pocket. There were opportunities everywhere: "When it is twenty thousand, then I would spend some in the house, on clothes or a TV. Then I know it is too much. It is so easy to spend!"

The store had reached capacity. Erlyn could have simply capped her borrowing at the amount she could spend on inventory, but that wouldn't have served her needs, either. The bank only made loans over six months, and the store needed restocking every two. It would not serve to borrow three times the restocking amount, since money lying around had a habit of disappearing. She was stuck.

But not completely stuck. Formal microcredit is not the only source of credit for the poor. In fact, even in places where microcredit is widespread, we see individuals using credit from neighbors, family members, store owners, and yes, the reviled (but reliable!) moneylender. In their recent book *Portfolios of the Poor,* Daryl Collins, Jonathan Morduch, Stuart Rutherford, and Orlanda Ruthven use detailed analyses of households in South Africa and Bangladesh to learn about the plethora of options and mechanisms the poor use to save and borrow. The story clearly is not as simple as "microcredit provides the poor with loans that they otherwise could not get."

In this vein, Erlyn had a specific solution, and the solution made house calls. The local moneylender offered forty-five-day and sixty-day loans, and he came by the shop each day to collect payments. His interest rate was higher than the nonprofit lenders, but he could lend Erlyn just the amount she needed, and for just as long as she needed it. To her, it was worth the additional cost. She left the bank and has been borrowing steadily, and quite happily, from a moneylender for the past two years.

This is not the way it's supposed to work. According to the promotional pamphlets, microcredit is supposed to help you wrest yourself away from the usurious clutches of the local moneylender, not convince you that, on balance, he offers a service better suited to your needs. What can explain this mystery?

Stripping Down to Bare-bones Loans

Actually, it's not such a mystery; there is less of a clear dividing line between microcredit and moneylending than you might imagine. People are often surprised to learn that the terms of many microloans around the world would violate the usury laws of most U.S. states. Consider a few examples from Mexico: The local affiliate of FINCA, a nonprofit microlender, lends at an 82 percent APR yield when all fees are included; Pro Mujer, another major nonprofit, lends at 56 percent. The for-profits aren't charging any more (but they get more of the heat—why is that?): Compartamos, for example, a publicly traded for-profit company, charges 73 percent. That's far worse than any American credit card. Even the low end of the microcredit interest rate spectrum, with annual rates in the neighborhood of 20 percent, is high by our standards.

This begs the question touched on earlier: What *is* microcredit,

if it's not just another way of saying "small loans"? Despite the buzz surrounding the concept, that's not an easy question to answer. Some modern incarnations of microfinance bear little resemblance to the system pioneered by Yunus with the bamboo craftswomen. Perhaps the best one can do is invoke former U.S. Supreme Court Justice Potter Stewart's famous description of pornography: "I know it when I see it." Still, there are some persistent features of microcredit—an explicit social mission, an emphasis on entrepreneurship, a requirement to spend loans on microbusinesses, group lending, frequent group meetings to make loan payments, a focus on women's empowerment through borrowing—that are commonly thought to distinguish it from plain-vanilla moneylending.

We can ease our way into the big questions about whether, how, and why microcredit works by stripping back all of these distinguishing features till we're left with the bare essentials: a dollar amount, a maturity date, and an interest rate. If even barebones loans like these can be beneficial to borrowers, then there is good reason to be optimistic about microloans in general.

In 2004, Jonathan Zinman and I were wrapping up a marketing and interest-rate study (which we saw in the last chapter) with Credit Indemnity in South Africa. The people there were friendly, smart, and fun to work with, but Credit Indemnity was *not* a warm, fuzzy microcredit operation. It was a for-profit consumer credit business with no social agenda—a closer cousin to payday-loans outfits in the United States, or Erlyn's friendly door-to-door moneylender, than to Muhammad Yunus's Grameen Bank. It didn't target women or entrepreneurs, didn't care what borrowers did with the money (so long as they paid it back!), and lent only to working people. And it charged about 200 percent APR. In short, it was in no danger of winning a Nobel Peace Prize.

What we need to know is: Do these loans actually make people better off?

Jonathan and I spotted a chance to find out. Over the course of our interest-rate and marketing study, we had been struck that Credit Indemnity spent a surprising amount of time turning away potential clients. In fact it was rejecting fully *half* of its applicants on account that they were too risky to lend to. But our analysis of the data suggested that clients who barely met the lending requirements were extremely profitable customers for the lender. So we had to wonder: Could it be that the barely rejected applicants would have been profitable too?

After a bit of prodding and a lot of brainstorming with their credit team, we came up with a simple idea for an RCT that would serve everybody. It would help Credit Indemnity to improve its operations (and potentially its bottom line), and would also allow us to answer our question about whether borrowers benefited from credit. Where researchers usually face a struggle between answering meaningful questions and limiting interruptions to partners' operations, this project struck a perfect balance.

It worked by piggybacking on the existing lending process. When a new customer came in to apply for a loan, a staff member fed some basic information, like age, income, and number of years in their job, into a computer program, which instantly returned a basic recommendation about creditworthiness—either a thumbs-up, a thumbs-down, or a "maybe." We modified the software so that some "maybes" would randomly be assigned a thumbs-up and others thumbs-down. While credit officers were allowed to ignore the computer's recommendation, the net effect was that some marginally creditworthy applicants were randomly granted loans. By tracking all the applicants on the cusp—both those who were randomly assigned to be accepted and those who were randomly

assigned to be rejected—and comparing their experiences, we could see whether receiving a loan made people better off.

A year later, a coherent picture had emerged. Applicants who received a random thumbs-up were significantly more likely to have kept their jobs, and had significantly higher incomes to show for it. Clients' families—not just the borrowers themselves—enjoyed greater prosperity too. The randomly approved applicants' households earned more money overall and were less likely to be below the poverty line. Survey responses showed that they were also less likely to go to bed hungry.

Most important, the strength of the results on income and job retention allowed us to effectively rule out the possibility that these loans were, on the whole, pernicious.

This was great news for advocates of microcredit. Actually, it was great news for advocates of payday loans too. Lenders around the world were being attacked left and right for pushing their evil debt on borrowers, but much of the ammunition was invective and innuendo—not facts. Given the paucity of reliable information on the impacts of credit, any evidence showing it to be *good*—even at high rates—was a welcome addition to the conversation.

Providing some hard evidence in favor of lending was a start, but the study with Credit Indemnity did more than that. It also showed us something interesting about the specific ways that loans can lead to prosperity. In many cases, we learned, the loans were used to deal with unexpected shocks.

Two common stories emerged. First, many borrowers used the loan to pay for transport-related costs. They repaired broken-down cars and motorbikes and bought bus fares, all of which allowed them to get to work on time and avoid getting into hot water with their employers. Second, borrowers sent money home to needy relatives in rural areas. Had they been unable to send

assistance, many would have been obliged to pull up stakes and go in person to help their loved ones, a move that would have spelled disaster for their steady jobs at home. But with the aid of credit—even the high-priced consumer variety—both stories had comparatively happy endings. The paychecks kept rolling in.

Golden Eggs and the Case for Microcredit

So far, so good. We have learned that bare-bones small loans can work for Credit Indemnity's eligible borrowers, people in formal employment. Now what about the usual target market of microcredit, small-scale entrepreneurs?

The basic idea behind microcredit is that the poor actually have great economic opportunities, but that they lack the resources to take advantage of them. Here's a typical example: Lucia, a seamstress, makes her living sewing and mending clothes by hand. The $5 profit she makes each day is just enough to feed her family and pay their rent. With a $100 electric sewing machine she could double her output (and her profits), but that's money she doesn't have—until she pays a visit to a microlender.

Lucia takes a six-month loan for $100, buys the sewing machine, and starts earning $10 per day. Even if the lender charges 100 percent APR—which, again, would be an unthinkably (and probably unlawfully) high interest rate in the United States, but is entirely realistic for a microloan—Lucia still comes out ahead, and by a wide margin. She has to set aside just under a dollar each day to make her monthly payment of $21.85, leaving her with $9 a day for her family instead of the $5 she earned previously. Once the loan is paid off, she keeps that last dollar for herself and goes home each day with the full $10. And so, without much fanfare, Lucia nearly doubles her income thanks to a 100 percent–APR loan.

Simple, right?

If such lucrative business opportunities do exist for the poor, then high interest rates on microloans are not such a problem; borrowers and banks can both win. But that's a big "if." A one-time hundred-dollar investment that doubles long-term profits, like Lucia's sewing machine in our example, is a goose that lays golden eggs. Are there really, as microcredit advocates claim, so many of those golden geese waddling around the stalls of Dakar's or Dhaka's outdoor markets, or making themselves at home in the flooded rice paddies of Thai smallholders' farms?

We have to answer this fundamental question to know whether and when microcredit can be beneficial at all. Because one thing is certain: It can only work if clients pay back their loans. No matter what the interest rate, if clients rely on an increase in profits from borrowing to make their payments, then the viability of the whole system depends on how much that increase will be. In economic jargon, the question to ask here is "What is the marginal return to capital for the enterprise?" In other words, if a microentrepreneur puts an extra dollar into her business, how much more profit will she earn?

In 2005, three economists, Suresh de Mel from the University of Peradeniya in Sri Lanka, David McKenzie from the World Bank and IPA, and Chris Woodruff from the University of California at San Diego, set out for southern Sri Lanka to answer that question and find out what kind of business prospects the poor really had. How powerful were the economic engines of microenterprise, after all? Their strategy was simple and direct: They would inject money into some businesses and see how much additional profit was generated.

Going door-to-door, the researchers found 408 microentrepreneurs. They were tailors, lace tatters, bamboo craftspeople,

owners of small grocery stores, bicycle repairmen—the prototypical microentrepeneurs that we hear about every time we hear about microcredit. Half of them were randomly selected to receive a grant of either one hundred or two hundred dollars (the amount was also randomly chosen). This was a sizable amount, roughly equivalent to three or six months' profits from the typical business.

The researchers tracked the profits of all 408 businesses with quarterly surveys over the following fifteen months, and compared those of grant recipients with those of nonrecipients. Recipients' monthly profits increased by about 6 percent of the grant amount on average. That is, investing an additional hundred dollars in the business generated six dollars more in profits per month, or seventy-two dollars more in profits per year. And potentially even more if the additional profits were reinvested back into the business. As a reference, if you put all your money into an investment with 70 percent annual returns (and kept reinvesting the profits), your wealth would almost double every year. That's a golden-egg-laying goose if ever there was one.

Why Isn't Microcredit More Popular?

If microentrepreneurs around the world can earn high returns like their counterparts in Sri Lanka, then it's looking even better for microcredit. But hold on a moment. This apparent profusion of golden-egg-laying geese is actually a profound puzzle. If returns really were so high, traditional economics would expect people to funnel every available dollar toward their outrageously profitable businesses. Microentrepreneurs should be knocking down lenders' doors.

Trouble is, they aren't.

In the part of southern Sri Lanka where de Mel, McKenzie, and Woodruff conducted their study, microloans were widely available and reasonably cheap—interest rates were in the neighborhood of 20 percent APR, far lower than the returns the microentrepreneurs they had studied stood to make on average—so there seemed to be potential for profitable borrowing by these folks. But in fact there had been very little. Only one in nine had ever taken any kind of formal loan.

It's not just the southern Sri Lankans who are strangely reticent. For, despite widespread enthusiasm in the developed world, it would appear that one very important group is not entirely sold on microcredit: the poor. At first blush the figure of 155 million clients worldwide is an impressive one, but let's look a little closer. Compare that with the number of poor people. About half the world's population—well over three billion people, or twenty times the number of microcredit clients—live on less than $2.50 per day. So even if every microcredit client was poor (and not all of them are), still less than 5 percent of the poor would be borrowers.

Realistically, 5 percent is a conservative estimate. Not every poor person is eligible for microcredit, or has access to it in the first place. But that number actually doesn't seem too far off. A landmark study in Hyderabad, India, found a similar figure to the one from Sri Lanka—that somewhere between 10 and 20 percent of eligible borrowers choose to take loans. If people vote with their feet, microloans aren't winning any elections. And that means the Ghanaian taxi driver we met at the start of this chapter is far from alone. What can explain this puzzle?

Maybe the eight in nine microentrepreneurs in the Sri Lanka study who failed to take out loans were simply ignoring the knock of opportunity. But let's suppose they weren't. There are still two plausible explanations for the low level of borrowing.

The first explanation is a mathematical quirk. Maybe the big average annual returns observed in Sri Lanka only tell half the story. After all, an *average* of 70 percent doesn't mean that *everybody* saw a return of 70 percent on the nose. Let's say that half had 140 percent returns and the other half had zero: Then the average return would still be 70 percent, but we wouldn't be surprised to see the zero-percenters passing up microloans.

In fact, there was evidence to support this kind of story. Returns weren't the same across the board; they were different for different types of people. Some of the differences were just what you'd expect. For instance, more-educated and smarter microentrepreneurs seemed to do better (although, statistically speaking, these weren't robust results; the study wasn't designed to get at such granular analysis with only 408 participants). An additional year of schooling increased returns by a quarter, and success on a simple test of cognitive ability was a strong predictor for high business returns.

But other differences in returns were surprising and troubling, most notably the disparity between the sexes. There was strong evidence that men had high returns from their businesses, and much weaker evidence that women did. Men in the study had average annual returns of about 80 percent, while women's average returns were actually negative. Could it be that only men can run successful microenterprises?

Now, the general claim that women can't succeed as microentrepreneurs seems patently false. Take a walk through a crowded market in just about any developing country: The voices you will hear calling out the prices of vegetables are women's voices; the hawkers making their way down the aisles are announced by the rustling of their long skirts. Indeed, women are the lifeblood of microenterprise in much of the developing world. Moreover,

much of the microfinance movement, from Yunus's Grameen Bank on down, has emphasized lending to women—largely because they are believed to be more responsible as borrowers than men. But if their businesses are destined to be unprofitable, then clearly they are not the right people to take on entrepreneurial loans.

Is all the emphasis on women really misplaced? I hope not; but the findings from Sri Lanka force us to confront that uncomfortable question.

Fortunately, there is a second possible explanation for the low level of formal borrowing. Maybe people were driven away from microlenders by excessive restrictions on the use of borrowed money. In Sri Lanka as in the rest of the world, many microlenders require that loans be used exclusively to finance business activities. That means, for instance, that a tailor could take a loan to buy a sewing machine, but not to buy ready-made clothes for her children.

The problem was that the entrepreneurs in Sri Lanka didn't want to finance just their business activities. They had other ideas.

De Mel, McKenzie, and Woodruff had designed their study to see just how far these other ideas went. The grants they made to entrepreneurs came in two flavors. Half were "in-kind": Recipients could choose any business-related items up to the grant amount, and the researchers went with them to buy it. The other half were made in cash with no strings attached. Recipients were told they could spend the money on anything they liked.

The researchers found that recipients of no-strings-attached cash grants spent just over half (58 percent) on business purchases. The rest went toward savings, paying off debts, and everyday consumption items like food, clothes, medicine, and bus fare. If this is really how they wanted to spend their money,

is it any surprise that they weren't taking more entrepreneurial microloans?

Maybe we should think of this question another way: Why were microlenders making so many rules about how loan money could be spent? (The answer, ultimately, is that we as donors tell them to. Look at Kiva.org. We like the idea that our loans go to microentrepreneurial types. Would people give as much to Kiva if the appeals read: "Help fund this person's loan so she can buy a new television or pave her floor"?) We will see more about the wisdom—and the futility—of these rules in the next chapter.

A Little Meat on the Bare Bones

Two years after we had worked with Credit Indemnity to measure the impact of credit on borrowers in South Africa, Jonathan Zinman and I had a chance to replicate our Credit Indemnity study with a Filipino lender that made entrepreneurial loans. It was a great opportunity to see whether a more traditional version of microcredit (i.e., one that targeted entrepreneurs) could produce the same positive impacts as its consumer-oriented cousin. Maybe we would even find evidence to support those uplifting success stories we read in the brochures: the bread baker whose business takes off when she buys a new oven, FINCA's Mrs. Potosí and her thriving sweater concern.

As is the case with much of IPA's microfinance work in the Philippines, we have microfinance guru John Owens to thank for introducing us to our partner. He led us to Reggie Ocampo, president of First Macro Bank, a lender in and around the capital city of Manila with some seven thousand clients.

Much more so than Credit Indemnity, First Macro sits squarely in the microcredit universe. It lends exclusively to

entrepreneurs, and loans are supposed to be spent solely on borrowers' businesses. Most of its clients have no formal employment, no credit history, and no collateral to secure their loans. And while First Macro is a for-profit business, it does have an explicit social agenda. Its mission statement talks about "community development," "customer-driven products," and "sustainable growth." First Macro's loans are also about two-thirds cheaper, at 63 percent APR, than the ones we studied in South Africa.

But operationally there were a lot of similarities between the two lenders. Like Credit Indemnity, First Macro made loans to individual borrowers, typically with maturities of a few months, and they fed information about each applicant into a computer program that instantly produced a basic creditworthiness recommendation. So it was fairly straightforward to adapt our earlier experiment.

The replication with First Macro worked almost exactly like the Credit Indemnity study. Zinman and I modified the creditworthiness software so that some first-time applicants whose scores were just on the edge (i.e., the "maybes," who actually made up about three-quarters of the applicants) were randomly approved. Over the following two years, we surveyed everyone, including those who were rejected, to see how their lives had changed. Had the ones who got loans prospered?

Yes and no. Looking at all the applicants together, the results were unremarkable. Business profits were 10 percent higher for those who got loans, but statistically the increase was not significant, so we can't say with any confidence that the change in profits had anything to do with getting loans.

Looking at specific groups of applicants, it turned out there

were some striking things to say, after all—but they were not the things microcredit evangelists wanted to hear. Not everybody succeeded. First, as in Sri Lanka, men did much better than women. They saw three times the increase in business profits as their female counterparts. Second, better-off borrowers proved much more adept at putting their loans to work: for the (relatively) wealthier half of applicants, getting a loan led to a 25 percent jump in business profits, whereas for those less well-off, we could not say with confidence that the loans had any effect on profits at all. So poor women, the stock heroes of microcredit lore the world over, did not steal the show in Manila.

For that matter, there was something else about the story emerging from First Macro that didn't square with conventional wisdom. The endpoints of the narrative arc matched—in general, businesses that received loans went from less to more profitable—but the middle part of the plot was a surprise. We had thought we might find an excuse to dust off those durable bromides about microcredit allowing enterprises to grow, spreading outward like great hydrangea blossoms, bursting with the life and vivid color of a magnolia in early spring, et cetera. No such luck. We found that where businesses actually improved, most did so not through a process of unfettered growth, but through pruning.

That's right: Increases in profits were driven mostly by *shrinking* firms, not expanding ones. Applicants who (randomly) received loans consolidated and pared down their operations. They had fewer businesses overall, and the businesses they did have employed fewer paid workers. Costs fell and profits rose. It was that simple.

Simple, but also unexpected. After all, nobody pitches

microcredit with stories about closing down businesses and laying off workers. But maybe they should try; if nothing else, they would have evidence to back them up.

Can Microcredit Transform Communities?

What we've seen so far suggests that at least *some* people can and do prosper from access to microcredit. But the stories one hears from staunch advocates—think again of the adapted proverb "Give a man a fish, he'll eat for a day. Give a woman microcredit, she, her husband, her children, and her extended family will eat for a lifetime"—imply something much stronger: not only that a huge breadth of individuals around the world can benefit directly from these loans, but that the rising tide lifts all boats. The great promise of microcredit is that it can be plunked down almost anywhere and be expected to pull entire communities up out of poverty.

One way to find out whether this is true is to go ahead and try: See what happens when microfinance arrives in a community for the first time. In 2005, Abhijit Banerjee, Esther Duflo, Rachel Glennerster, and Cynthia Kinnan, four economists from J-PAL and IPA, converged on Hyderabad, India, to conduct an RCT. They partnered with Spandana, an Indian microlender serving some 1.2 million clients with group loans. At the time, Spandana was planning to expand by opening branches in new neighborhoods. Working with the researchers, they identified about a hundred neighborhoods where microloans were not yet available, and randomly selected half to receive a branch during the following year.

In late 2007, about a year after the branch openings, the researchers surveyed widely in all hundred neighborhoods. Where branches had been built, they spoke not only with those

who had borrowed, but also with those who hadn't. They were interested in the experience of the community as a whole—not just of the go-getters who were first in line at the new branches.

The first thing they noticed was that there actually weren't all that many go-getters. Just as we saw earlier in the Sri Lanka study, fewer than one in five people who met Spandana's eligibility criteria were sufficiently enticed to come in and take loans. Fewer still invested those loans in a microenterprise. In fact, the most common reason for borrowing was to pay off other debt—usually of the high-interest, moneylender variety.

In light of those facts, maybe it is not so surprising that, despite the shiny new Spandana branches on their streets, communities were not transformed overnight. The surveys found no marked changes in women's empowerment, children's school enrollment rates, or spending on health, hygiene, and food. Another way to see this was by tracking the total amount households spent each month—on everything from dinners to diapers, school fees to cigarettes. A year after the branch openings, total expenditures hadn't increased. It looked like people were, on the whole, no wealthier than before.

So for poor communities in Hyderabad, the introduction of microcredit didn't mean instant prosperity for all; but this was not the whole story. As with First Macro in Manila, the interesting dynamics here were below the surface. They had to do with different *kinds* of people and the different ways they responded to increased access to credit.

The researchers broke down the residents of the hundred Hyderabad neighborhoods. First they separated out everyone who already owned a business. Then they used a model to predict whether a person was likely to start a new business based on some demographic information about his or her entire household—how

much land it owned, how many working-age women it included, and whether the wife of the household head was literate and had a paying job. They used the model to split the remaining people into two groups according to the strength of their entrepreneurial bent. Once each person had been labeled as an actual entrepreneur, a likely entrepreneur, or an unlikely entrepreneur, the researchers could compare the groups to see how credit impacted each of those groups.

This three-way division gets at the heart of our question. Do the poor share a common and equal capacity to exploit microloans for their own—and their families', and their communities'—benefit? Or does that ability belong to some more than others?

Comparing the three groups side by side, the differences were striking. And they told a coherent story.

Business-minded folks did well. Actual entrepreneurs tended to funnel money into their existing enterprises. Likely entrepreneurs cut back on consumption—especially consumption of so-called "temptation goods" like alcohol, cigarettes, lottery tickets, and roadside cups of tea (the Indian equivalent of Starbucks)—and ramped up spending on durable goods. They bought exactly the kinds of things you'd need to start a business: sewing machines if they were tailors, ovens if they were bakers, refrigerators if they were grocers.

All this business-related spending meant people were building and fueling economic engines. Despite the researchers' finding that people were not wealthier on the whole, they appeared to be heading in that direction. And the cutback in spending on temptation goods suggested that, with their entrepreneurial dreams now in reach, people were making smart sacrifices to achieve their goals. So far, the classic story about microcredit was safe.

But the unlikely entrepreneurs threw a major wrench into the works. They didn't buy durable goods or invest in businesses; they just consumed more. More of everything, from clothes to food to cigarettes and cups of tea. And at the end of the day, they weren't any wealthier than when they started. All they had left was their obligation to Spandana. So they wound up looking more like characters from a cautionary tale about, say, credit card debt than like the inspiring figures of microcredit literature.

The Means, Not the End

Now, we really need to be clear about the evidence we've reviewed in this chapter. It does *not* mean that microcredit is a failure, or that the enormous amount of enthusiasm it has generated is necessarily misplaced. All it means is that the jury is still out. Since the initial trials haven't come up all roses, the burden shifts slightly on to microcredit's advocates to make a strong case for it, and on to researchers to dig deeper and learn in what contexts it works best—or works at all. No single study, conducted in one place and at one point in time, can generate sufficient evidence to make worldwide prescriptions. One of the biggest challenges in development is to replicate evaluations in enough places and contexts that we finally arrive at universal lessons. This challenge is part of what motivated me to found IPA, an organization dedicated to the hard, slogging work that will ultimately bridge the gap between single studies and comprehensive, consistent evidence that we can take to the bank, so to speak.

The punch line is that what we've learned in this chapter about the limitations of microcredit is *not* a tragedy! It just means that not everybody is a born entrepreneur—or a born

microcredit client—any more than everybody is a born fisherman. In the next chapter, we'll have more to say about why.

So the problem with microcredit is not microcredit. The success of microlenders, as viable businesses serving the poor, is genuinely impressive. And, more important, thanks to the explosion of the industry in the past three decades, millions of people around have more choices than they did before. These are truly great things.

The problem with microcredit is the way it has been pitched: as a one-size-fits-all solution to poverty that can be adopted effectively even without careful impact evaluations, and as something that every poor person should want. For all its merits, it is not that.

I am reminded of something I heard at a gathering on microcredit hosted by the Center for Global Development in early 2010. A group of academics, policymakers, and practitioners had been brought together to discuss the negative spin the media gave to the microcredit evaluations I've talked about in this chapter. Someone at the gathering summarized the palpable sense of concern and foreboding among the attendees: "The future of microcredit is at stake."

What really is at stake here? Microcredit is the means to the end, not the end itself. What's at stake is an opportunity to improve the lives of the poor. Millions of dollars pour into development aid, but it's not nearly enough to solve the problems of poverty. My inner economist, the part of me that sees the world in terms of trade-offs, gets frustrated that when we direct so much of our money, efforts, and good intentions toward microcredit, we don't direct them toward other things—like savings, insurance, education, and health. Some of those other things, many

of which you'll read about in this book, work, and are cheaper and more inclusive ways to get to our ultimate goal of reducing poverty.

So how can we do the best with the resources we have? And can we inspire more people to get involved, by giving them the confidence that there are programs that really work? That's what is at stake.

The tool is not what matters; reducing poverty is.