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Micro-credit and micro-finance: functional and conceptual differences

Khandakar Qudrat-I Elahi and M. Lutfor Rahman

Introduction

The terms *micro-credit* and *micro-finance* are often used synonymously. This has created confusions and misunderstandings in both development discourse and policy making. Muhammad Yunus (2004a), founder of the Grameen Bank, explains that 'the word "microcredit" did not exist before the seventies. Now it has become a buzz-word among the development practitioners. In the process, the word has been imputed to mean everything to everybody.' It now seems obvious that there are serious disagreements among micro-credit practitioners and policy makers about the role of small-loan programmes in efforts to alleviate Third World (TW) poverty, and disagreements therefore about the type of individual involved in such programmes. This article examines the functional and conceptual differences between micro-credit and micro-finance.

Micro-credit and micro-finance: functional differences

Micro-credit evolved as a part of paradigm shift in development thinking. Western interests in international development followed the political independence of TW countries in the post-war period. To help improve the social and economic conditions of the former colonies, national and international agencies were created to transfer Western funds and materials (Harcourt 1997). This policy is popularly known as the 'top-down' approach to development, because the TW governments that received international aid and loans were primarily responsible for how they were used.

Unfortunately, these international aid programmes were largely unsuccessful. The failure was attributed to the lack of participation by the intended beneficiaries of development projects in the process of designing, formulating, and implementing these projects (Rehnema 1992; Waddimba 1979; Wolfe 1981). Thus, the 'top-down' approach was gradually substituted by the still popular 'bottom-up' approach, which views participation and participatory methods of interaction as essential dimensions of development. The World Bank endorsed the idea in 1973, when Robert MacNamara (1973) told his audience that no programme would help small farmers if it was designed by people who had no knowledge of the farmers' problems, and implemented by those who had little interests in their future. Eventually, the 'bottom-up' approach, or 'participation and participatory methods', began to dominate policies of bilateral and multilateral agencies (Stiglitz 1999; Wolfensohn 1999).

The new policy regime accorded greater roles to NGOs in the distribution of international aid earmarked for poverty alleviation. NGOs are characterised by their independence of

government, their non-profit status, and their motivation to serve humanitarian, social, or cultural interests (World Bank 1996). In terms of functions, they (i) provide goods and services not usually supplied by the state or the private sector; (ii) help the government to achieve its development objectives by providing public information, education, communications campaigns, etc.; and (iii) organise citizens to voice their aspirations, concerns, and alternatives for consideration by policy makers (Clark 1999).

Grameen-type credit programmes meet these conditions. These programmes generally provide small loans of about US\$ 100, primarily to poor rural women, who have little access to conventional banking facilities. The loans are given for the purpose of supporting income-generating activities in the informal economy, often through self-employment. Rather than providing collateral, borrowers must make regular savings as a precondition for getting such loans (Grameen Bank 2004; Yunus 2004a).

Micro-credit organisations are generally NGOs, and so are not motivated by the wish to make profit. They differ from charitable bodies because, rather than assuming that poverty is the result of personal failings on the part of the poor, micro-credit NGOs believe that poverty is created through social processes that deprive the poor of their rightful access to social resources, including credit. Indeed, some micro-credit advocates treat credit as a kind of human right, and believe that they can inspire social and economic revolution through organising the poor under the banner of the Grameen-type micro-credit organisations.

The tremendous success of micro-credit programmes in reaching poor women in rural areas, coupled with exceptionally high rates of loan recovery, soon attracted the attention of the international donor community. For instance, the 1997 Microcredit Summit was attended by 2900 delegates from 137 countries, representing 1500 organisations from all over the globe (Microcredit Summit 1997). This popularity inspired academic interest in the topic, leading to the coinage of the term *micro-finance* in the late 1990s.

Micro-finance is defined as a development approach that provides financial as well as social intermediation (Ledgerwood 1999; Robinson 2002). The financial intermediation includes the provision of savings, credit, and insurance services, while social intermediation involves organising citizens' groups to voice their aspirations and raise concerns for consideration by policy makers and develop their self-confidence. These services are provided by three types of lender: formal institutions, such as rural banks and co-operatives; semi-formal institutions, such as NGOs; and informal sources such as moneylenders and shopkeepers. Institutional micro-finance includes micro-finance services provided by both formal and semi-formal institutions, collectively referred to as Micro-finance Institutions (MFIs) (Asian Development Bank 2004).

The basic functional difference between micro-credit and micro-finance programmes concerns the type of service that they provide. The former, such as Grameen, provide mainly one kind of service – loan distribution and recovery – which is linked to group formation and compulsory savings. Micro-finance programmes, on the other hand, provide all kinds of financial service, including micro-credit. Thus micro-credit is a necessary, but not sufficient, element of the new financial sector that seeks to cater to the credit needs of the poor who do not have access to formal sources.

This is perhaps the reason why the micro-finance movement is described as the second revolution in credit theory and policy (Woller 2002). The first revolution concerned micro-credit, and was focused on overcoming the structural barriers to providing savings and credit services to the poor. These barriers include information asymmetries, lack of collateral, high cost, high risk, and systematic market bias. The key methods used in micro-credit schemes are the following:

- a standardised and limited set of products and services
- group lending

- social collateral
- forced savings
- small initial loan size
- loan size tied to savings
- standardised loan repayment and disbursement schedules
- frequent repayments.

The promoters of the second revolution describe these innovations as ‘inward-looking’, saying that their primary purpose is to satisfy organisational and donor demands, not the demands of their customers or clients. More specifically, micro-credit programmes provide ‘product-centred’ services, as they find customers to match the demands of their product (small loans), rather than developing products to match the demands of their customers. Thus the proponents of the second revolution recommend replacing the product-centred approach with the customer-centred approach. This new approach involves developing and providing financial services that the customers want. Evidence suggests that the product-centred orientation is becoming increasingly dysfunctional (Woller 2002). The micro-finance landscape is changing fast, in terms of both time and geography. One consequence is that micro-credit organisations are losing their monopoly over the market to non-institutional sources of credit.

Micro-credit and micro-finance: conceptual differences

From the functional point of view, the micro-finance revolution is in reality a transformation of the micro-credit revolution that started in the mid-1970s. This perhaps explains why the two terms are often used synonymously, and/or the two types of programme are examined under the same heading (Morduck 1999; Ledgerwood 1999). The authors who use these terms interchangeably regard the differences between them as semantic rather than substantive.

This benign view, however, cannot be maintained if one looks at the supply side of micro-finance programmes. The issue has become critical, as underlined by Yunus (2004a): ‘The point is that every time we use the word “microcredit” we should make it clear which type (or cluster of types) of microcredit we are talking about. Otherwise we’ll continue to create endless confusion in our discussion . . . I am arguing that we must discontinue using the term “microcredit” or “microfinance” without identifying its category.’ Yunus identifies the following categories of micro-credit/micro-finance provider:

- traditional informal micro-credit: moneylenders, pawn shops, friends and relatives, consumer credit in the informal market
- micro-credit based on traditional informal groups: *tontin*, *su su*, ROSCA, etc.
- activity-based micro-credit through conventional or specialised banks: agricultural credit, livestock credit, fisheries credit, handloom credit, etc.
- rural credit through specialised banks
- co-operative micro-credit: credit unions, savings and loan associations, savings banks, etc.
- consumer micro-credit
- bank/NGO partnership-based micro-credit
- Grameen-type micro-credit, or Grameencredit
- other types of NGO micro-credit
- other types of non-NGO non-collateralised micro-credit.

This categorisation shows the diverse motives of micro-lenders supplying loans to the poor. For example, micro-credit NGOs and moneylenders have quite different reasons for providing their loan services, with NGOs seeking to help those who are exploited by informal

moneylenders because they lack adequate access to institutional sources of credit. It is therefore critical to examine the underlying conceptual differences between micro-credit and micro-finance in relation to poverty alleviation.

Unfortunately there are very few studies that discuss the micro-finance revolution from a conceptual perspective, an important exception being *Microfinance and Poverty Alleviation – Case Studies from Asia and the Pacific* (Remenyi and Quiñones Jr 2000). This book takes the traditional banking view of micro-finance. Banking, defined as financial intermediation, involves bringing together ‘the independent acts of savers and borrowers to facilitate one another’s goals’. The only difference between micro-finance and the formal banking system is that the latter is geared to rich urban clients, while the market for micro-finance services consists primarily of poor rural people who need credit in order to pursue their small enterprises in the informal economy. Micro-finance entrepreneurs are usually business people who apply the usual profit motives to meet this demand and seek to be self-financing. Therefore ‘subsidized credit and subsidized banking with the poor are inimical to “best practice in microfinance”’ (Remenyi 2000: 27).

Clearly, then, there are two fundamental conceptual differences between micro-credit and micro-finance. The first concerns the profit motive. NGOs or non-profits that run micro-credit programmes do not, by definition, seek to make a profit. Micro-finance, however, is a for-profit private venture. The second fundamental conceptual difference concerns the means by which the operations are financed. Micro-credit programmes that are run by non-profits depend upon external finance, but micro-finance programmes set out to make a profit and must eventually be self-financing. For example, moneylenders use their own money to do their business; they do not approach either national or international donor agencies for investment funds. And national and international development agencies cannot help them to pursue their lending ventures, for obvious reasons.

Small loans: conflicts in theory and policy

Do these differences really matter in terms of framing sustainable poverty-alleviation policies? Current practice in both theoretical and policy discussions would suggest not, since otherwise professionals would have been far more careful in following these analytical and policy trends.

We argue that these differences do matter. From an academic perspective, the debate deals with human motives for undertaking economic activities. This debate goes back to Adam Smith’s theories, articulated in two of his masterpieces – one philosophical and the other economic. The philosophical work, *The Theory of Moral Sentiments*, is an inquiry into moral psychology, which concerns the nature of moral judgement (Raphael 1985). According to Smith, the original source of moral judgement lies in the concept of sympathy. No matter how selfish human beings are, they have an innate interest in the fortunes of others, although they may derive no gain other than the pleasure of seeing another’s good fortune. Thus human nature includes such qualities as the compassion that we feel for the misery of others, whether we witness it directly or are made to imagine it. The economic treatise, *An Inquiry into the Nature and Causes of the Wealth of Nations*, on the other hand, argues that human selfishness is the key to material progress in the non-communist state. These seemingly incompatible perceptions of human nature remain the subject of academic debate (Tribe 1999; Witztum 1998), suggesting that one needs to be very careful when ascribing human motives in making an intellectual analysis.

Besides this historical debate, the current literature shows tremendous interests in the issue. Smith’s theory, often described as *homo economicus*, underlines human selfishness as appropriate economic behaviour. However, sympathy or altruism is empirically observed as an essential element of human nature, as shown by the existence of charitable organisations from time

immemorial. These are defined as a body of individuals who organise their voluntary activities for any or all of the following three main reasons: (i) to perform public tasks that have been delegated to them by the state; (ii) to perform public tasks for which there is demand that neither the state nor the commercial sector is willing to fulfil; and (iii) to influence the policies of the state or the commercial sector (Hall 1987). A substantial body of economic theory now deals with the issues and problems of the non-profit organisations (also called 'the third sector').

While these economic theories concerning the non-profit sector do not really challenge Smith's behavioural maxim, the new branch of economic psychology does so. The French social psychologist Gabriel Tarde, who developed this concept, believed that Adam Smith did not draw upon his knowledge about human nature, established in the *Moral Sentiments*, when he wrote *Wealth of Nations*. Tarde believed that since human beings are fundamentally social in nature, the appropriate basis for theorising economic behaviour ought to be social interaction (Warneryd 1988).

However, Tarde failed to encourage many economists to follow his lead. The new field eventually became established through the works of George Katona, a US psychologist. Today economic psychology is defined as a discipline that studies the psychological mechanisms and processes that underline consumption and other economic behaviour. It deals with preferences, choices, decisions, and factors influencing these, as well as the consequences of decisions and choices with respect to the satisfaction of needs (Warneryd 1988). One aspect of human behaviour that is accorded great importance in this field is altruism, or charity. From the neo-classical perspective, altruism should not exist, because there is no obvious economic gain from charitable action, and those who disadvantage themselves to favour others in the race for survival will not thrive (Khalil 2004; Walker 2002; 2004).

The importance of this discussion is that ideas of sympathy or social conscience have turned out to be key concepts in relation to poverty-alleviation programmes. The World Bank's Community-Driven Development (CDD) initiative (World Bank 2004a) is part of the bottom-up approach to the development. Rather than viewing poor people as the target of poverty-reduction efforts, CDD tries to treat poor people and their institutions as assets and partners in development. Community groups often work in partnership with demand-responsive support organisations and service providers, including local government, the private sector, NGOs, and central government agencies. CDD is presented as a way to provide social and infrastructure services, to organise economic activity and resource management, to empower poor people, improve governance, and enhance the security of the poorest.

The CDD initiative is embedded in the idea of social capital, which refers to institutions, relationships, and norms that shape the quality and quantity of social interactions. Evidence suggests that social cohesion is critical for economic prosperity and sustainable development. Social capital, the Bank (2004b) says, is not just the sum of a society's institutions: it is the glue that holds them together.

For his part, Yunus (1998) is promoting the idea of capitalism that is driven by social awareness. He argues that it is possible to develop capitalist enterprises that maximise profit, subject to the fair interests of their customers. The rationale goes as follows: the current neo-classical theory of production is incomplete, because it is founded on the assumption that individuals pursue businesses solely in order to maximise their profits. This cannot be a general model of capitalism, however, because it excludes individuals who are concerned about the welfare of others. A more general principle is that an entrepreneur maximises a bundle consisting of two rates of return: financial return (or profit) and social return. This assumption creates three groups of entrepreneurs (Elahi and Danopoulos 2004). The first group consists of traditional capitalists who mainly maximise financial returns (or profits). The second comprises philanthropic organisations, such as traditional micro-credit NGOs and public credit agencies, both of which maximise

mainly social returns. The third group consists of entrepreneurs who combine both rates of return in making their investment decision, but must generate a positive financial return. This group includes the micro-finance entrepreneurs, who are socially concerned people, and micro-finance, which is to be treated as a capitalist enterprise that incorporates social awareness.

Yunus (2004b) has since defined the third group as belonging to a comprehensive category of social entrepreneurs. They include all those who are willing to offer their time and energy to the task of addressing the social and economic problems faced by groups or communities, whether at the local or the global level.

It seems clear that for neither the World Bank nor Muhammad Yunus do for-profit moneylenders form part of the micro-finance revolution. It is therefore a serious error, both theoretically and in terms of policy analysis, to lump together all kinds of micro-lender who are prepared to provide collateral-free loans. However, Yunus' idea of 'social-consciousness-driven capitalism' runs into the problem of trying to determine whether an individual is entering the micro-lending business with or without social consciousness.

Finally, to use micro-credit and micro-finance as synonymous terms seems to contradict the way in which rural development policies have evolved. From the 1950s to the 1970s, the Bank helped to develop para-statal rural development organisations, to modernise agriculture as well as to protect small farmers from informal lenders who usually charge high rates of interest. From the 1980s the Bank began to involve NGOs in rural credit markets. The current policy of promoting for-profit financial ventures seems to run counter to earlier directions.

Conclusion

This article has analysed the implications of using the terms *micro-credit* and *micro-finance* interchangeably, and has examined the functional and conceptual differences between them. Micro-credit programmes provide mainly one kind of service: loan distribution and collection, and the financial and organisational activities associated with such operations. Micro-finance programmes provide a range of financial and organisational services, including credit, savings, insurance, and community development. In terms of their functions, it may be argued that the differences are semantic rather than substantive. However, the conceptual differences are fundamental and far-reaching. Most micro-credit programmes are run by NGOs, which are by definition voluntary, non-profit development organisations that depend on external sources of finance. By contrast, micro-finance programmes seek to generate enough profit to be self-financing.

From an academic or theoretical perspective, while the theory of capitalism is founded on the assumed selfishness of human nature, a substantial body of economic theory on the so-called third sector deals with the opposite aspect of human nature – altruism or sympathy. This holds that the capitalist economy is made up of two sectors – the public and the private – and it is therefore irrational to mix up the private and the third sector.

We conclude that the design of policies and institutions for the sustainable alleviation of Third World poverty must be based on an understanding of the conceptual differences between micro-credit and micro-finance. These conceptual distinctions are of far greater importance than are any functional differences in terms of their theoretical and policy implications. Indeed, it might be asked whether micro-finance programmes can be legitimately included as part of the multilateral poverty-alleviation programmes that have evolved over the last 60 years.

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