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Employment, not microcredit, is the solution

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The Nobel Peace Price for 2006 was awarded to the Grameen Bank in Bangladesh and its founder Muhammad Yunus, a pioneer of the microcredit movement. The Nobel Committee affirmed that microcredit must play "a major part" in eliminating poverty. The United Nations, having designated 2005 as the International year of Microcredit, declares on its website, "currently microentrepreneurs use loans as small as $100 to grow thriving business and, in turn, provide their families, leading to strong and flourishing local economies." The Indian bank ICICI plans to make loans of as little as $100 to 25 million rural clients in five years. Finance Minister P. Chidambaram too is a supporter of microcredit.

Given this intensity of interest in microcredit, it is reasonable to ask whether it is really an effective tool for eradicating poverty. Microcredit often yields non-economic benefits such as increasing self-esteem and social cohesion, and empowering women. It also helps the poor smooth consumption over periods of cyclical or unexpected crisis. But, that is not enough; the key issue is whether microcredit helps eradicate poverty. *The Economist* magazine concluded that while "heart-warming case studies abound, rigorous empirical analyses are rare." A few studies have even found that micro-credit has a negative impact on poverty; poor households simply become poorer through the

additional burden of debt. However, most studies suggest that microcredit is beneficial but only to a limited extent. The reality is less attractive than the promise.

Why is microcredit not more effective? The problem lies not with microcredit but rather with microenterprises. The United Nations' declaration that microentrepreneurs use loans to grow thriving businesses leading to flourishing economies is hype. A client of microcredit is an entrepreneur in the literal sense: she raises the capital, manages the business and is the residual claimant of the earnings. But, the current usage of the word 'entrepreneur' requires more than the literal definition. Entrepreneurship is the engine of Joseph Schumpeter's dynamism of 'creative destruction.' An entrepreneur is a person of vision and creativity who converts a new idea into a successful innovation, into a new business model. Some clients of microcredit are certainly true entrepreneurs, and have created thriving businesses – these are the heart-warming anecdotes. But the vast majority of microcredit clients are caught in subsistence activities with no prospect of competitive advantage. In an insightful survey on the economic lives of the poor, Abhijit Banerjee writes that the self-employed poor usually have no specialized skills and often practice multiple occupations. Many of these businesses operate at too small a scale. Banerjee points out that the median business operated by the poor has no paid staff; most of these businesses have very few assets as well. With low skills, little capital and no scale economies, these businesses operate in arenas with low entry barriers and too much competition; they have low productivity and lead to meager earnings that cannot lift their owners out of poverty.

This should not be too surprising. Most people do not have the skills, vision, creativity, and persistence to be true entrepreneurs. Even in developed countries with high levels of education and infrastructure, about 90% of the labor force are employees rather than entrepreneurs. Even with greater availability of financial services in developed countries, only a small fraction have used credit for entrepreneurial purposes. Most clients of microcredit are not microentrepreneurs by choice and would gladly take a factory job at reasonable wages if possible. We should not romanticize the idea of the 'poor as entrepreneurs'. The International Labor Organization (ILO) uses a more appropriate term: 'own account workers.'

Employment

Creating opportunities for steady employment at reasonable wages is the best way to take people out of poverty. The ILO states that "nothing is more fundamental to poverty reduction than employment." In development economics there is much theoretical and empirical support for the increasing preponderance of wage labor in a developing economy. It is instructive to look at the pattern of poverty and employment over time in China, India and Africa (which together account for about three-quarters of the poor in the world), using World Bank and ILO data.

	People below $2/day Late 1980s	**People below $2/day Late 1990s**
China	67.4%	50.1%
India	83.2%	78.8%
Africa	76.1%	76.1%

	Employment/Population Late 1980s	Employment/Population Late 1990s
China	51.0%	58.7%
India	29.5%	35.8%
Africa	33.4%	30.1%

In China, where the incidence of poverty has declined significantly, a large and growing fraction of the population is employed. In Africa, where the incidence of poverty has remained unchanged, a small and shrinking fraction of the population is employed. India's performance lies somewhere in between. India's efforts at poverty reduction have been hampered by its poor performance in job creation. A recent IMF Working Paper attributes India's jobless growth to a distorted emphasis on capital intensive and skill intensive development path. Capital intensive sectors, such as heavy manufacturing, and skill intensive sectors, such as information technology, will not solve India's poverty problem. The trickle down effects of general economic growth are too little and too slow. India needs to emphasize growth in labor intensive, low-skill sectors such as light manufacturing, garments and tourism. Seven IITs do not compensate for 40% illiteracy rate. Bangalore does not compensate for the pervasive poverty in Bihar.

Scale economies

Many people who have jobs are still stuck below the poverty line – the working poor. Whether an employee is 'poor' or not depends on her wages, size of the household, and the income of other household members. It is not enough to create jobs; we also have to

increase productivity such that the wages are high enough to enable the employees to rise above poverty.

	Working poor/Employment Late 1980s	Working poor/Employment Late 1990s
China	79.6%	35.2%
India	75.0%	62.0%
Africa	63.4%	65.4%

On this dimension too, India's performance is mediocre. One cause of this poor growth in productivity in India is inadequate scale economies in its enterprises. The IMF study cited earlier found that the average firm size in India is less then one-tenth the comparable size in other emerging economies. The emphasis on microcredit will only make this problem worse.

Rather than lending $200 to 500 women so that each can buy a sowing machine and set up a microenterprise manufacturing garments, it is much better to lend $100,000 to an entrepreneur with managerial capabilities and business acumen and help her to set up a garment manufacturing business employing 500 people. Now the business can exploit economies of scale, deploy specialized assets, and use modern business processes to generate value for both its owners and employees.