SHOULD MICRO FINANCE BE SUBSIDIZED? WHAT ARE THE COSTS AND BENEFITS?

Plush white clouds pour down rich rains on our barren land, but it is not actually the clouds that we should be indebted to. The clouds owe this blessing of water to the tiny water vapours that evaporate skywards right from our soil, our lakes and our rivers. So everything that reaches the glory of heights, owes something to the lowest of its rungs.

Same is the case in a nation's perspective. Much of the wealth that a country possesses is a contribution of its grass-root level workers. The micro-enterprise sector in Pakistan contributes about 20% of the total value added in the economy. Of the total growth in employment of 1.2 million jobs since 1977, almost 1.1 million were created in the small-scale industries. Because these industries are more labour intensive, they generate more jobs per unit of capital invested. In return, such industry deserves especially designed financing schemes for their support. Micro finance is one such step that is being adopted around the world. Pakistan's current government has also been keen enough in this regard and the Micro Finance is thus sprouting up in our country.

For the purpose of development, growth or for routine business operations, one of the most important issues for an enterprise is to gain access to external funding. This is mainly because the main banks require personal collateral or security from the borrower, who often does not have the sort of assets that banks want to see. In developed market economies, a financial intermediary system, the money market, channels savings to those who need loans and can use them effectively. At the same time, there are numerous sad incidents in every country when enterprises fail to get access to external funds.

The design of these micro-credit schemes has frequently been debated. The focal point of the argument is whether to emphasize giving out soft loans (with low interest rates) or increasing profitability. The technical literature describes the two types of micro financing with attributes of "**subsidized**" and "**sustainable**".

The selection between these two types determines the final impact of micro financing strategies. Whether or not to adopt the subsidy is a conceptual question which can only be answered by keeping its opposite methodology of sustainability in perspective. The costs of one become the drawbacks of the other but weighing the pros and cons in all, things seem to be brighter on the sustainable micro financing side and darker on the subsidized. The real motive of micro financing is alleviation of poverty and it is not possible in the long run with subsidization.

A much sharper criticism of subsidized credit programs is that they cannot survive over the long term. Nancy Barry of Women's World Banking (1995) asserts that "Few low income entrepreneurs end up benefiting from subsidized programs, because these programs fail before they reach significant numbers." She argues further that "micro enterprise financial intermediaries have learned that they cannot depend on governments and donors as reliable, long-term sources of subsidized funding. Efficient financial intermediaries need to charge high rates to cover the costs of making small loans."

We can hope to reach most of our poor households only if microfinance institutions can mobilize relatively large amounts of commercial finance at market rates. They cannot do this unless they charge interest rates that cover total costs.

Subsidized schemes justify their low (sometimes negative in real terms) interest rates, based on the view that only this can mean real support to the enterprises. Another frequently expressed reason for low interest rates is that the enterprises to be supported are in a difficult situation, with low profitability, and therefore are unable to pay high interest rates.

Sustainable schemes on the other hand have a more realistic approach. They believe that excess income generation should be supported in the enterprises by the provided funds. Consequently, if the placement of funds is successful, the payment of high interest rates becomes affordable for the business. In fact, it guarantees that the executors of the program actually promote the economy. It is only then that they make their best efforts in order to make constructive and productive use of the lent amounts.

The use of relatively high interest rates follows from the view that the borrower must pay for the higher risks and higher operating expenses of the loan, which is also a core rule in bank loans. Therefore the sustainable plans involve the extension of money markets to areas where it did not operate before. This counts as an important benefit of the sustainable schemes that becomes apparent in the long run.

Subsidized programs require on-going financing even if the real interest rate is not negative, since the operating expenses are not covered by the interest margin. This implies that the cost of providing low-interest loans to the micro enterprises would remain dependent on its donors indefinitely. Since we are a developing country and our government's budget is always tight, we need to chalk out welfare plans that are self-sufficient. Sustainable schemes, on the other hand, do not require on-going financing, since the interest income covers the operating expenses and losses. So the sustainable strategy is a self sufficient one.

The downside of subsidy does not end here. The ability of subsidized micro-financing schemes to attract additional funding is quite weak, because they can only be financed as donations. The donor therefore becomes the most important customer for the organization managing the loans and the donor's requirements become the primary focus rather than those of the business borrowers. This is a serious setback to the working of subsidized plans.

Looking at both sides of the picture, sustainable strategy has a much higher probability of attracting additional funds, because it can increase the invested funds. If implemented on a large scale, it can even arouse the attention of traditional credit market players. This will eventually improve the financing position of small enterprises. On the other hand, we can not hope to get the credit market's attention in case of subsidy and this makes the micro enterprises stagnant at micro level. In India, there are various private companies that started at micro level and now own balance sheets worth billions. The reason was that they aroused credit market's interest which is not the case in subsidized micro financing.

Subsidizing the micro financing process, contrarily builds a glass-wall between the credit marketers and the micro enterprises. This glass-wall isolates them and prohibits their growth beyond the parameters of that micro financing scheme.

Most of our micro finance institutions and banks put exclusive focus on subsidized credit only. It is assumed by the micro finance managers that the only factor that prevents our poor people from becoming successful entrepreneurs and trade tycoons is the lack of seed capital but the picture is entirely different. A simple profile of our society shows that they need many other services along with credit to run successful and sustainable businesses. Within micro financing entrepreneurial guidance is more efficient than subsidy. We can then charge a larger percentage of interest and the borrower would not mind if only he is enabled by us to generate enough to return our lending.

In case of sustainable plans, even without any administrative regulations, it is of basic interest to both creditors and borrowers to make sure that business growth is achieved, since a failure necessarily involves financial losses for both of them. This way, healthy competition is increased in the market.

There are segments in the informal credit market of Pakistan which already finance development projects with high interest rates among micro-enterprises. It is also a well known practice that under certain circumstances, businesses are even willing to pursue relatively expensive funds, if they hope to be able to pay them back. This gives us all the more reason for bringing about sustainable instead of subsidized micro financing.

In our country, most of the micro financing is being done through banks. The involvement of banks and savings co-operatives in lending management is a very good initiative. Our government has also involved banks in this regard. Currently, there were two micro finance banks; Khushhali Bank and Agha Khan Micro Finance Bank. The third one with the name of First Rozgar Bank is being set up in Karachi. Many countries' records show that such co-operation between banks and non-profit organizations has been quite successful. The primary aim of banks in an era of globalization and growing competition however is an increase in gains. This competition tilts the banks' inclination towards sustainable schemes.

The micro finance network of our country is still in its budding stage. All of our deserving micro enterprises are not able to access the micro finance schemes meant for them. Therefore, instead of subsidizing the financial terms of our loans, we should attempt to subsidize the access to the credit initially. We can do this even within the circle of sustainable micro finance.

Pakistani financial experts are also of the view that in order to achieve sustainability, it is important that micro-finance framework should encourage inherently sustainable institutions and programmes. The economists say that the vision adopted by the international community for micro-financing programme was primarily to enhance its outreach to the people, while building social capital and to mitigate the risks.

Looking at the positive aspects of subsidy, it is a fact that many path-breaking innovations in the microfinance industry have come from "subsidized" MFIs (Micro Financing Institutions). Perhaps two of the most significant innovations in the industry; group lending and village banking, were developed by mission-driven MFIs (e.g., Grameen Bank, ACCION, and FINCA) There are some noticeable benefits of subsidizing that we can not overlook. Subsidized loans are cheap loans and, irrespective of whether they finance development or not, they always help liquidity and do not force the business into focusing on financial return. Ignoring the financial aspect of the story, subsidizing would be a brilliant act of social service. The government support through funds is one way to enable subsidy to continue functioning but this is not a perpetual solution. Subsidy can be adopted in the margins of social welfare projects to extremely poor people but it can certainly not be a long-term financial scheme due to its lack of stability and dependence on donors.

Enterprise promotion experts often mention the adage "if you wish to help someone who is starving, do not give him a fish, teach him how to fish." The subsidized micro financing creates dependence and rarely promote the establishment of a long-term stable and sustainable business. In sustainable programs, however, both the enterprises and the executors of programs are in a situation in which their basic mutual interests include learning to build a successful business and pay the liabilities, i.e. they learn to fish!

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