

Does Microcredit Increase Household Welfare in the Absence of Microinsurance?

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Summary. — This study answers the question: Does a combination of microcredit and microinsurance improve the wellbeing of low-income households? We examine this challenge through Heckman sample selection, instrumental variable and treatment effect models. The findings indicate that households using microcredit in combination with microinsurance derive significant gains in terms of welfare improvement. Microcredit may be good but its benefit to the poor is enhanced and sustained if the poverty trapping risks are covered with microinsurance. To this extent, combining microcredit with microinsurance will empower the poor to make a sustainable exit from poverty.

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1. INTRODUCTION

Microfinance services – microcredit, microsavings, and microinsurance – can help households manage exposure to risks and improve household’s welfare through income and consumption smoothing, asset accumulation and women empowerment. Microcredit provides low-income households with funding in a timely manner to acquire essential assets and meet certain unexpected expenses. This facilitated the growth of its customers in developing countries from 16.5 million in 1997 to 154.8 million clients in 2007 representing 838.2% growth (Daley-Harris, 2009). Microcredit, especially productive loans, has been found to increase per capita household income (Imai & Azam, 2012), enhances households’ multidimensional well-being and improves the living standards of rural folks (Adjei, Arun, & Hossain, 2009; Imai, Arun, & Annim, 2010).

Similarly, microinsurance is the defense of low-income households living and working in the informal sector against specific risks in exchange for regular premium payments proportionate to the probability and cost of the risk involved (Churchill, 2007). It is a risk transfer tool that helps low-income households to escape poverty traps (Dercon, 2003) by protecting them against the financial consequences of life-cycle risks (Binnendijk, Koren, & Dror, 2012). Combining microinsurance with microcredit or microsavings services may ensure that income and consumption smoothing is done with ease. It may eliminate asset pawning or liquidation at “give-away” prices and thus promotes financial stability among low-income households. These three micro financial services complete the risk management toolkit needed by low-income households to manage risk effectively and efficiently in order to improve their welfare outcomes. Microfinance may also include micro-leasing, micro-money transfer, and other non-financial services such as training and education for clients.

Although microcredit has a lot of potential for extending markets, increasing welfare and fostering socio-economic change, it presents a number of puzzles, many of which have not yet been resolved conclusively (Armendariz & Morduch, 2010). In particular the available empirical evidence about its impact on households’ welfare has been inconclusive and

controversial. Whereas one group of researchers such as Schuler, Hashemi and Riley (1997), Pitt and Khandker (1996), Imai *et al.* (2010), Montgomery and Weiss (2011), Deloach and Lamanna (2011), Imai, Gaiha, Thapa, and Annim (2012) and Mazumder and Lu (2015) provide evidence of its beneficial socio-economic impact, others such as Adams and Von Pischke (1992), Rogaly (1996), Garikipati (2008), Annim, Dasmani, and Armah (2011) and Maldonado and González-Vega (2008) indicate otherwise. A third group shows mixed effects of microcredit on clients’ well-being (see Coleman, 2006; Ganle, Afriyie, & Segbefia, 2015; Rooyen, Stewart, & Wet, 2012).

The current study seeks to stimulate discussion into new ways of making microcredit a welfare enhancing instrument. This discussion may help researchers and policy makers to resolve the controversies generated among the three strands of the literature. Microcredit may be good, but its true potential to improve the welfare of the poor is best realized if combined with an appropriate microinsurance scheme. The trap of poverty is not only the lack of credit, but also life cycle and economic risks that threaten the very survival of the poor. Thus giving them credit without indemnifying them against risks may have little or no positive impact on them. Whereas microinsurance covers the health, funeral, fire, theft, drought, and economic risks of the poor, microcredit enhances their income-generating capacity through the financing of new machines, improved seeds for cultivation, improved animal breeds and expansion of microenterprises.

In the event of risk the pay-out from microinsurance ensures that microcredit funds are not diverted to resolve the risky event. Hence advancing microcredit to the poor in combination with microinsurance will equip them to face the shackles of poverty head-on and make a permanent escape from poverty. The evidence emerging from this line of thought confirms that microcredit if combined with microinsurance can improve the well-being of the poor. For instance, Chakrabarty (2012) reports that microcredit in combination with microinsurance has a very strong effect in reducing child labor among extremely poor households in Bangladesh.

Much of the attention of the studies on combined microfinance – microcredit in combination with microinsurance or microsavings – has been focused on microfinance institutions' (MFIs) product diversification (see e.g., Caplan, 2008; Kwon, 2010; Labie, 2009) and on MFIs' sustainability and productivity (Rossel-Cambier, 2012). The literature indicates that combined microfinance can be beneficial to MFIs in the form of reduced overhead costs resulting from integrated client administration, lower transaction cost, wider outreach, and client loyalty (ILO, 2006; Rossel-Cambier, 2012). It also improves loan repayment rates (Roth, Churchill, Ramm, & Namerta, 2005) as well as the efficiency and productivity of MFIs (Rossel-Cambier, 2012).

This study seeks to re-focus the research into combined microfinance on the clients rather than on MFIs in order to determine whether combined microfinance inure to the benefits of low-income households. In particular we ask: are combined microfinance products better than stand-alone products in improving the welfare of low-income households? To this extent, it is worth exploring whether the combination of microcredit with microinsurance either enhances the welfare of low-income households or makes them even more vulnerable.

We examine this research question through the use of an asset index instead of money metric income and consumption expenditure as a measure of welfare of low-income households. Whereas asset index has been used quite extensively in the welfare literature to measure households' well-being levels, (see e.g., Booysen, Servaas, Ronelle, Michael, & Gideon, 2008; Echevin, 2011; Filmer & Scott, 2012; Harttgen, Klasen, & Vollmer, 2013; Njong & Ningaye, 2008; Sahn & Stifel, 2000), its application in both the microcredit and microinsurance literature has been limited. This study is one of the first attempts to link asset index to microcredit and microinsurance. To control for selection bias and endogeneity we employed three empirical models: Heckman sample selection, treatment effects, and instrumental variable models to estimate the individual and the combined effects of microcredit and microinsurance on household welfare.

The rest of the paper is organized as follows: the review of the literature is captured in Section 2, Section 3 provides an overview of the microfinance industry in Ghana; the methodology is in Section 4, the results are presented and discussed in Section 5 and the conclusion is presented in Section 6.

2. LITERATURE REVIEW

Microfinance exists to meet the needs of those households and microenterprises which have been excluded or segmented out of the formal financial market due to reasons such as clients lack of tangible collateral, perceived as highly risky due to informational opacity and the high transaction cost involved in intermediating for such low-income clients (Abor & Biepkke, 2006; Tagoe, Nyarko, & Anuwa-Amarh, 2005). The extension of credit to low-income earners assists in the creation of households microenterprises, which helps to generate employment and extra income for poor households and villages (Bateman, 2010).

According to Bateman (2010, p. 25), "poverty is not simply a lack of income; it is also a lack of income at the time it is needed". Hence for the poor, getting microcredit to smooth out certain key household consumption expenditures is a great relief afforded them by MFIs. For instance, during the lean or dry season, rural farmers are assisted by microloans to meet their households' health and education expenditures. Such loans, which are then repaid during the harvesting period,

enable poor farmers to compensate for the ups and downs of economic life and overcome vulnerability (Bateman, 2010).

Despite acknowledging the potential welfare enhancing effect of microcredit services, Bateman (2010) provoked an intense debate about the ability of microfinance to lead to sustainable improvement in the welfare of poor households. He argued that the so-called welfare impact vehicles – income and employment generation, consumption smoothing, gender empowerment and a helper of the helpless (poorest) – through which microfinance is acclaimed to impact positively on the poor are all myths and "largely built on hype and on egregious half-truths". He further posits quite strongly that "microfinance is largely *antagonistic* to sustainable economic and social development, and so also to sustainable poverty reduction. Put simply, microfinance does not work" (Bateman, 2010, p. 1). The crux of his argument is that microfinance is a poverty trap and an anti-developmental policy.

(a) *The empirical literature*

The empirical literature concerning the microfinance industry is growing in leaps and bounds and so are the controversies regarding its capacity to equip the poor to escape the poverty trap. The evidence concerning its effects on welfare is very much inconclusive, ranging from the very radical position of Bateman (2010) that microfinance does not work as well as the near zero impact in Thailand (Cull, Demircuc-Kunt, & Morduch, 2009) to the remarkable positive effects in Bangladesh (Imai & Azam, 2012). This section reviews three strands of the empirical literature: studies showing positive, negative, and mixed/zero impacts of microcredit.

On the positive side, Imai *et al.* (2010) show the effects of microcredit on poverty reduction by using the nation-wide cross sectional data collected by the Small Industries Development Bank of India (SIDBI) on 5,260 clients and non-clients of 20 MFIs affiliated to SIDBI. The authors used an index based on households' food security and socio-economic characteristics to rank households on five index-based ranking indicators ranging from the very poor households to households with surplus resources. They then employed the treatment effect model to estimate the effects of microfinance productive loans on household poverty alleviation. Propensity score matching and Tobit regression were used to augment and check the robustness of the results. Their findings indicate that microfinance productive loans have a significant positive influence on households' welfare outcomes and that this positive impact is more profound in rural areas than in urban centers.

In a similar study Imai and Azam (2012) used four series of national panel data of the Bangladesh Rural Employment Support Foundation (PKSF) collected on 3,000 participants and non-participants households of 13 MFIs across Bangladesh. The study reports that access to MFIs' productive loans has a significant increasing impact on households' per capita income, but access to general loans does not. The paper further indicates that the analysis of each series of the panel data shows a reducing trend of the strength of microfinance to equip households to reduce poverty: that is, the capacity of microfinance to reduce poverty, even though positive, is at a reducing rate. The authors thus conclude by calling for the re-focusing of microfinance on its primary objective of reducing poverty and the need to monitor loans utilization.

A similar study in Ghana on a cross-section survey of 547 households was conducted by Adjei *et al.* (2009) to evaluate how the products of one microfinance institution – Sinapi Aba Trust (SAT) – facilitates asset build-up among the program participants. In particular, the study assessed how access

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