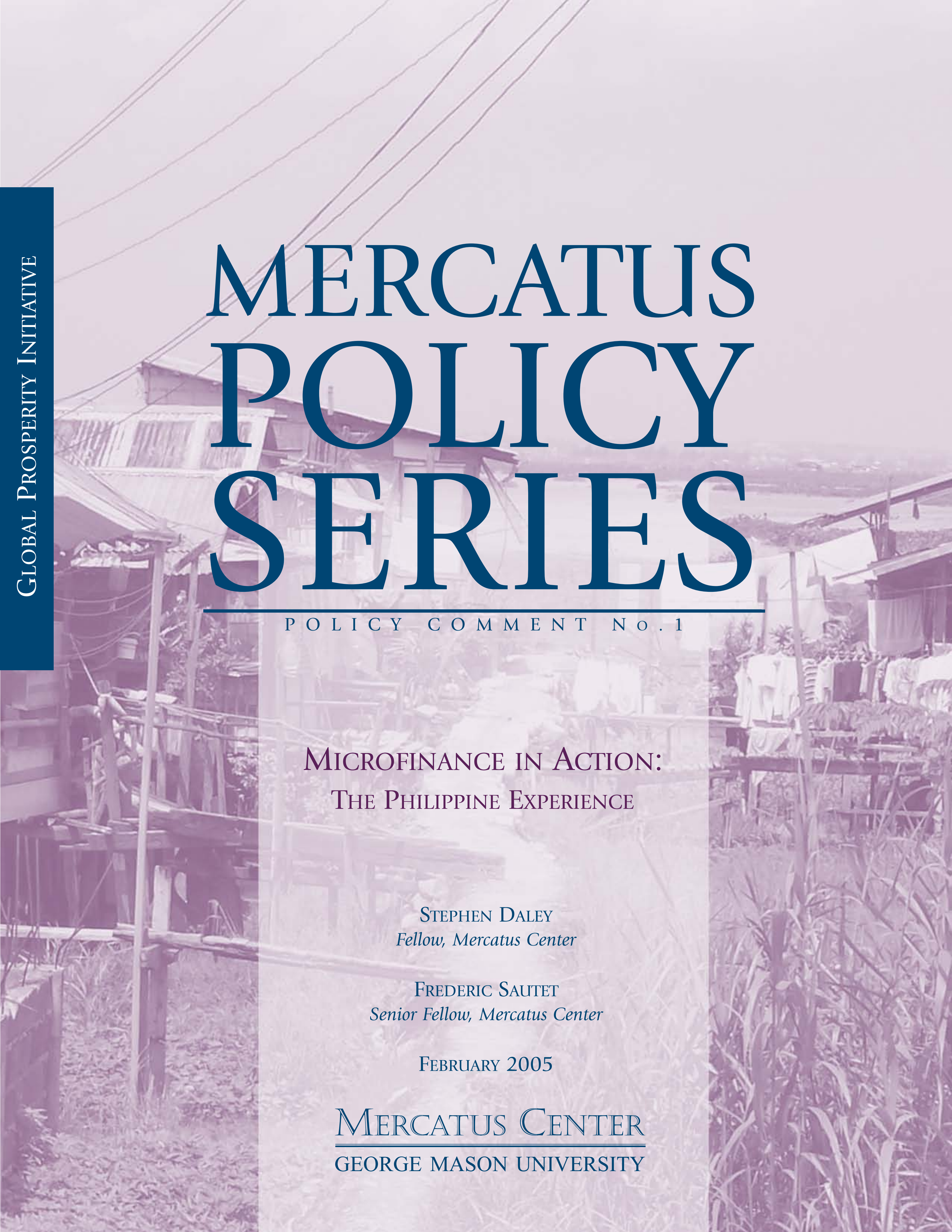

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POLICY COMMENT No. 1

MICROFINANCE IN ACTION:
THE PHILIPPINE EXPERIENCE

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Cover photo: Stephen Daley - Looking out at Pasig River. All photos are property of Stephen Daley.

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STEPHEN DALEY AND FREDERIC SAUTET

EXECUTIVE SUMMARY

International efforts to alleviate poverty in the poorest of nations are increasingly turning to microfinance for solutions. The United Nations's recent declaration that 2005 is the "International Year of Micro-Credit" means that there will be more pressure than ever on development agencies to increase financial commitments to microfinance organizations.

For the past 20 years, the Philippines has served as a natural experiment for microfinance. As one of the oldest and most active microfinance environments in the world, the Philippines has much to teach about the potential for microfinance to alleviate poverty, and to serve as a stepping stone to prosperity.

However, one must not lose sight of the fact that microfinance has become a viable option only because the institutional environment in many developing countries is unworkable. Microfinance is a band aid – a necessary band aid at times, but a band aid nevertheless.

While microfinance has proven its ability to combat poverty in the short-term, deeper institutional reforms are required if development efforts are going to put the poorest of the poor on the path to prosperity.

The Philippines and other countries in similar situations need to address fundamental institutional concerns such as:

- Discriminatory laws;
- Excessive regulation;
- Endemic corruption; and,
- The lack of formalized property rights.

Microfinance will only be successful when combined with efforts to enhance the institutional environment in which exchanges take place. Entrepreneurs prosper and microfinance organizations are profitable by relying on the savings market, not subsidies, to meet the needs of their borrowers.

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MICROFINANCE IN ACTION:
THE PHILIPPINE EXPERIENCE

INTRODUCTION

The World Bank's *World Development Report, Attacking Poverty* (2000) shows there has been little, if any, progress in the attempt to alleviate the number of people living in poverty throughout the world. Despite the best efforts of governments and aid agencies almost half of the world population continues to live on less than US$2 a day. With the failure of so many development efforts, microfinance, small loans to the poor, is increasingly seen as a leading way to assist in the eradication of poverty.

The Philippines has experienced one of the most active microfinance environments in the world since the 1980s. Indeed, President Gloria Macapagal-Arroyo has committed a great deal of money and resources to the promotion of microfinance since taking office in 2001. As such the Philippine example can provide insight into the potential for microfinance to assist in the alleviation of poverty and the promotion of development in the larger developing world.

In November 2004 the Philippines was included in the list of countries eligible to apply for Millennium Challenge Account assistance through the "Threshold Program" to be administered by the US Agency for International Development (USAID). It is likely that the current enthusiasm for microfinance will guide any proposal Arroyo's government submits to USAID.[1] This makes the analysis and recommendations contained in this Policy Comment all the more relevant, as success will likely be imitated and failure will not only mean continued misery for the millions of Filipinos living in poverty but also another setback in the international effort to stop the cycle of extreme poverty worldwide.

This Policy Comment explores the ability of microfinance to assist the very poor in the developing world by examining the lessons from the implementation of microfinance programs in the Philippines.[2] These lessons are:

- Microfinance has become a 'viable option' only because of a poorly functioning institutional environment;

[1] The MCC press release detailing the threshold countries for 2005 is available online: <http://www.mca.gov/public_affairs/press_releases/pr_041108.pdf>.

[2] Over two summers nearly 500 microfinance borrowers were interviewed during the course of three field research trips, sponsored by the Mercatus Center's Global Prosperity Initiative. These interviews were conducted in March 2003, May-July 2003, and June-July 2004 with 9 government officials, 24 microfinance managers and loan officers, and 489 microfinance borrowers.

- Microfinance is working reasonably well as a band-aid solution to poverty, i.e. it puts food on the table;
- Microfinance is not providing a bridge to sustainable development because it fails to address the root causes of poverty. As such, microfinance borrowers fall short of graduating (i.e. entering the formal economy), which should be the ultimate goal of microfinance.

In order for microfinance to become a bridge to a sustainable solution, institutional reforms are necessary. In the case of the Philippines, from which important lessons can be drawn for other developing countries, these reforms are:

- The removal of discriminatory laws, which disenfranchise generations of people;
- The absolute need to recognize, codify and enforce property rights;
- Reduction in the scope of government activity in order to reduce corruption, and;
- Increased liberalization of the financial sector.

Organization of the policy comment

This Policy Comment proceeds as follows. **Section 1** provides a brief description of microfinance and discusses current views and efforts to help the poor. **Section 2** deals with policy barriers and their impact on microfinance. We outline three key problems hampering the effectiveness of microfinance in alleviating poverty in the Philippines. **Section 3** outlines reforms that address the issues discussed in the previous section. We conclude by detailing our recommendations for reform.

1. Microfinance and Development

What is Microfinance?

Microfinance is defined as the provision of a broad range of financial services such as deposit accounts, loans, payment services, money transfers, and insurance to poor and low-income households and their micro enterprises through banks and cooperatives, NGOs and even private moneylenders. The principle difference between microfinance and traditional lending arrangements is the absence of collateral with which to secure a loan. The most familiar model of microfinance lending is the Grameen system in which borrowers[3] are able to use their reputation, among their neighbors to obtain a loan. A small group of borrowers join together with each agreeing to be financially responsible for the others. Failure to meet this shared liability stops all of the group members from accessing further loans until all

[3] Groups usually begin with five members, and the majority of programs are established with the express purpose of serving women.

> "Microfinance is not providing a bridge to sustainable development because it fails to address the root causes of poverty."

accounts are brought back into 'good standing'. Other more individualized models of microfinance lending are also in use but share the characteristic of collateral-free lending that describes the Grameen model.[4]

Recent studies show that poor and low-income households have a large demand for microfinance services to finance their livelihood activities, consumption requirements, and other nonfood expenses such as education and housing improvements. The microfinance strategy is seen as the solution to this growing demand and the conventional wisdom suggests that most formal financial institutions do not serve the poor because of perceived high risks, high costs involved in small transactions, perceived low profitability, and the inability of the poor to provide the required physical collateral. The business culture of banks has not traditionally been geared to serve poor and low-income households, leaving the poor unable to access credit.[5] Many believe microfinance is a tool to bridge this finance gap.

Microfinance in Action

Josephine Posada is a typical microfinance success story. Josephine, a microfinance borrower interviewed in 2003 and again in 2004, lives in Welfare Village, a slum in the heart of Manila. Josephine used to wash clothes to supplement her husband's income, but with their three children they barely had enough for food. Their shanty was nothing more than a patch of dirt surrounded and covered by corrugated tin sheet, which would often leak during storms. Josephine felt terrible not being able to assist her aging parents, who were in similar circumstances. Josephine and her husband had an idea. If they could collect the garbage lying around it could then be sold to a recycler. Joining together with four others she was able to obtain a small loan (US$90) through a microfinance organization. Josephine used the money from her first loan to buy a tricycle and a set of small scales.

As Josephine worked hard and repaid her loan she was able to access larger loans. By continuing to invest in her business she has been able to expand so that today she has eight bikes and employs local teenagers as collectors. Josephine

[4] For a more thorough discussion of microfinance we refer the reader to the Policy Primer on Microfinance by the Mercatus Center (forthcoming).

[5] Stephen Daley and Jocelyn Badiola (2003) "Assessing Microfinance and the USAID MABS Program in the Philippines". Presented as a part of the U.S.A.I.D Forum *Series on the Role of Institutions in Promoting Economic Growth*. Washington D.C, September 17, 2003.

started her business almost three years ago. Over that period, her family's combined income has more than tripled and their food consumption has dramatically improved. Four years ago her family was eating one meal a day: rice. Today, Josephine's family not only eats regular meals, they are able to eat the food they like. Josephine now goes to the grocery store every Sunday to buy snacks for her children for school. The roof has been repaired so there are no more leaks, even during heavy rains, and the floor is now made of concrete. They have a television set, audio equipment and Josephine proudly carries her mobile phone.

The loan has dramatically improved Josephine's outlook for the future and that of her children. She has gone from feeling helpless to feeling empowered and in control of her own life, but the loan has done more than just increase Josephine's income. Her business provides employment for others, enabling boys, still attending school, to earn more than the minimum wage. This may well make the difference in their lives as they have seen firsthand what hard work and a little capital can accomplish.

Josephine's story illustrates the hope that microfinance offers to the poor: an opportunity to lift themselves out of poverty. Josephine's story seems almost miraculous but it is not unique. There are other microfinance borrowers, like Josephine, who use this injection of capital to build and grow a business.

2005: The year of Microfinance

Because of successes like that of Josephine, many believe microfinance to be the most promising solution to development problems. The United Nations has proclaimed 2005 the 'International Year of Microcredit'. As such the U.N has requested that special impetus be given to micro-credit/microfinance programs throughout the world. 2005 represents the last year for the global campaign to reach 100 million borrowers. This goal articulated by Mohammed Yunus, the founder of the Grameen Bank, was subsequently outlined in the Declaration and Plan of Action of the Microcredit Summit.[6]

The U.S Congress recently passed legislation aimed at helping U.S based microfinance NGOs reach more of the poor in the developing world. The legislation has made $200 million available for the fiscal year 2005.[7] Despite the attention and increased funding microfinance is receiving some claim it is still not enough. The current Microcredit Summit Campaign director, Sam Daley-Harris, believes the World Bank has more to do. He has recently complained that "less

[6] The Microcredit Summit held in Washington, D.C., 2-4 February 1997, with the Declaration available online: <http://www.gdrc.org/icm/summit/declare-support.html>. The United Nations proclamation is Resolution 1998/28 and is available online: <http://www.gdrc.org/icm/iym2005/un-resolution.html>.

[7] The Microfinance Results and Accountability Act of 2004, H.R. 3818.

Josephine Posada (on the right) and her loan officer (from the Philippine Entreprise Development Foundation) stand in front of Josephine's scrap collection business.

than 1% of the annual World Bank spending goes to microcredit. The World Bank can do better than that."[8]

THE PHILIPPINES'S BET ON MICROFINANCE

The current President of the Philippines, Gloria Macapagal-Arroyo when first assuming office in 2001, spoke of microfinance as the "cornerstone in the [Philippine] fight against poverty".[9] Arroyo's ten point plan, outlined in her inaugural address, called for loans to 3 million entrepreneurs.

In order to create an environment in which the poor can realize the benefits of the market economy the government is committed to improving access to credit for everyone, especially the poor. It is believed that microfinance has the potential to help integrate the poor into the market instead of promoting a culture of handouts, which only serves to entrench an entitlement mentality and further stifle initiative and investment.

In September 2004 the amount of loans through all microfinance programs in the Philippines had reached 2.5 billion pesos (US$ 50 million). The President has called for an additional 4.5 billion pesos (US$ 90 million), of government money to be distributed over the next ten years, to "develop a nationwide network of viable and sustainable microfinance institutions".[10] The govern-

[8] Charlotte Moore "Call for more loans for poorest", *The Guardian*, Friday December 10, 2004.
[9] GMA State of the Nation Address, 2001 available at <http://www.op.gov.ph>.
[10] Executive order of the President of the Philippines. E.O 110 – 8th July 2002 and available online: <http://www.news.ops.gov.ph/archives2002/july7.htm>.

"*It is believed that microfinance has the potential to help integrate the poor into the market instead of promoting a culture of handouts, which only serves to entrench an entitlement mentality and further stifle initiative and investment.*"

ment is also working to ensure that the Small Business Guarantee and Finance Corporation (a government financial institution) triples its lending to small and medium enterprises from the present 3 billion pesos (US$ 60 million) to 9 billion pesos (US$ 180 million) in the next 6 years.[11]

The graduation failure

Microfinance has improved the livelihood of many of its recipients, like Josephine. But as a tool of development it has so far failed to measure up to its promise.[12] As a consequence two distinct views have emerged. Microfinance can be thought of as either (a) a band-aid approach to development, or (b) as a bridge toward a sustainable solution ("graduation").[13]

The band-aid approach is a way of temporarily stemming the misery that comes with extreme poverty by addressing malnutrition, and increasing caloric intake and financial security. This type of approach is necessarily supported by governments and aid agencies.[14]

While providing immediate relief to those in need is necessary, this should not be the ultimate purpose of development programs. Microfinance must be about building the future sustainability of a financial sector which serves most of the population, including the poor. Advocates of microfinance extol its wide outreach, but the real test for microfinance must be its ability, when compared to the alternatives, of promoting economic development.

As such the second approach (graduation) takes a much longer view. It sees microfinance as a stepping stone which leads to graduation. Graduation implies moving from a dependence on informal personal relations to the more impersonal formal dealings taken for granted in developed countries. This move necessitates poor bor-

[11] Philippine Government press release 10th August 2004 available online: <http://www.philippineembassyusa.org/pr10aug04.htm#PRESS%20RELEASE%20NO.%201>.

[12] Jonathan Murdoch (1999) "The Microfinance Promise," *Journal of Economic Literature* XXXVII, 1569-1614.

[13] Robert Peck Christen and Deborah Drake (2002) "Commercialization: The New Reality of Microfinance" in *The Commercialization of Microfinance* edited by Deborah Drake and Elisabeth Rhyne. CT, U.S.A: Kumarian Press.

[14] A 1996 World Bank inventory of microfinance institutions found that roughly 60% of funding comes from the donor community. ("A Worldwide Inventory of Microfinance Institutions". *World Bank working paper-report no.* 19126).

rowers eventually leaving their microfinance lender and their group-mates, and using commercially operated banking services.

Consider Elvira Carino, who lives in Manila and whom we encountered while working on microfinance in the Philippines over the past two years. Ten years ago Elvira opened a sari-sari store from her home.[15] For a few years Elvira sold sugar, salt, coffee and some canned goods. She joined a microfinance program and was able to use this injection of money to buy soft drinks and beer by the case load. This enabled her to dramatically expand her business. Over time she established herself as a distributor to other sari-sari stores in her area so that today she owns two motorbike-driven tricycles and recently acquired a truck. Elvira and her family are doing very well: her husband left his minimum wage job to work in the business and they also have three full time employees.

> *"In Elvira's case, microfinance has not been a bridge; it has simply been a band-aid. A successful band-aid but a band-aid nevertheless."*

Elvira's is the sort of success story that microfinance supporters love to share. She pulled herself out of abject poverty, beginning with a loan of less than the equivalent of US$ 60. In 2003 Elvira left her microfinance provider. Unfortunately she did not graduate; she has not moved into the formal banking system. Despite her success she is unwilling to use the local banks. She believes that formal institutions, like banks, are all a part of the pervasive corruption of her country. Therefore she happily pays the higher interest rate her local informal lender (Mumbai) charges, as she has a good working relationship with him. In Elvira's case, microfinance has not been a bridge; it has simply been a band-aid. A successful band-aid but a band-aid nevertheless.

One common solution to the graduation failure is to increase the public funding of microfinance. While some advocates of microfinance see this solution as necessary (e.g. this is the Philippine government's plan), others are expressing concern.[16]

[15] A sari-sari store can be as simple as the store operators cutting a hole (like a ticket window) in the side of their residence through which they sell goods to the pedestrians passing by.
[16] Marguerite Robinson (2001) *The Microfinance Revolution: Sustainable Finance for the Poor,* Washington, DC: The World Bank, 2001.

Indeed increasing subsidization of microfinance programs will not help Elvira graduate. For graduation to happen, reform must address the systemic issues developing countries face. The balance of our policy comment will illustrate these very problems within the context of the Philippines.

“Reform must address the systemic issues developing countries face.”

2. Policy barriers and their impact on Microfinance

As discussed above, financing the businesses of the poor is the role Arroyo has chosen for her government to help alleviate the endemic poverty of her country. In this section we highlight three serious problems which threaten to stifle these efforts.

Excessive regulation

While population growth and corruption (discussed below) are often cited as negative influences on economic growth, an area of concern deserving greater attention is the government's regulatory regime.[17]

Government regulation of the labor market (including minimum wage legislation) has failed to reduce the incidence of poverty and has contributed to a poorly functioning labor market. Recent IMF research has called on the Philippine government to leave the minimum wage alone or to at least seek smaller and less frequent increases.[18] The impact of minimum wage laws on hiring of people by small businesses is not to be neglected.

For example, in July 2004 the government decided to clear the streets of Manila of sidewalk vendors.[19] Vendors need to acquire an official permit, which restricts entry into the market. The irony is that some of these vendors had invested funds obtained through microfinance schemes. The government's actions destroyed these thriving endeavors, and muted any benefit recipients enjoyed from participating in microfinance programs. The regulation, which was attempting to clean up the streets to improve the local environment, has had a negative impact on the development of these microenterprises. Regulation not only reduces the size of the formal economy, it also stifles the opportunities available to the entrepreneurial poor in the informal economy, as illustrated by the sidewalk-vendors example.

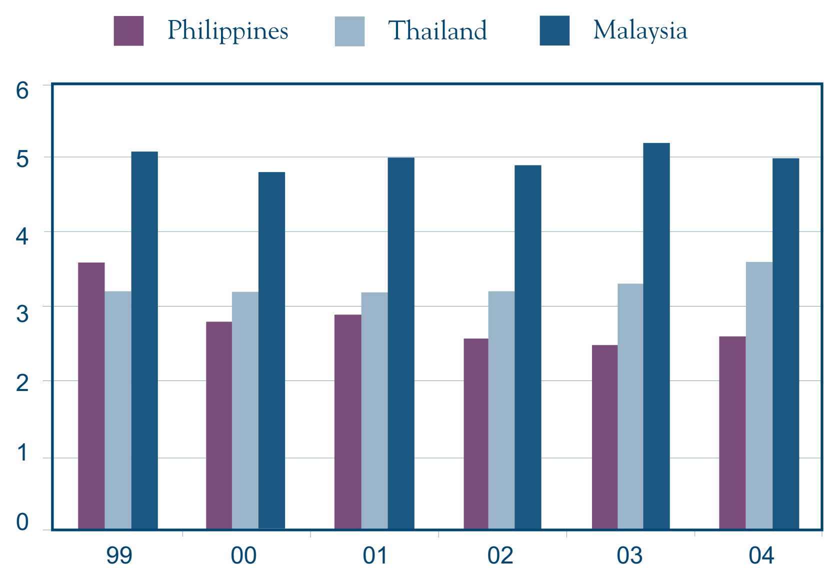
[17] Catharine Dalpino (2004) *Challenges for a Post-Election Philippines – Issues for U.S. Policy*. A Council on Foreign Relations Special Report.
[18] Ray Brooks (2002) “Why is Unemployment high in the Philippines?” *IMF Working Paper* No. 02/23.
[19] Philippine Daily Inquirer, July 24 available online: <http://www.inq7.net/met/2004/jul/24/met_2-1.htm>.

Endemic corruption

Despite enjoying distinction as the longest running democracy in Asia, "[the Philippines] is mired in economic and fiscal limbo, justifying its reputation as one of the most corrupt economies in Asia".[20] In a recent survey of Philippine business owners 30% believed companies in their sector obtained contracts with the use of bribes. And 57% of business owners believe that government contracts are awarded on the basis of bribery.[21] Transparency International gives the Philippines a score of 2.6 out of a possible 10.[22] The graph below depicts the Philippines's annual score along with the scores of two neighboring countries. Malaysia and Thailand have remained fairly stable between 1999-2004 (in both absolute score and comparative world ranking). The Philippines however has experienced increasing corruption and a subsequent drop in its comparative world ranking (from 54th out of 102 countries in 1999 to 102nd in 2004 out of possible 145 countries).[23]

Corruption decreases the confidence people have in the police and judicial system. Corruption of

Corruption Index



Transparency International Corruption Perceptions Index (CPI) values for the Philippines, Malaysia and Thailand (1999-2004).[22]

[20] U.S. Agency for International Development - Philippines Overview available online: <http://www.usaid.gov/pubs/cbj2002/ane/ph/>.
[21] Third annual (2002) SWS *Survey of Enterprises About Public Sector Corruption*.
[22] Transparency International ranks countries based upon the transparency of their government dealings. Each country is given a raw score (0 – 10) with 10 being the best and 0 being the worst. A country with a relatively high score demonstrates that dealings within the country are more transparent and less value is lost through corruption.
[23] The Philippines is more corrupt than Russia (90th) and the Dominican Republic (87th) and tied with Uganda and Zambia. So not only is the Philippines corrupt, as many Asian countries are perceived to be, it is significantly more so than its neighbors.

the economic environment is cited again and again throughout the course of our interviews. Because of this, people, especially the poor, are not willing to risk transactions with people they do not know or trust. This lack of trust in formal processes results in many of the micro-entrepreneurs not registering their businesses with the local authorities. Many of these micro-entrepreneurs are concerned that registration brings their business to the attention of the local government and this could lead to their need to pay money over and above the registration fee. Josephine, discussed above, has not registered her business. Similarly, Josephine is presently able to pay the boys who work for her more than the minimum wage. However if Josephine were to declare her business and all of her employees she might be forced to pay considerably less to her employees as a share of her revenue would be lost to bribes.

The lack of formalized property rights

Many of the poor in Manila live in densely packed slums which offer little in the way of infrastructure. Dirt tracks separate homes that lean against each other. They are made of corrugated tin sheets or even heavy board, and their slopping dirt floors become slick when it rains. Water is available from shared open ground wells or it is carried in and sold by water boys. The open sewage, where available, is simply a concrete channel pedestrians must be careful not to step in as they traverse the neighborhood. People live in homes they do not own and have little chance of ever owning, due to the lack of formal property ownership in these slum areas.

Estimates suggest that as much as 50% of the land in Manila is without clear title.[24] However within these communities, which can house as many as a quarter of a million people, there are small businesses run by the people who live in homes they only informally own. Hernando De Soto has labeled this informal ownership 'dead capital'. By this he means the poor are unable to access the value of the capital because informal ownership is not recognized by financial institutions in the same way as formally titled property.

We should not be surprised to learn that the lack of clear title, and restrictions on transferring

> *"People live in homes they do not own and have little chance of ever owning, due to the lack of formal property ownership in these slum areas."*

[24] Hernando De Soto (2000) *The Mystery of Capital*. New York: Basic Books.

Elvira Carino (on the right) pictured in front of her business with her husband and one of her four children.

property even when there is clear title, has resulted in a poorly functioning land market. Reports suggest that the functioning of land markets "has worsened considerably between 1985 and 1998 [making] it more difficult for the poor to gain access to land."[25]

The reason most cited for making funds available through microfinance and small business lenders is the unmet demand of the poor for funds.[26] It is believed that the (private) financial sector, as it is currently operating, is unwilling or incapable of servicing the poor. Instead of simply blaming the banks for this credit gap, it is important to recognize the role played by the lack of clear title. Legally recognized ownership of land would help the poor by providing them with formally recognized assets employable as collateral in a commercial transaction. Secure property rights will increase the willingness of traditional banks to seek out lending opportunities among the poor. This would allow the financial sector to reach those who currently only have access to microfinance.

3. Institutional prescriptions for development and growth

As discussed in the introduction, in order for microfinance to become a bridge toward a sustainable solution–that is, for individuals to graduate–institutional reforms are necessary. In

[25] Klaus Deininger, F. Lara, M. Maertens, A. Quisumbing (1999). "Agrarian Reform in the Philippines: Past Impact and Future Challenges". Global Development Network: <http://orion.forumone.com/gdnet/files.fcgi/189_final4.PDF>.
[26] Interviews with the National Anti-poverty Commission (July 2003) and the People Credit and Finance Corporation (July 2003).

"Secure property rights will increase the willingness of traditional banks to seek out lending opportunities among the poor."

this section we present the reforms in greater detail.

Reducing corruption

The increasing gap between government revenue and expenditure is expanding the deficit at an alarming rate.[27] This has led to calls, from the World Bank among others, for the government to increase its revenue as a share of GDP. A recent study advised the Philippine government to privatize the collection of taxes.[28] It was hoped this would build transparency, reduce corruption and raise the government's revenue as a share of GDP. Such suggestions were not well received by the revenue authorities.

A more transparent tax collection regime would assist in building more accountability and a more efficient public sector. However, focusing on tax collection (especially if it leads to an increase in the tax burden) is misguided. What matters most is promoting an environment in which entrepreneurial endeavors and investment are encouraged. By doing this, the economy will grow and government revenue will increase removing the need to burden the private sector by increasing current taxes or introducing new taxes.

Increased government spending on development places more pressure on public deficit spending. This focus on government-led microfinance is misguided. Indeed, in a country experiencing such high levels of regulation and corruption, it hardly seems appropriate to advocate increasing the flow of money and resources from private individuals to public officials.

Reducing the number of laws and reducing the scope of government activity while improving the strength and transparency of essential government services is the key to reducing the ability of government employees to use their authority to obtain graft and bribes.

Reforming land markets: Property, collateral and foreclosure

The poor who have lived on the same land for years must have these rights formally recognized. This will unlock the dead capital discussed above.

[27] Government debt now stands at 70% of GDP. (2003).

[28] In 1997 the governments of the Philippines and the U.S. jointly established the AGILE project, or "Accelerating Growth, Investment and Liberalization with Equity." AGILE was developed to provide support to accelerate economic policy reforms, generate growth, help create jobs, and reduce poverty. The Philippine Government and USAID jointly supervise AGILE through a steering committee, chaired by the Philippine Department of Finance.

De Soto has estimated that the current value of dead capital in the Philippines is roughly US$ 132 billion. This figure is more than 600 times the amount the government intends to inject into microfinance and small-business lending over the next decade.[29]

Interviews with officials from several rural banks indicate that the lack of property titling is only part of the problem. Not only must real property be titled to be used as collateral, but it also must be transferable to the creditors in case of foreclosure.

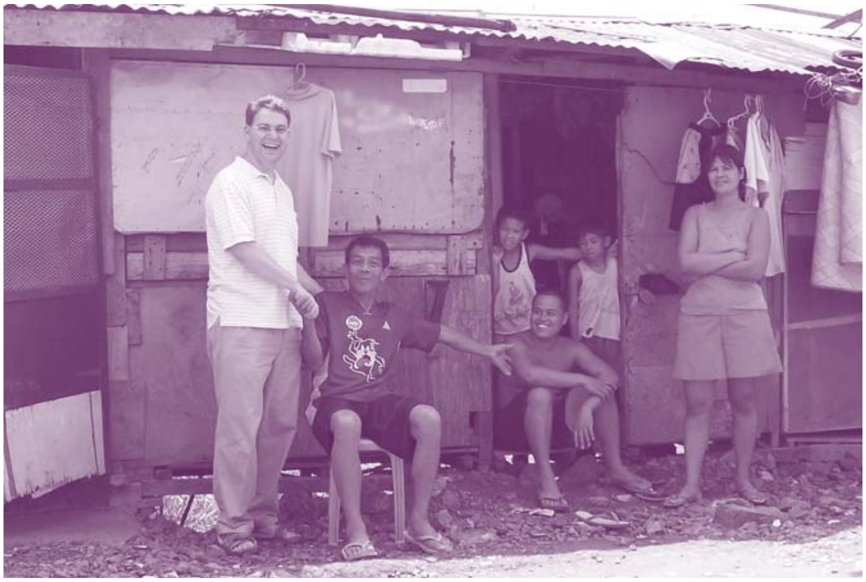
Bank officials describe a difficult and costly process when foreclosure is necessary because existing laws make it difficult to foreclose on defaulting borrowers. Legislation designed to protect failed businesses ends up hurting even those that are successful, as banks are less willing to allocate funds to this general class of customers. Moreover, the interest rate must be higher to compensate for the increased risk of losing the outlaid funds.

President Marcos (1965-1986) and subsequent governments have all attempted to help the rural poor through land reform. The Comprehensive Agrarian Land Reform Program (CARP) has been responsible for reallocating millions of hectares of land from the previously established large holdings into smaller lots, which are then given to the workers of the land.

To ensure the staying power of this program, CARP land recipients are unable to sell their land or use it as collateral. This, as pointed out above, makes it impossible for the private financial sector to function well. Senate legislation introduced in late 2004 would lift this restriction, but it faces opposition from three alternative bills in the lower house and vocal opposition from advocacy groups.[30] These alternative bills would allow CARP land recipients to borrow using their land as collateral, but it would still restrict a lender's ability to foreclose. The Secretary of the Department of Agrarian Reform has urged the Philippine Congress to allow the foreclosure of any land, including CARP land, to any person or legal entity in an effort to revitalize land markets. This is a crucial step toward enabling stronger financial institutions.

Titling, in conjunction with reform of the existing mortgage and foreclosure laws, will not only help the land markets function more efficiently, it will also encourage and stimulate the flow of funds into the poorer communities. This will have a similar initial effect as expanding the funds made available through microfinance, but

[29] See De Soto (2000: 251), footnote 23. We used an exchange rate of 50 peso to one US dollar. See also Philippine government press release (20th September 2004).
[30] Philippine Senate Bill 206.



Stephen Daley (far left) with a family living in one of Manila's many slums.

with a more sustainable long-term benefit.

This method of reform provides two clear benefits. First, the government will no longer need to inject money into the microfinance sector. This is because the owners of newly titled property would have access to finance through traditional banking practices. Second, a better functioning land market would promote a more efficient financial sector.

Opening the door to competition

The early 1990s saw some liberalization of the Philippine financial sector. The improvements however were concentrated in areas serviced by large multinational banks. This meant that the large national corporations enjoyed the benefits of this targeted liberalization without a corresponding improvement in the financial environment for the small and medium sized firms, or the poor and their micro-enterprises.

Politicians and advocacy groups often complain about the lack of access to funds for the poor and also the 'high' interest rates they face from informal lenders. The best way to ensure that rates are as low as possible is to make sure the environment is one conducive to competitive entry. In the Philippines rural banks must be 100% owned by Filipinos. This means that foreign banks, like Bank Rakyat Indonesia are unable to operate in the Philippines. This is a bank with a proven track record of successful lending, primarily to the poor. Allowing foreign banks and owners would stimulate the competition between rural banks and other NGOs, helping serve the unmet demand of the poor.

Opening the door to foreign competition will bring new entrants. However there is also a segment of the domestic population that is economically disenfranchised. Just being born in the Philippines does not grant citizenship. A child's father must be a Philippine citizen in order for the child to be so endowed. This has important implications for immigrants. Whether they have been there for generations or newly immigrate, they cannot become citizens. As such they cannot own property or the majority share of a corporation, no matter its size. As a result, immigrants generally create ties within their own ethnic network.

This is the case with many Indians. Sikh Indian immigrants often become informal money lenders (also called Bombay 5-6ers or Mumbai).[31] They cannot own property or a business but have access to money, through their social networks, which they lend to local Filipinos. They charge much higher rates than the banks, which is to be expected considering the Mumbai have almost no recourse against default (there is no collateral to repossess and there are no enforceable contracts).[32]

Official estimates of the informal sector (not just lending) put it at 40% of official GDP.[33] For instance, most respondents in surveys of Philippine rice farmers indicate they have borrowed and they continue to borrow from informal sources. Recent studies have shown that access to traditional banking does not necessarily enhance yields or increase the adoption of new growing technologies when compared with informal borrowing.[34] Inefficient markets are more often the result of well intentioned government regulation, which prohibits entry into the lending market.[35]

Removing legal discrimination based upon ethnicity would help many of these informal lenders

> *"Microfinance has become a 'viable option' only because of a poorly functioning institutional environment."*

[31] Mari Kondi (2003) "The 'Bombay 5-6': Last Resource Informal Financiers for Philippine Micro-Enterprises", *Kyoto Review of South East Asia*, Oct 2003.

[32] The borrowers' incentive to repay is driven by considerations of reputation. Mumbai lenders generally gather together on Sundays and share information on borrowers, particularly defaulters. The consequences of failing to repay one Mumbai lender can be dire: no other Mumbai will be willing to lend money to the defaulter.

[33] United Nations Economic and Social Commission for Asia and the Pacific, OECD/UNESCAP/ADB Workshop on Assessing and Improving Statistical Quality: Measuring the Non-observed Economy 11-14 May 2004; Bangkok Country Paper: *Measuring the Non-Observed Economy (NOE): The Philippines experience*.

[34] Alice B. Mataia and David C. Dawe. (2004). "Is Credit a Constraint to Increasing Rice Production?" *PhilRice-IRRI Policy Memo*. Unpublished.

[35] Informal Sector Newsletter. "Subsistence or Self-Employment? Access to Credit for the Poor Asia" by the Center for International Private Enterprise; available online: <http://www.cipe.org/publications/fs/ert/e02/5self.htm>.

move into the formal economy. This would reduce the cost of informal lending and would be reflected in declining interest rates.

Ethnically targeted laws are the plague of the developing world. Liberalizing markets and granting rights, equal opportunity to buy and trade property, can dramatically improve the functioning of both land and financial markets while also promoting a more equitable society.

Reducing corruption, reforming land markets, and opening the door to competition are among the most urgent institutional reforms needed. Microfinance can then become the bridge between the informal and formal sectors and not serve only as a band-aid.

Towards sustainable development

Sustainable development requires effective financial intermediation.[36] This in turn requires both halves of the financial market to function in harmony so that mobilized savings throughout the economy generate a dynamic loanable funds market.

Marguerite Robinson and others have argued that the poor, while demanding credit, have a large unmet demand for saving products and services. However, the combination of legal restrictions (e.g. NGOs cannot hold deposits), and negative incentives (e.g. subsidizing loans and grants) provide a deleterious context for microfinance institutions to mobilize savings.

Ten years ago the microfinance sector was full of NGOs dependent on grants and subsidized loans from the government, aid agencies, and private donors. We are now seeing the transformation of some of the large successful NGOs into cooperatives or even banks. More of the existing rural banks are entering the microfinance sector and some of those already involved are expanding their programs without using government funds. They are successfully mobilizing savings. This pattern of sustainable expansion must be encouraged; but this will not happen if the government expands its involvement (through fund injection).

The subsidized approach to microfinance ignores the development of the saving side of the financial market. In doing so, it weakens rather than strengthens the financial sector, and discourages the type of investment the government is officially saying it wants to encourage.

Alternatively, implementing these reforms will promote the virtuous cycle of financial intermediation, which improves the access to finance for

[36] See footnote 16.

the poor. This environment will foster the graduation of microfinance borrowers such that Elvira and others like her may enter the formal economy.

CONCLUSION

The Philippines offers a unique window into a diverse set of experiments with microfinance. Development officials now focusing on microfinance around the globe would do well to learn from its over 20 years of experience.

Assessing the Microfinance bet

"Will the Philippine government's microfinance bet pay off?" is a question officials hope to answer with a resounding "yes".

The Philippine government previously committed itself to establishing "a supportive and appropriate policy and institutional framework for a private-led micro-financial market". Present policy, however, suggests the government is undertaking a different course of action.

As shown above a sustainable solution requires many institutional reforms. Without a greater mobilization of savings, increased funding of microfinance providers is an inappropriate response, as many barriers stifle the effectiveness of microfinance programs. Excessive regulation of markets, endemic corruption, and the lack of formalized property rights are problems that must be addressed. If these barriers continue to exist, microfinance will never become the bridge between the informal and the formal sectors, as it was intended to be.

Where to from here?

Microfinance is helping the poor. However, it is not helping even the most successful among them enter the formal financial sector. Graduation cannot be obtained by injecting more money into the microfinance sector. As such, the lessons of the Philippine experience provide the following insights:

- Microfinance has become a 'viable option' only because of a poorly functioning institutional environment, i.e. if the institutional environment was properly functioning, the need for microfinance would be greatly reduced;
- Microfinance is working reasonably well as a band-aid solution to poverty, i.e. it puts food on the table;
- Microfinance is not providing a bridge to sustainable development, because it fails to address the root causes of poverty. As such, microfinance borrowers fall short of graduating.

The future success of microfinance depends on deeper institutional reforms. The path to a modern economy requires secure property rights, trusted mechanisms of enforcement and an absence, or at least a massive reduction, in corruption and predation. Simply put the government and international aid agencies would do best to invest their efforts in the reforms outlined in this policy comment if a sustainable solution is the goal:

- Remove discriminatory laws, which have disenfranchised and continue to disenfranchise generations of people (i.e. grant domestic non-citizens the same rights as citizens to own property and businesses; liberalize and remove restriction to foreign ownership);
- Title real property (and more generally establishing a property rights environment that provides clearly defined, fully tradable, real, and personal property rights that are alienable, and defendable in impartial tribunals);
- Reduce the scope of government activity in order to reduce corruption; and
- Increase the liberalization of the financial sector (i.e. reform the mortgage and foreclosure laws).

The lives of millions of people are improved when the right mix of reforms are advocated and enacted. Working to enhance the economic environment in which exchange takes place might not produce the almost instantaneous results many wish to see. However, it will prepare the terrain to enable a greater degree of entrepreneurial activity among the poor. This will create wealth and alleviate poverty in ways governments and aid agencies have only dreamed.

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