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Microfinance Institutions as a Vehicle for Poverty Eradication in Developing Countries: Evidence from the East African Community Member States

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Abstract

This paper focuses on examining the link that exists between microfinance institutions (MFIs) and poverty eradication efforts in developing countries, specifically focusing on the East African member states of Burundi, Democratic Republic of Congo (DRC), Kenya, Rwanda, South Sudan, Tanzania, and Uganda. The study was driven by the varying interpretations, debates, and opposing opinions in literature on the effects of MFIs on poverty eradication in developing economies, particularly in the East African Community (EAC). The study used a depth literature search using secondary data on the role of MFIs in poverty eradication in the EAC context. The results pointed out that despite the challenges such as high transaction rates, limited funding and others, microfinance credit has played a significant role in poverty eradication among poor/low-income families in the EAC Member States. Therefore, the study recommends that governments of the EAC Member States should increase government support, and conducive working environments should be provided to ensure microfinance institutions reach as

many less privileged individuals as possible so as to raise their economic status.

Keywords: Financial Inclusion, Microfinance Institutions (MFIs), Poverty eradication, developing countries, East African Community (EAC)

1. Introduction

The traditional understanding of microfinance originated in Bangladesh in the early 1970s through the Grameen bank model of Dr. Muhammad Yunus (Bangladesh Bureau of Statistics (BBS), 2014; Mutoko & Mutoko, 2020). Dr. Yunus' model involved supporting informal rural small businesses with microloans to fight high poverty rates. The success of this model, especially in repayment of said loans by these poor rural folk, led to many international organisations adopting microfinance as a poverty eradication policy. This success also led to the awarding of the 2006 Nobel Peace Prize jointly to Dr. Muhammad Yunus and the Grameen bank (The Nobel Peace Prize, 2006).

This generally accepted model, copied since then around the world, is premised on providing small loans to the rural poor to start or support an economic activity undertaken by the said beneficiaries. Repayments are pegged on meeting the operational expenses incurred by the lending institution and not on profit making. The belief here is that this method will help the rural poor to gradually move from their poor backgrounds to having a sustained income through entrepreneurship.

However, the success of the global movement to replicate Dr. Yunus' model has also encountered some limitations (Moreno, 2010; Shamit, 2016). The authors observed that the growth of MFIs over the years into commercialised institutions has thus effectively killed Dr. Yunus' dream of poverty eradication in the 20th century. Also, the authors have used microfinance information available in the public domain to review microfinance in Africa and more specifically in the EAC region. The commercialisation of MFIs on the continent and in the EAC has led to a more focused approach on a relatively wealthy small number of individuals over the large number of poor individuals who would be most suited to this method.

Still, there remains a gap to help elevate the microfinance industry in the EAC to the great potential it can achieve, while also tackling the trade-off between outreach and sustainability. In addition, there is a legislative gap in some cases, thus limiting the incentives for MFIs to enact suitable strategies, measures, and introduction of financial products and services aimed at boosting the financial inclusion of the poor. This study therefore traces the influence of microfinance as a poverty eradication vehicle in developing countries with a focus on the EAC Members States of Burundi, Democratic

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Republic of Congo (DRC), Kenya, Rwanda, South Sudan, Tanzania, and Uganda.

Furthermore, Thorsten (2015) described microfinance as an effort to provide financial services to individuals and small businesses that are not eligible for standard commercial banking services. These beneficiaries generally have low-incomes, and they are self-employed or employed in the informal sector. They usually lack documented ownership titles of their assets and have inadequate legal identity documents. Many previous studies have empirically investigated the strong connection between poverty eradication and microfinance. Most conclude that microfinance has the capacity to reduce poverty in developing countries such as the EAC.

This was highlighted particularly after the declaration of the UN International Year of Microcredit (2005) that helped shine a spotlight on enhancing financial inclusion in the banking sector while also focusing on the importance of microfinance to micro entrepreneurs and microenterprises globally as well as the awarding of the 2006 Nobel Peace Prize jointly to Dr. Muhammad Yunus and the Grameen bank (Armendariz & Morduch, 2005; Bakhtiari, 2011; Gibbons & Meehan, 2002; Imai, Arun & Annim, 2010; Johnson & Rogaly, 1997; Kimmitt & Munoz, 2017; Mutoko & Mutoko, 2020; Niaz & Khan, 2021; Norfarah, Siti-Nabiha & Kamalia, 2019; Yusuf, Saidu & Ahmed, 2015). Several studies have shown a favourable connection between poverty alleviation and microfinance, as well as where loans are given to women entrepreneurs (Al-Shami et al., 2017; Khandker, 2005; Pitt & Khandker, 1998; Ukanwa, Xiong & Anderson, 2018; Ul-Hameed, Mohammad & Kadir, 2018).

The East African Community (EAC) is a socio-political and economic organisation composed of 7 countries; Burundi, the Democratic Republic of the Congo (DRC), Kenya, Rwanda, South Sudan, the United Republic of Tanzania, and Uganda. The original bloc was founded in 1967, initially as a group of only 3 countries (Kenya, Tanzania and Uganda). It collapsed in 1977 before it was revived again in 2000. Geographically, the bloc stretches from the Indian Ocean in the East (Kenya and Tanzania) to the Atlantic Ocean in the West (DRC). It has an estimated combined population of 281,050,447 ("East African Community," n.d.), the 4th largest population in the world, which is considered as a single entity.

The ultimate objective of the EAC regional integration is to establish a unitary political federation. This is the 4th step after the customs union, common market, and monetary union. There is incomplete proof connecting EAC integration and poverty, though figures show the increased trade has led to decreased fiscal and multidimensional poverty for Rwanda, Tanzania, and Uganda (Gasiorek et al., 2016). Small and Medium-sized Enterprises (SMEs) within the EAC mainly operate within the informal sectors with women as key

 ISSN: 1857-7881 (Print) e - ISSN 1857-7431

implementors ("East African Business Council", n.d.). SMEs are key pillars of the EAC economy in innovation, socio-economic progress, and social integration. They provide more than 60% of employment, constitute about 90% of traders, and share about 29% of the EAC Gross Domestic Product (GDP). They have also meaningfully enabled women empowerment, poverty alleviation, and distribution of incomes (ITC, 2014).

The EAC regional integration agenda, in line with the African Continental Free Trade Area (AFCTA), looks at establishing a barrier free market for local goods and traders so as to eliminate border barriers within these regional/continental blocs. With these lofty ambitions, SMEs and small-scale micro enterprises will be the biggest beneficiaries of such policies. Another objective of this study was to look at the current operating policy environment of MFIs in the EAC and if they are prepared to operate in the planned common markets, and whether they will be impactful to deliver envisioned poverty reduction goals or if they will be stifled by competition and collapse.

The EAC comprises 3rd world countries with majority of the citizens, just like in Africa, being considered poor. In addition, instability (political and civil) has been and remains part of the bloc. All but Kenya and Tanzania have been affected by civil strife and/or war in one form or another. Even in 2022, the DRC and South Sudan still have conflicts within their borders, and Burundi is still emerging from global sanctions, political strife, and isolationism. The bloc has also suffered from the effects of the global COVID-19 pandemic which has resulted in a near closure of the economies of the countries. All of these add to the levels of poverty with governments in the bloc unable to fully provide (socio-economically) for the poor citizens.

With the vast majority of citizens in the EAC, being small scale farmers and traders, microfinance provides a realistic and attainable approach to poverty eradication in the bloc. However, there have been other studies that have cast doubt on this notion of microfinance as a vehicle for poverty eradication. Profiteering by financial institutions on the whole reduces the efficacy of microfinance in reducing poverty (Chowdhury, 2009; Shahriar, Schwarz & Newman, 2016).

Also, while microfinance offers financial security if well utilised, it is critical that the beneficiaries of credit facilities have essential commercial knowledge and skills for them to fully use the microloans received from MFIs to expand existing microenterprises and generate jobs. Furthermore, MFIs are unable to bring long-term development and poverty eradication by themselves as they are one of many players and factors in the sector. In addition, issues such as errors in statistical analysis have been shown to reduce the overall positive impact of MFIs on families' livelihoods (Copestake & Williams, 2011).

 ISSN: 1857-7881 (Print) e - ISSN 1857-7431

While the link between microfinance and its impact on poverty eradication remains contested, the authors will endeavour to bring a fresh new outlook on the influence of microfinance approaches on poverty eradication. The section below provides some analysis about applicable literature on microfinance, particularly how it can serve as an instrument for poverty eradication in developing countries. The methodology used is found in Section 3. The findings and discussions are in Section 4 and concluding observations and recommendations are in the closing section.

2. Literature Review

This section examines current literature that touches on the importance of microfinance and MFIs and their effect on poverty eradication in developing economies. The authors endeavoured to present an outlook of MFIs globally in Africa, particularly in the EAC, and their correlation to poverty eradication. This study is guided by the poverty lending approach (Kumari, 2020) which stresses the use of microfinance as an instrument for poverty alleviation through provision of capital to the poor. Input from governments, donors, NGOs, and similar agencies is critical towards keeping interest rates low (Machingambi, 2020). This approach borrows from the Grameen Bank model that focuses on microcredit to poor micro entrepreneurs while facilitating flexible repayment approaches with reduced focus on MFIs' sustainability and profitability.

Therefore, this study focuses on the following 3 key components of Microfinance and MFIs.

2.1. Importance of Microfinance and MFIs

Microfinance is generally accepted as an important vehicle for poverty eradication which leads to advances in the socio-economic welfare of poor people (Bel et al., 2015). It enables many people to expand their household incomes and meet their expenses while helping them to navigate economic hardships (Bel et al., 2015). Microfinance programmes generally raise incomes and market expansion through providing credit among other services to young entrepreneurs (Kimando et al., 2012; Mawa, 2018; Nathan et al., 2004).

Microfinance has been recognised to have a positive impact on poverty eradication at macro level and thus plays a big role in socioeconomic development and poverty eradication in Sub-Saharan African countries (Bel et al., 2015). Generally, MFIs have a crucial effect on borrowers' revenues, particularly in urban areas with the average income of MFI clients being more than that of new clients or non-clients (Samer et al., 2015). There is conclusive evidence of the impact of MFI on poverty eradication (Hulme & Mosley, 1998; Khandker, 2005; Tedeschi, 2010).

 ISSN: 1857-7881 (Print) e - ISSN 1857-7431

The growth of technology, especially mobile money transactions in the EAC, has led to its high adoption as a business tool by both MFIs in disbursement and collection and by micro entrepreneurs in the course of conducting business. Matlala et al. (2014) highlights the high adoption of technology among entrepreneurs which further acts as a tool to reduce operating costs while increasing revenues as well as for connectivity and customer service.

In addition to the above outlook, the authors acknowledge the impact of MFIs in allowing the poor to gain access to capital in some capacity. This access to financial capital has the potential for poverty eradication in Africa and the EAC. This capital connection to the poor allowed the authors to examine some important characteristics of microfinance in developing nations, and the impact of using Dr. Yunus' microfinance approaches which include group lending, short repayment periods, and small loans among others.

2.2. Challenges of Microfinance and MFIs

Some of the challenges that MFIs encounter include lack of product diversification, late or delayed loan repayments, high interest rates, high transaction costs, poor outreach, lack of access to microfinance facilities for urban poor/low-income families, insufficient funding, demand and supply gaps in supporting microcredit and micro savings, lack of documentary evidence of credit-worthiness, and repayment tracking problems (Nasir, 2013; Das et al., 2011; Muithya et al., 2021). Some of these challenges can be overcome by ensuring more MFI products and services diversification, ensuring reasonable interest rates on microloans, more involvement of angel investors, use of high integrity as a consideration for clients, group lending, inclusion of all of the poor regardless of location and new innovations such as use of reasonable mobile phone loans among others.

MFIs have for the most part morphed into "baby" commercial banks, with many of the formal banking approaches that Dr. Yunus' idea of microfinance frowned upon. This commercialisation of MFIs has led to these institutions, in some cases, actually becoming an impediment to sustainable socio-economic growth. This in turn negates efforts to eradicate poverty for the poor in Africa and the EAC region.

The authors have also looked at some of the criteria followed by MFIs in providing microcredit with the knowledge that microfinance access has a crucial impact on poverty eradication. This was confirmed by small sample surveys conducted on 4 MFIs. The surveys discovered that the financial institutions impacted income and asset levels positively. Furthermore, it was discovered that more successful borrowers have voluntary savings deposits (Das et al., 2011). As such, challenges of MFIs can be overcome by financial inclusion of as many low-income families seeking these facilities as possible.

 ISSN: 1857-7881 (Print) e - ISSN 1857-7431

2.3. Microfinance and MFIs' Impact on Gender, Rural, and Low-Income Households

There is a lot of literary analysis on women empowerment and microfinance and the resultant effects (Abdulmalik et al., 2018; Bogale, 2018; Garikipati, 2012; Hashemi et al., 1996; Pitt et al., 2006; Rahman et al., 2009; Steele et al., 2001). Further review looks at the impacts of microfinance on Africa's rural households. It suggested that MFI services stimulate income generation, activate opportunities, increase revenue, boost empowerment opportunities, and improve the welfare of the poor (Alam & Azad, 2021). At the same time, poverty reduction goes hand in hand with sustainability (Akhter & Zaman, 2015). Therefore, reducing poverty is moot if it is not accompanied by efforts that maintain financial sustainability of the beneficiaries.

This study further looked at other impacts of microfinance such as effects on health, nutrition, education, built resources, and home consumption levels (Bel et al., 2015; Samer et al., 2015). The results of one study show that beneficiaries' welfare and estimated income were positively impacted by microcredit loans' housing index. There was also a reduction in family sizes. The conclusions include that access to microcredit helped recipients to exploit available business opportunities through start-ups or planning and growing existing businesses (Anthony & Isaac, 2012).

Microfinance offers a wide range of fiscal products and amenities such as microcredit, money transfers, savings accounts, and insurance to low-income/poor families. Its primary objective was to reach poor and unbanked members of the society, particularly the poor, women, youth, rural folks, illiterate among others. This objective hinged on the premise that access to microcredit services by these neglected groups would lead to starting up or expanding of microenterprises. This would further help them break the generational cycle of poverty. When well implemented, this form of microfinance intervention has made long lasting socio-economic improvements in the lives of the above-mentioned groups (Alam & Azad, 2021; Kimando et al., 2012).

Consequently, the effects of microfinance on poor/low-income household revenues and consumption in developing countries were shown to ultimately lead to poverty eradication. The results show a positive impact of microfinance services on beneficiaries' welfare (Mawa, 2018). However, the continued use of traditional banking techniques by commercial banks, especially in rural areas (Akhter & Zaman, 2015), has led to the growth of informal financial credit sources such as moneylenders, pawn shops, friends/family, revolving loan associations, etc. (Ntiedo, 2016). They are generally unregulated and commonly charge very high interest rates akin to exploitation of borrowers.

 ISSN: 1857-7881 (Print) e - ISSN 1857-7431

3. Research Methodology

Creswell (2009) observes that research consists of how the researcher collects, analyses, and interprets the data in the study. The current study used desktop review of existing secondary data where the researchers extensively reviewed literature on microfinance and poverty eradication in developing countries with reference to EAC Member States**.** Melissa (2013) observes that secondary analysis is a systematic method with procedural and evaluative steps, which is flexible and can be utilized in several ways.

The authors collected data primarily from peer reviewed journal articles and research journals. They also reviewed private and public sector reports, online trade magazines and newspapers, officially published country and EAC public (government) portals/databases/repositories/websites, books, published and unpublished technical papers, official blogs, and other related sources.

The main reason for using this research method is due to the readily available large and reliable data. Thus, collating it further helped the study come up with informed conclusion. The available data also helped the authors to identify the research work that has already been done, thus avoiding replication while also providing knowledge on methodologies and approaches used. It is also less time consuming and inexpensive in nature. As a result, authors can reliably come up with conclusions and identify limitations and areas of future research.

4. Findings and Discussion

The often-quoted markers of microcredit program success, such as high loan repayment rates, are only one part of a theoretical coin with financial, social, and human capital relevant for the positive management of microenterprises forming the other part (Buckley, 1997; Hameed, Mohammad & Shahar, 2020). From this, Buckley (1997) went further to state that there was minute proof to show that microfinance could impact the growth of microenterprises and micro entrepreneurs into larger well managed entities with more income streams, profits or high employment levels. This conclusion was from an analysis of 3 African countries; Ghana, Kenya, and Malawi.

This study has found out that MFIs in general have played a big role towards poverty eradication in developing countries, especially in East African Community Member States. Although there are similarities in some member states, differences were shown to occur in other cases.

4.1. Influence of Importance of Microfinance and MFIs

4.1.1. Microcredit Borrowers' Status

The authors found that the majority of lenders of microfinance institutions were from poor backgrounds. The Uganda National Household Survey (UNHS, 2016/2017) data shows that a majority of those benefiting

 ISSN: 1857-7881 (Print) e - ISSN 1857-7431

from microfinances were in the informal sectors in Uganda. These included credit and cooperative societies, microcredit schemes, relatives, friends, and unregulated money lenders among others. The borrowers from poor backgrounds are able to acquire finances at reasonable interest rates that are injected into various small businesses to improve their economic status.

The Burundi financial inclusion survey (2012) noted that in the bankable adult populace, just 3.7% had access to a bank account, over 23% use standard/informal non-banking establishments, while 73.3% were entirely left out of the banking system. The snapshot of just 26.7% of the 90% of the populace residing in semi-urban and rural areas having access to a financial system shows how difficult it is for the most-needy to access microcredit facilities offered by MFIs.

The status of the borrowers is also affected by the number of MFIs in the jurisdiction (Nakabugo et al., 2022). This is uneven across the EAC countries. Kenya and Uganda have a more robust microfinance space as compared to other members, while Rwanda leads in numbers vis a vis penetration. Other countries have limited statistical data on numbers involved.

4.1.2. Credit-Worthiness Requirements for Microloans

From the findings of the study, it was discovered that borrowers acquiring loans from MFIs are required to provide very lenient security as compared to other formal lending financial institutions. These securities are a reducible minimum which the poor borrowers can meet, while the formal lending systems tend to utilise a collateral-based approach that makes them inaccessible to poor/low-income households who do not have the required collateral.

There are other innovative approaches such as that of Urwego Opportunity Microfinance Bank (UOMB), a Rwandan based microfinance, that provides credit using mainly group lending. This means members are accountable for both the repayment of their own loans and also for other group members' loans in case of a non-payment. This approach allows for poor/low-income families to access loans without the provision of collateral.

It is also worth noting that in some cases, land constitutes a vital form of collateral that formal sector financial institutions as well as some MFIs accept as compared to only guarantors or shares that one holds in a particular microfinance institution in order to acquire credit (UNHS, 2016/2017). This can be difficult for the very poor as many do not have land or the official land title documentation that are required as security. Bazira (2020) contends that in Burundi, insufficiency of guarantees is one of the reasons products and services offered by traditional financial institutions are inaccessible to a significant part of the population.

 ISSN: 1857-7881 (Print) e - ISSN 1857-7431

4.2. Influence of the Challenges of Microfinance and MFIs

4.2.1. Rural/ Urban Location of Microfinance Institutions

The commercialisation of MFIs means there has been a gradual shift of location to urban areas as compared to the rural areas. This makes it hard for the poor clients who may be willing to acquire credit to uplift the economic status. The proportion of urban people with access to microcredit from MFIs is at a higher rate compared to that of rural people (UNHS, 2016/2017). This implies that microfinance institutions favoured the urban sectors in their provision of services.

4.2.2. Commercialisation of MFIs

There continues to be an enhanced focus on profitability and sustainability within MFIs and their operating principles. This is usually as a result of financial growth or change in the business model of the microcredit institution (D'Espallier et al., 2017). It is also as a result of credit officers' incentives (Beisland, D'Espallier & Mersland, 2019) with commissions on loans disbursed, thereby favouring larger loans to reliable (less risky) clients. The debate on MFI sustainability and profitability versus focus on the poor remains contentious and challenging since there are many variables involved.

4.3. Influence of Microfinance and MFIs' Impact on Gender, Rural, and Low-Income Households

4.3.1. Access to Credit by Gender

It was discovered that most finance institutions target mainly women. This concentration on women was a result of the belief that women required a semblance of affirmative action as a result of their previous neglect due to traditional and socio-economic policies. More women acquiring credit means more households will be uplifted, hence resulting to the eradication of poverty. This was confirmed by a Uganda ministry of finance planning and economic development study undertaken on microfinance outreach in 2004.

This focus on women is also as a result of their well-known high repayment interest rates which has remained a recognised factor since the start of the solidarity microfinance movement by Dr. Yunus Mohammad. Women form a large part of small-scale while microenterprises form a majority of members of SHGs and other group lending programs in most rural areas. This is why they are the majority beneficiaries of MFI credit.

4.3.2. Structure of the Loans

The authors found out that MFIs are friendly in structuring their loans according to the needs and demands of their clients from various economic backgrounds. These microloans are usually structured based on customer demands, the capacity of the institution in question, and the risk management

 ISSN: 1857-7881 (Print) e - ISSN 1857-7431

policies. The repayment plans for microloans usually involve instalments linked to the borrower's revenue streams such as their incomes and expenditures. These structures make sure that all clients who want credit/loans are covered and no one is left out.

4.3.3. Client Related Barriers

There were various barriers that hindered poor clients accessing microfinance institutions. The study conducted on Urwego Opportunity Microfinance Bank (UOMB) in Rwanda indicates that there is a poor saving culture for the poor/low-income people in Rwanda. They fear getting microloans to start new or expand existing businesses. As a result, they end up excluding themselves from microfinance services. More wealthy individuals usually exclude poor/low-income families from microfinance services. However, these same persons also exclude themselves (Fischer & Sriram, 2002). There is also the barrier of poor transportation costs as many of the poor/low-income households reside in rural parts of the country, which requires high transport costs to access them.

Weiss, Montgomery, and Kurmanalieva (2003) contend that financial services offered by microfinance in developing countries often serve people with low incomes who would otherwise be turned down by standard banking institutions. These days, microfinance has developed into a vital investment opportunity in 3rd world countries in regions such as South America, Asia, and Africa. This is the reason why global organisations such as the United Nations (UN), the International Monetary Fund (IMF), the World Bank, and continental bodies such as the European Union (EU), the American Development Bank, the African Development Bank (ADB), and the Asian Development Bank among other financial organisations, globally and continentally, continue to provide microfinance funding and research programs.

Conclusion

As noted in the findings, MFIs play a huge part in poverty eradication among poor/low-income families in the East African Community Member States despite their setback. The authors hope that this paper will be an addition to the various studies previously undertaken that seek to shed more light on the healthy varying interpretations, debates, and opposing opinions in literature on the effects of MFIs on poverty eradication in developing economies, in this case, with a particular focus on the EAC. The authors believe MFIs have led to a net positive impact in poverty eradication. Nevertheless, it has also had some few challenges in reaching the core poor people in the community.

 ISSN: 1857-7881 (Print) e - ISSN 1857-7431

In addition, the current operating policy environment of MFIs in the EAC region is still localised to country jurisdictions and affected MFIs are currently ill prepared to operate in the planned common markets, be it regional or continental. At current operating levels, there is a high likelihood of MFIs negatively impacting the delivery of the envisioned poverty reduction goals. Concerned government agencies and the management of said institutions need to actively prepare for the advent of the envisioned common markets. If this is not done, these MFIs will quickly wilt in the face of regional/continental competition and collapse.

Recommendations

The study established that MFIs play a huge part in poverty eradication among poor/low-income families and therefore enhances financial inclusion in the EAC Member States. The study urges MFIs to introduce more diverse categories of microloans that attract different interest rates so as to reach more low-income people. It also urges restraint of the focus on profitability (commercialisation) of MFIs since it negatively affects this noble goal of poverty eradication. This will eventually reduce the net positive effects of MFIs on poverty eradication. Moreover, Governments in the EAC Member States should increase support and provide favourable policies and working environments to ensure MFIs reach as many low-income individuals as possible. This will help to raise their economic status and that of the country as well.

Limitation and Future Research

The study used a qualitative method by reviewing existing secondary data on MFIs in Africa. As argued, “no scientific social research can be conducted purely by following only one method” (Hossain, 2001, p.22). Hence, future research should incorporate quantitative methods and primary data for validation of this study.

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 ISSN: 1857-7881 (Print) e - ISSN 1857-7431

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