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Micro-Lending and Macro-Results

The Norwegian Nobel Committee awarded the 2006 Peace Prize to Economics Professor Muhammad Yunus and his micro-credit company, the Grameen Bank of Bangladesh, in October. Their hard work in understanding and meeting the simple yet diverse needs of the poor may not bring an end to world poverty, but it provides governments and philanthropists with valuable lessons in how to structure their own relief programs.

You may not have heard of economist Muhammad Yunus or his "micro-credit" company, the Grameen Bank, because their small-scale, bottom-up approach to helping the world's neediest is not glamorous and promises nothing extraordinary. Yet the Norwegian Nobel Committee awarded the 2006 Nobel Peace Prize jointly to Yunus and his Grameen Bank, in recognition of "their efforts to create economic and social development from below."

In other words, the Grameen Bank and similar "bottom up" institutions have proven themselves more effective in lessening poverty than the commendable efforts of rock stars, such as Bono, or economists, such as Jeffery Sachs (which have mainly served to raise the awareness of extreme poverty, rather that decreasing it). The same can be said of the largely "top down" aid programs of donor governments and non-governmental organizations, which have seldom had lasting effects.

Since it was first awarded in 1901, the Peace Prize has usually been given to leading figures of the day—diplomats, political leaders, and heads of international organizations or movements—in recognition of their high-level efforts to prevent wars and resolve international conflicts. This is one of the few times it has been given for such a small-scale program. It is also the first time the prize has been awarded to an economist, and the first time it has been used to link poverty and peace.

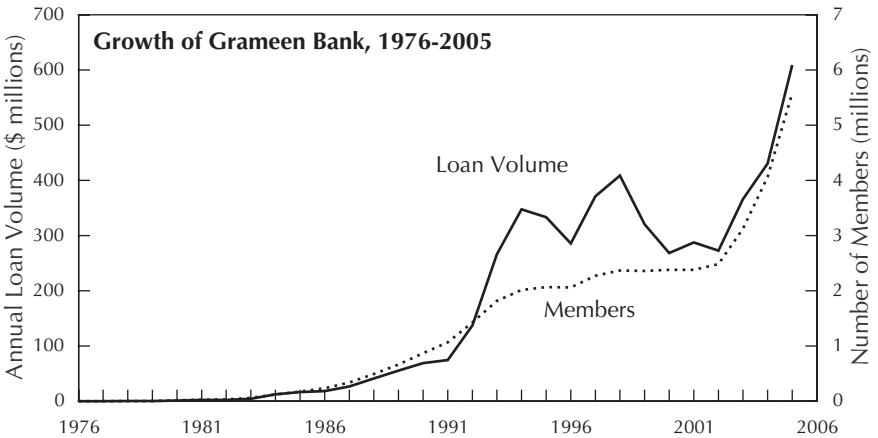
Micro-credit—the lending of small loans to extremely poor people—is not the sword that will strike the Gordian knot of world poverty. Sixty years of unsuccessful development programs remind us that no simple solution exists. However, in their innovative approach to removing barriers that prevent the poor from increasing their productive abilities, Yunus and Grameen have offered policymakers one more valuable ingredient, necessary but not sufficient, for eradicating poverty on a massive scale. Typical development programs miss this key point by focusing on simplistic and poorly-designed answers to long-standing problems.

Sweating the Small Stuff

As a Chittagong University economics professor in Bangladesh, Yunus and a team of graduate students went directly into the poor neighboring village of Jobra and determined that a large obstacle to progress for the poor was lack of access to credit. In 1976, he loaned $27 out of his own pocket to a group of 42 villagers and found them to be credit-worthy. Traditional credit institutions are unwilling to make loans to the very poor in underdeveloped countries because the poor lack collateral to back the loans; or, if they do own property, poorly developed legal institutions result in insecure titles to those properties. The few who do manage to obtain credit pay a high price: Informal credit mechanisms (such as loan sharks) routinely charge upward of 200 percent per year in interest.

Formally chartered in 1983 with less than $4 million in start-up funds from the government, Grameen Bank is based on a simple idea—lending very small amounts to poor entrepreneurs. The Bank's average loan is less than $200 dollars and it charges clients just 20 percent interest. Having access to affordable credit allows recipients to engage in modest entrepreneurial activities, such as investing in grocery shops, raising livestock, weaving, sewing, etc. This enables them to produce beyond a subsistence level and, through further specialization and trade, lift themselves out of extreme poverty.

Grameen Bank pays attention to details. For example, Yunus recognized that while the poor have no physical capital to post as collateral, they have an enormous amount of "social capi-



tal"—basically, their standing in the community—that is just as important to protect. Therefore, loans are awarded to groups of five and, rather than signing a legal contract, each member of the group informally guarantees the loans of the others. The threat of ostracism and other sanctions encourages disciplined repayment. Groups are also encouraged or required to save to further ensure repayment.

Ninety-seven percent of loans are made to women, for two reasons. One, Yunus believed that they were the neediest, given the discrimination against women and their limited opportunities in a conservative Islamic culture that restricts a woman's personal, social and economic activities outside her home. Two, he found that women were much more likely than men to repay the loans.

Each member of the group undergoes a two-week training session to learn about bank procedures, how to save, and how to sign her name. Borrowers are encouraged to adhere to Grameen Bank's "four principles"—discipline, unity, courage, and hard work—and to follow guidelines that emphasize hygiene, environmental stewardship, and education (for example, "we shall not live in dilapidated houses," "we shall build and use pit-latrines," and "we shall educate our children").

In short, Grameen overcomes a problem endemic to one-size-fits-all aid programs—lack of information—by understanding village traditions and cultures in all of the areas in which it operates. Most of the Grameen staff themselves come from the villages and have participated in its programs; most of its borrowers own the bank's stock; and its board of directors is representative of its client base.

The costs of administering such a hands-on program are extensive—particularly since Bangladesh, though densely populated, is a largely rural country. Interest rates are also high, for various economic reasons but also because of the natural calamities that occur every year. Floods, cyclones, and tornadoes represent a structural risk for Grameen, one not faced by banks in other locations. Nevertheless, Grameen has grown dramatically since its founding, as shown in the chart on the previous page. As its loan portfolio has expanded to serve roughly six million clients, Grameen has grown to employ nearly 19,000 staff—many of them former borrowers—across 3,226 branches. The bank's stock is now 94 percent owned by the borrowers, referred to as bank members. This is due in part to a requirement that each borrower purchase a share of Grameen stock (currently valued at about $1.50).

Research on the bank has been limited, but shows that it has enjoyed modest success. While it required substantial subsidies to get off the ground, the bank claims to be self-sufficient today. The average household income of bank members is estimated to be 25 percent higher than that of similar non-member households from the same village. Twenty percent now live below the measured poverty line, compared with 56 percent of non-members. The loan repayment rate is reported to be 98 percent, although the exact rate is disputed due to the unclear treatment of delinquent loans. (Loans that have been delinquent for more than a year are estimated to represent one-fifth of the loan portfolio.) While high repayment rates might simply reflect selective lending on the bank's part or generous accounting, the fact that Grameen has survived for a quarter century by serving poor clientele, has eliminated its subsidies, and has turned a profit in all but three years suggests that it is doing something right.

Grameen's success derives from having a tightly focused goal with measurable outcomes—providing loans to enable the extremely poor to develop their under-utilized skills, and tracking rates of loan repayment and reapplication to measure success. It gets feedback from the poor people it is trying to help. The bank staff goes to the villages, rather than requiring villagers to find them, and they customize loan programs to meet diverse needs. If expectations are not met, Grameen's employees and stockholders suffer, particularly since stockholders cannot sell or trade their stock.

The program also recognizes that poverty is not merely a technical engineering problem that can be solved by developing a better formula from afar. The reasons that prosperity eludes so much of the world are complex, and many aid programs falter when they try to impose overly ambitious and detailed solutions. In contrast, the Grameen Bank does not dictate what its clients do with their loans—only that they pay the money back. And the best way for them to do that is to do something productive. Ultimately this is the only way for them to raise their standard of living.

The Failure of Traditional Development Assistance

Starting with President Truman's "Point Four" program in 1949, over $2.3 trillion of development assistance has flowed from the West to jump-start the development of the world's poorest countries. Yet nearly 60 years later, over one billion people in the world remain as poor as, or poorer than, people were before the Industrial Revolution began. Perhaps the West has been too stingy—foreign aid has made up less than three-tenths of one percent of the more than one *quadrillion dollars* of output it has produced over the same time period. But $2 trillion surely buys something—and with too few success stories and far too many failures, aid clearly has been misdirected and its delivery has been poorly designed.

Some of this failure is due to graft in both the donor and recipient countries. But a larger reason is that rich countries and wealthy donors often do not have the requisite information about how to meet the diverse needs of the world's poorest people, nor do they have the incentives to ensure that those needs are met. Grandiose promises are further unlikely to be kept when the aid is delivered via the weak and/or corrupt formal institutions that prevail in developing countries.

The Next Fad?

Micro-credit is not a new idea in development. Jonathan Swift founded the Irish Loan Funds in the early eighteenth century to make small loans to the poor in Ireland, and informal mechanisms such as "tandas" in Mexico and "tontines" in West Africa are centuries-old traditions. But its popularity has surged in the last decade, with a seven-fold increase in the number of micro-finance agencies (over 3,100 now exist worldwide). Micro-credit has reached an estimated 450 million people, according to its proponents, and has the air of becoming the "next big thing" in development circles.

Economic history has taught us to have a healthy skepticism, however, about the wisdom of dedicating a huge amount of resources into micro-credit enterprises. The best way to overcome poverty is to eliminate barriers that stifle inventiveness, creativity, and private enterprise among the poor. While mi-

cro-credit can help do this, the same factors that have long stifled progress in poor countries will ultimately limit the potential gains from such programs.

Moreover, even well-designed micro-credit programs can fail. Most require substantial subsidies before becoming profitable. More important, while organizations like Grameen may provide opportunities for people to open businesses, they have little control over other factors that influence whether people in poor countries have an incentive to invest in their futures. Creating these incentives requires poor countries to reduce the red tape that strangles growth, to restore confidence in their currencies, and to promote the rule of law (by recognizing strong property rights, eliminating corruption and thievery, and enforcing contracts).

These institutional reforms cannot be applied uniformly from abroad, but must be nurtured by honest people from within. Thus, micro-credit and other similar projects should be structured so that donors, rich country governments, and international aid agencies pay heed to the specific circumstances and customs of the people they are trying to help. It also helps if, as with Grameen, those giving the aid have a direct stake in the success of any proposed project.

In sum, scaling up Grameen-type lending programs will not solve the most intractable problems that poor countries face. But the awarding of the Nobel Peace Prize to Muhammad Yunus and Grameen Bank is a reminder that micro-credit nonetheless can play an important role in alleviating immediate penury. Massive poverty will take generations to eradicate. Even if programs like Grameen are successful in making a mother into an entrepreneur, she will hardly ever have the chance to ascend into the middle-class herself; but if they help her to raise healthier, better-educated children, subsequent generations may well have those opportunities. ❑

THE NEW PENSION LAW: BACK TO THE FUTURE?*

The new pension law will not stave off the decline of traditional pensions but it addresses some of the flaws that have undermined 401(k)s as an alternative for retirement saving.

When President Bush signed the Pension Protection Act of 2006 in August, he said that it introduced "the most comprehensive reforms to America's pension system in over 30 years." He neglected to mention that this pension system, which has provided generous benefits to millions of today's retirees, is rapidly becoming a thing of the past.

By pensions, we mean here *defined-benefit* pensions. These are the traditional gold-watch plans, where employees work their 30 or 40 years for the same company, then retire with a gold-watch ceremony and a fixed-dollar monthly benefit for as long as they live.

This sort of arrangement is rapidly approaching extinction, at least among private-sector employees. Employers find them too costly to fund, and the costs are also unpredictable. The amount they must set aside each year to fund them can change markedly whenever, as is usually the situation, investment returns, price inflation, and wage rates differ from the actuaries' assumptions. Employers increasingly prefer to pass the burden of investment risk to workers by offering them 401(k)s and other *defined-contribution* plans instead.

Many companies began to move from traditional pensions to 401(k)-type plans during the 1980s and 1990s. The shift has accelerated in the past few years, as even blue-chip companies like Coca-Cola, IBM, and Verizon have terminated traditional defined-benefit plans, while sweetening the terms of their 401(k) plans. By late 2005, an estimated 47 million private-sector employees participated in 401(k) plans, over twice the number in defined-benefit pension plans.

In 401(k)-type accounts, variations on the basic model are linked by one big outcome. The employer assumes no liability for guaranteeing a specific benefit and no obligation beyond making any promised contributions during an employee's years of service. Instead, employees who enroll set aside a given percentage of their pre-tax pay each month (typically up to six percent of it) and employers typically "match" some portion (typically half) of the employee's contribution.

Under the Pension Protection Act of 2006, the wheel has turned again, to try to improve 401(k) plans by encouraging employers to make them more "automatic" and to take more responsibility for investment decisions. In practice, this may also make them somewhat *more like the traditional pension plans they have tended to replace*.

Judging by the new law, Congress apparently believed that as traditional pension plans have faded, too few employees were taking full advantage of 401(k)s and similar plans. An estimated one-fifth to one-third of employees who could take part in these plans decline to do so, including some who pass up the chance to get employer contributions.

Growing evidence also suggests that many workers do not have the time, expertise, or inclination to manage their money in ways that most money managers would consider sensible or rational. Concerns about this helped shape the 2006 pension-law overhaul, in ways that reduce the number of explicit decisions employees have to make about their accounts. The new law also opens the door for employers to provide more investment education for employees.

Influences on the 2006 Law

Other motives played a part in the design of the Pension Protection Act of 2006: There is ample evidence that many Americans have not saved much for their retirement; businesses saw traditional defined-benefit pensions as expensive and unwieldy; the government's Pension Benefit Guaranty Corporation (PBGC) appeared to face a funding crisis; the rising prominence of 401(k)-type plans has exposed defects that needed fixing; Social Security benefits are unlikely to be increased to fill the growing gap in retirement savings left by vanishing pensions; and last but not least, mutual funds and financial advisors wanted more business.

In other words, the traditional three pillars of retirement financing—pensions, Social Security, and personal saving—had come to look increasingly shaky as the basis for a national retirement system. The 900-plus pages of the new law can be understood as an omnibus (or sprawling) attempt to remedy a variety of ills and also respond to a cacophony of interests and pressures.

Here we focus on the new rules that are most important for current workers.

*This article is by R.D. Norton, an AIER Research Fellow.

In the meantime, it should be understood that *nothing in the new law changes the benefits or terms for people already in retirement*.

The main changes affecting companies and their employees take place as of 2008. At that point, for example, new employees at companies offering 401(k)-type plans will be automatically enrolled in company plans, with the right to "opt out" if they so choose. Companies will be encouraged to increase the share of employee wages and salaries going into the accounts, year-by-year, *e.g.*, when raises are given. They will also be encouraged (but not required) to match employee savings.

Companies will also have to offer three forms of assets to invest in, beyond company stock. The "default investments" for employee accounts will be mutual funds (stocks), not money-market funds or other low-risk, low-return investments. Businesses will be allowed to have accounts "managed" either by a "certified" computer model or by financial advisors, including representatives of mutual-fund companies. Finally, companies will be encouraged to offer "safest available annuities" to retiring employees, converting lump-sums into pension-like, constant payouts.

Improving 401(k)s: Managed Accounts

How will all this work to increase savings? Two ways. First, it makes 401(k)s more automatic. Second, it encourages companies to use the relatively new, hybrid "cash-balance" plans. Consider first the changes in 401(k) arrangements.

To take full advantage of your 401(k) or similar plan, you must do three things: enroll, save, and invest. A growing body of evidence shows that many workers have trouble with each of these steps, and certain provisions of the 2006 pension law are aimed at improving the situation.

As to the first two problems, enrolling and saving, the new law encourages a combination of "opt-out," "step-up," and matching provisions, to boost contributions to 401(k) accounts. A new employee would be automatically enrolled in an account, subject to a 90-day period to opt out. Under the step-up feature, employees would have the share of their wages going into the account raised from three percent in their first year on the job to four percent in the second year, five percent in the third year, and six percent in the fourth year.

As to matching contributions by employers, the law encourages but, as before, does not require it. The suggested standard is 100 percent matching by the company for the first one percent the employee sets aside, followed by 50 percent matching for the next five percent the employee saves. In all, that's a recommended 3.5 percent company match, with a total combined employer-employee contribution of 9.5 percent of wages a year.

What about the third problem, investing? One option recommended in the law is for employers to provide access to interactive computerized software that employees could use, at least once a year, to compare their asset allocation to some "norm" for investors in similar circumstances. The second and more controversial (and probably more expensive) path to investment advice involves face-to-face conversations at least annually with financial advisors.

In the meantime, a further feature of the new law tends to bring the story full circle, *i.e.*, it opens the door for 401(k)s to offer, when you retire, the assurance of a guaranteed monthly income—which was, after all, the defining characteristic of traditional pension plans. Specifically, the new law gives businesses clarification on something called the "safest available annuity" standard. The hope is that this will encourage them to convert the 401(k) account balances of retiring employees from lump sums to annuities—giving them a guaranteed monthly income during their retirement. As with the new rules on account management, turning a lump-sum balance into an annuity makes the whole 401(k) approach more like a traditional pension.

Cash-Balance Plans

Yet another example of such circularities is the "cash-balance" plan. This is a hybrid that combines features of defined-benefit pensions and 401(k)-type accounts. The effect is to give the employer more certainty as to what liabilities are being incurred for pensions. But, particularly for those nearing retirement, a conversion by the employer from a traditional pension to a cash-balance plan is likely to reduce workers' pension benefits.

In an update to reflect the terms of the Pension Protection Act of 2006, the Department of Labor draws distinctions between cash-balance plans and 401(k)s. Cash-balance plans retain defined benefits, while 401(k)s feature defined contributions. Participation in cash-balance plans generally does not depend on the workers contributing part of their compensation to the plan. The investments of cash-balance plans are managed by the employer, whereas with 401(k) plans, workers bear the risks and rewards of investment choices.

In addition, unlike many 401(k) plans, cash-balance plans are required to offer employees the ability to receive their benefits in the form of lifetime annuities. Finally, since they are defined-benefit plans, the benefits promised by cash-balance plans are usually insured by the Federal Government, via the PBGC. Defined-contribution plans, including 401(k) plans, are not insured.

Outlook

Despite its name, the new Pension Protection Act is unlikely to do much to preserve the traditional defined-benefit pension plan, at least in the private sector.

However, the new law brings some of the paternalistic features of traditional pensions to 401(k)s, by encouraging employers to take more responsibility for the plans. Employees will not be forced to save or to diversify their investments, but the automated approach will make this the "default" outcome. Some critics object to this paternalistic approach. But, from a public policy standpoint, it may be the least objectionable way to address the looming costs of paying for the retirement of an aging America. ❑

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