Chapter 14
Reducing Inequality in Developing Countries Through Microfinance:
Any Correlation So Far?

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ABSTRACT

Even though microfinance is expected to significantly affect macro variables such as inequality, poverty, and human development, there has not been enough empirical study on the impact analysis at the macro level, such as the effect of microfinance on inequality, especially in developing countries of Africa. This chapter, therefore, provides a detailed empirical analysis of the correlation between microfinance and inequality in West Africa sub-region. The correlation coefficient shows that although there is a positive linear connection between the possibilities of microfinance to reduce inequality; it has not contributed significantly to poverty reduction with the independent variables. The findings further suggest that the most robust explanatory variables for inequality reduction are GDP per capita and democracy which are invariably significant with positive sign. Taken together, these findings reinforce the intuition that greater democracy and provision and expansion of financial infrastructures especially in backward countries of the region are necessary for microfinance to thrive and contribute abundantly to inequality reduction.

INTRODUCTION

The positive impact of financial deepening in poverty-inequality reduction, human development, consumption smoothening, gender equality and economic growth across countries or regions has been emphasized in the literature (World Bank, 2001; Ahlin & Jiang, 2008; Swain & Floro, 2008; Kai & Hamori, 2009; Bird, Hattel, Sasaki & Attapich, 2011; Tchouassi, 2011;Kazi & Leonard, 2012;Leikem, 2012; Kasali,

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Ahmed & Lim, 2015, *inter-alia*). Microfinance as a veritable tool to delivering financial services to rural dwellers plays an important role in making financial market meet its obligation of bridging the financial bank between urban and rural dwellers. Since the 1990s, there is enough evidence suggesting that the number of microfinance has been on the rise. From 2006-2007, Microfinance in the continent experienced a 25 percent rapid increase in the number borrowers and 31 percent in savers. Although it is expected that such increase in the number of microfinance would improve human development through reduction in inequality in the region, there has not been enough empirical research on the impact, such as the correlation between microfinanceand inequality reduction in West Africa sub-region.

The establishment of Microfinance is predicated on economic development paradigm that aims at poverty reduction through financial services to the poor, low income earners and micro-entrepreneurs that cannot access similar services from the formal financial market (Ashraf & Ibrahim 2014). It is therefore a means of advancing small loans to the poor with to enable them finance small and medium scale businesses that would provide them adequate income to take care of their needs. The institutions were originally designed to assist the poor households and advance credits to entrepreneurs, provide services like savings, rural credit, consumer credit and other financial services (Duku, 2002). In this regard, the provision of microfinance institutions connotes the procedure of making available very small range of financial services to the poor with the purpose of making them take up new opportunities which the development process offers. It is a development tool that makes the rendering of services like money transfers, savings opportunities, and credit and insurance services possible. It is therefore an economic phenomenon that enhances the potentials of low income group in the society (Basir, Amin & Naeem, 2010; Muller & Bibi, 2010). It is an essential aid to increase productivity of the poor and essential ingredient for economic development. Microfinance came to being because of the need to enhance the latent capacity of the poor for entrepreneurship by providing microfinance services to enable them engage in economic activities and be more self-reliant, increase employment opportunities, enhance household income and create wealth (CBN, Microfinance Policy, 2005). Hence, microfinance can be described as poverty alleviation interventions which enable banks to lend small credit to the poor, to offer them opportunity to take part in economic activities. The poor are thus helped to escape the poverty trap.

In principle, a better microfinance can help overcome economic barriers, and thereby increase growth and reduce inequality. Indeed, a more developed and deeper financial sector has been shown to aid economic growth. But it should be noted that financial reform will only reduce inequality if it improves access for more individuals with growth opportunities. Microfinance enables poor women to engage in income-generating activities that help them become financially independent, strengthening their decision-making power within the household and society.

Meanwhile, a study by International Finance Corporation (IFC) (2014) highlighted that one of the largest constraints to private sector development in Africa is lack of access to financial services. This is particularly severe in Sub-Saharan Africa, where only between 5 percent and 25 percent of households have a formal relationship with a financial institution. UNDP (2013) notes that most African countries are undertaking economic reforms, including the establishment of sound macroeconomic conditions, market-based economic policies and improvements of the business environment all of which support growth of microfinance. The report highlights various ways in which the economic environment for microfinance has improved, including through strengthened regional arrangements and benefit from bilateral trade preferences, as well as the rise of emerging markets as fertile ground for entrepreneurs. However, microfinance in Africa still faces challenges, which dampens the strengths and opportunities

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