RESEARCH INSIGHTS

Do Better-Connected Community Members Benefit More from Subsidized Credit?

- More powerful and less productive households, both in terms of wealth and connections, ended up obtaining more credit from a community-based lending program. Informal markets partially attenuated these targeting distortions by redirecting credit from connected to unconnected households, albeit at higher rates.
- Despite the targeting distortions, a community-based approach may still be more appealing than other centralized criteria to target credit.
- Eliminating the connection-based advantage may lead to village-level gains in terms of equity and output.

CONTEXT

Between 2001 and 2002, the Thai government donated resources to over 90 percent of rural villages as part of one of the largest micro-credit interventions ever implemented: the Million Baht Village Fund (MBVF). The program's stated objective was to deliver individual-liability loans to promote income generation and to provide support to households experiencing hardships. Funds were fully managed by locally elected Village Fund Committees (VFCs) made up of community members. The program was implemented in villages with well-established local political elites such as the village council, which represent the main link between community members and higher-level authorities.

PROJECT

The project utilizes the monthly panel of the Townsend Thai Project to estimate household-level productivity before the rollout of the program and utilizes novel data on membership in local organizations and economic networks to measure connections with the local elite. The author first analyzes which of these characteristics predicts program participation during the first two years following the program's rollout, then tests whether informal credit markets can offset some of the allocative distortions related to program credit. Finally, the author analyzes how the allocation achieved by community members compares to a centralized approach to allocating loans based on repayment history.

RESULTS

The community members in charge of allocating the program loans did not target beneficiaries based on productivity, neediness, or repayment. Instead, the VFCs allocated credit to richer and less productive villagers. This result holds under different measures of productivity and need. Connections with the local political elite seem to have generated targeting distortions; village council members and household with direct connections to them were 31 and 14 percentage points, respectively, more likely to obtain program credit. These connections-based distortions were also reflected in forgone returns to the lender. Elite-connected borrowers tend to borrow at lower interest rates when they borrowed from the program, relative to other member-funded community lending groups in the village, while unconnected villagers borrowed at similar interest rates regardless of the lender. In turn, unconnected households who were less likely to borrow from the program indirectly benefited from the credit expansion induced by the program by borrowing from relatives, albeit at an average annual interest rate twice as high as that of the program loans. Not surprisingly, these allocative distortions in program credit had implications for inequality. Counterfactual analysis suggests that eliminating the connection-based advantage may lead to a 9.7 percent decline in village-level inequality. However, despite being prone to favoritism, a community-based approach to allocating loans may be preferable to other centralized credit-scoring models. Counterfactual simulations suggest that those approaches would have led to even more unequal results.

Key Concept

HOUSEHOLD PRODUCTIVITY

The ability of households to turn inputs into outputs.

POLICY IMPLICATIONS

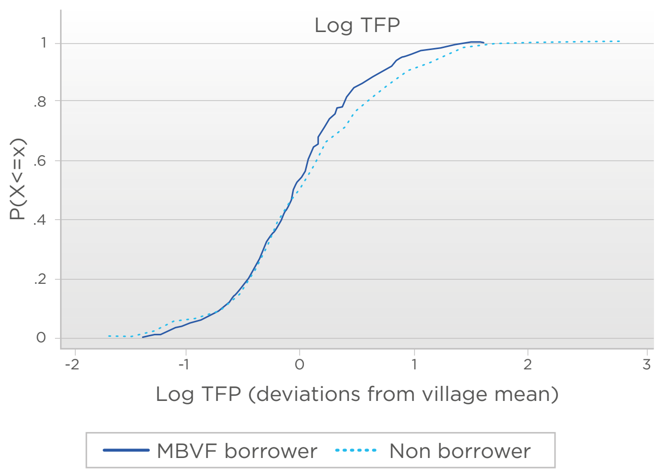
Local targeting schemes can lead to misallocation, particularly when the targeting criteria include attributes that are hard to verify and when community members lack the means to hold their leaders accountable. Despite these disadvantages, community-based approaches to targeting public resources may remain an appealing option for at least two reasons. First, informal credit markets can attenuate the initial targeting distortions by reallocating resources to erroneously excluded beneficiaries. Second, other centralized mechanisms such as scoring models may only target those who already have access to credit. A policy alternative is to improve program design to minimize the scope of favoritism in community-based programs. Favoritism could be minimized through changes in program design that induce non-elite households to participate directly in the monitoring process or enable verification by community members.

Key Concept

DECENTRALIZATION

Transfer of control of an activity to several local offices rather than a single one.

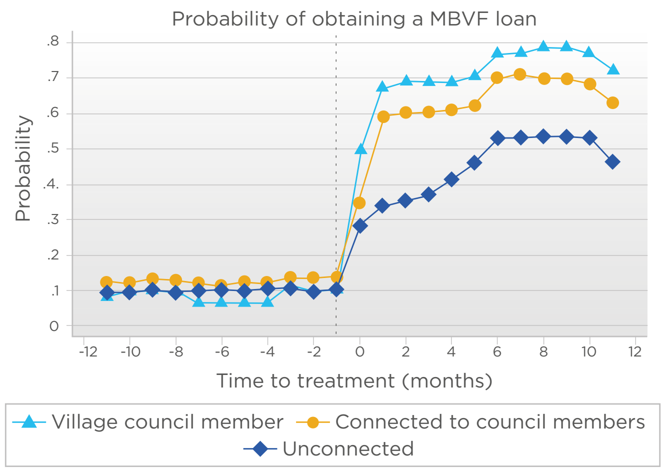
Figure 1. Total Factor Productivity of Households



Kolgomoroc-Smirnoff test for equality of distributions (P-val): 0.075

Note: Comparing borrowers with non-borrowers, VFCs did not lend to the most productive households.

Figure 2. Probability of Obtaining an MBVF Loan



Note: Elite members and households with connections to the elite were more likely to obtain program credit than unconnected households.

FULL STUDY

[Vera-Cossio, Diego. 2018. "*Targeting Credit Through Community Members.*"]

DEPARTMENT OF RESEARCH AND CHIEF ECONOMIST

The Department of Research and Chief Economist generates new ideas to enrich the knowledge base that supports the policy agenda of the Inter-American Development Bank (IDB) and its member countries for achieving sustainable and equitable development in the region. To maximize the impact of its research, the Research Department carries out activities that serve as inputs to other IDB departments, governments, the academic community and public opinion in the region.

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