Applications of Elasticity – classroom discussions

- In the next class we will discuss a series of applications of the concept of elasticity to economic policy formation.
- In advance of that class please review the following two tables and read the following four case studies:

*The tables on pages 72 and 81 of the course textbook (see next page)*

“Mulled Whines” from *Economist* Magazine December 21st 2013 (attached)

“Yesterday’s Fuel” from *Economist* Magazine August 3rd 2013 (attached)

“Starbucks Grounds Zero” from *Economist* Magazine July 5th 2008 (attached)

“Waist Banned” from *Economist* Magazine August 1st 2009 (attached)

“Microcredit: Put to the Test” from *Economist* Magazine May 16th 2013 (attached)

**In class we will review/discuss:**

- The elasticity tables and the above articles (the first two have associated questions)

- The price elasticity of demand for tobacco products in Ireland using data from the Office of Tobacco Control, Revenue Commissioners and a Department of Finance tax strategy paper.

- Elasticities for Beer and Wine in the UK using data from a study by the Institute for Fiscal Studies (IFS).

- ESRI examinations of the impact of a carbon tax in Ireland.

- DOEHLG study on elasticity of plastic bags and changes to plastic bag levy.

- Differences in the short-term and long-term price elasticity of oil across all OECD countries using data from Forfas.

- UK Road Traffic income and price elasticities using data from a University of London study.

- Elasticities for public transport usage in the UK using data from a 2004 study in the UK.

- Income and Price elasticities for various types of food products using data from the UK.
### Table 3.4: Price Elasticities in Ireland

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<tr>
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<tr>
<td>Food</td>
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<td>-0.42</td>
<td>-0.57</td>
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<tr>
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<td>-0.56</td>
<td>-0.65</td>
</tr>
<tr>
<td>Tobacco</td>
<td>-</td>
<td>-</td>
<td>-0.35</td>
</tr>
<tr>
<td>Clothing and footwear</td>
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<td>-0.70</td>
<td>-0.69</td>
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<tr>
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<td>-</td>
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<tr>
<td>Fuel and power</td>
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<td>Durables</td>
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<tr>
<td>Transport and equipment</td>
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<td>-1.02</td>
<td>-1.06</td>
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<tr>
<td>Other goods</td>
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<tr>
<td>Services</td>
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<td>-1.01</td>
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### Table 3.7: Income Elasticities in Ireland

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<tbody>
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<tr>
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<td>-</td>
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</table>
Alcohol pricing

Mulled whines

People are drinking less but doing so more harmfully. Policymakers want higher prices—causing a headache for the booze industry

Dec 21st 2013 | From the print edition

BY DAY tourists flock to Plaza de España in central Madrid to snap photos beside the sculpture of Miguel de Cervantes, author of “Don Quixote”. By night a newer facet of Spanish culture is on display: loitering groups of young people downing plastic bottles of whisky and vodka mixed with Fanta Lemon. The ground is littered with empties. Nearby, three young men help a friend vomiting on the pavement.

Such carousing was once rare in Spain. A Mediterranean drinking culture prevailed in which alcohol was taken only with food. That is changing. In Spain and many other rich countries, alcohol intake is becoming a bigger problem—for some groups. Overall, the global consumption of alcohol has been stable since 1990, according to the World Health Organisation. Around half of the planet’s population is teetotal. But those who drink alcohol do so more hazardously. Policymakers are looking for ways to address this. A new and much-watched experiment in Scotland, for example, involves setting a minimum price for each unit of alcohol.

Individual consumption peaked in Spain in 1975 but young people are increasingly indulging in the botellón, (literally “big bottle”): drinking outdoors to get drunk. In France, another country with traditionally moderate drinking patterns, a similar trend is emerging. In the past three years hospital admissions from alcohol abuse have risen 30% there, to 400,000 a year. Bingeing is so common that in July it gained an official name, beuerie express. Across much of the rich world, many people (not just the young) are drinking greater quantities in a single session.
Responsible drinkers pose little risk to others. But the growth in hazardous drinking habits has far-reaching implications. Deaths from the overuse of alcohol rose from 750,000 in 1990 to 2.5m in 2011, nearly 4% of all fatalities worldwide. Alcohol causes long-term ill-health, but even a single binge can end in hospital: in Britain, for example, such admissions doubled in 2003-10. It is not only drunks who suffer from their excess. Booze contributes to a third of all deaths on Europe’s roads each year and stokes abuse and violence. It features in almost all public-order offences in Ireland; up to 80% of Australian police work is alcohol- and drug-related; across the European Union, it is linked to 65% of domestic violence and 40% of murders. When lower output and higher social costs are taken into account, alcohol costs Europe and America hundreds of billions a year, up to 1.5% of GDP by some estimates.

The industry has introduced some modest schemes to encourage responsible drinking. Governments have stepped up education campaigns; most restrict the sale of alcohol in some regard, by licensing premises, setting opening hours and banning purchases by children. But all that is largely outweighed by another factor: health campaigners say that in many countries booze is simply too cheap.

Increasingly alcohol is drunk at home, rather than in bars or restaurants, and is often deeply discounted. In Britain and Ireland supermarkets frequently sell drinks at or below cost, to lure in customers: cheap strong cider means a Scotsman can reach his recommended weekly drinking limit of 21 units (210ml of pure alcohol) for just £4.62 ($7.50); an Irishwoman can buy her 14 units for €6.30 ($8.70). The trend is spreading. Walmart, an American chain, recently started selling beer almost at cost.

The cheaper the liquor, the more people drink. That is not just bar-room wisdom. A 2009 paper in *Addiction*, a public health journal, reviewed 112 distinct studies of changes in alcohol taxes and found an unambiguous link. This suggested that a 10% price rise in prices would cut consumption by around 5%.

Two groups are particularly price sensitive. Heavy drinkers tend to trade down and seek out cheaper booze to maintain their intake. They drink at home and are likely to die early of alcohol-related illness. Such topers account for a large share of consumption: in Scotland 80% of alcohol is drunk by 30% of boozers. A second category is young and under age merrymakers who often have low or minimal income. They cannot afford to drink as much when prices rise.

Most government initiatives on prices have been tentative. In 1998 Germany introduced a so-called “apple-juice law”: in places where booze is consumed, at least one alcohol-free beverage must cost less than the cheapest alcoholic one. This does not deal with domestic consumption, though, which accounts for most hazardous drinking. In 2014 Britain will introduce a ban on selling alcohol at below cost price, but this will affect less than 1% of all booze on sale, according to the Sheffield Alcohol Research Group, a British academic...
consortium. Alcohol duties in some tax-thirsty European countries have been rising for a decade but wine and cider are both taxed by volume, not just strength. That means a sweet wine with 6% alcohol bears the same tax as a riesling with 10%.

More convincing are the efforts of several Canadian provinces, which have a floor price for a unit of each type of alcohol: the stronger a drink, the more it costs. When this policy was introduced in British Columbia in 2002, with an average 10% price increase, an immediate, substantial and significant reduction in wholly alcohol-attributable deaths followed, says Tim Stockwell of the province’s University of Victoria. The longer-term effect is striking too. Over the 2002-09 period, figures show a 32% drop in such deaths. In Saskatchewan a similar price rise in 2010 was associated with an 8.4% drop in drinking.

Scotland is raising the bar. In May 2012 its devolved parliament passed an ambitious bill to introduce a minimum unit price of 50p. This would affect the price of 60% of booze on sale: a 70cl bottle of Tesco Value Vodka would rise by around £4.50, to around £13, but classy Smirnoff by only 13p, according to Scottish government calculations. The Scotch Whisky Association (SWA), a trade body, has challenged the legislation, which was due to come into force in 2013. It would breach European law and could affect exports, says its spokeswoman, Rosemary Gallagher. The SWA lost the case in Scotland’s highest civil court, but its appeal will be heard in February. If it loses again, it may appeal to London or to Europe.

Five continental wine-producing nations have joined the fight against Scotland’s law. Bulgaria, France, Italy, Portugal and Spain say it is illegal and could hurt their own drinks industries. Cheap plonk (mostly foreign) would suffer more than pricey whisky (mostly domestic), they say.

What happens in Scotland will affect policy elsewhere; other governments are watching the legal battle with interest. One house of the Swiss parliament has already voted for a minimum price though the other voted against. New Zealand is considering a bill. The British government pulled back from an earlier plan to introduce a nationwide floor price but may reconsider its policy if Scotland’s proves successful; some English councils are trying to introduce minimum pricing rules locally. The Irish cabinet is discussing a similar notion but awaits the Scots’ verdict.

For all their reputation as a nation of soaks, Scots actually constitute a small market. The SWA says its big concern is other countries introducing similar bills if the Scottish legislation goes ahead. The real fear is of “contagion”, agrees Martin McKee of the London School of Hygiene and Tropical Medicine. “Scotland shows Europe what is possible.” Just as bans on indoor smoking spread rapidly from country to country, the Scottish decision on the price of booze could raise drink prices all over the world. A sobering thought in the festive season.

From the print edition: International
The future of oil

Yesterday’s fuel

The world’s thirst for oil could be nearing a peak. That is bad news for producers, excellent for everyone else

Aug 3rd 2013 | From the print edition

THE dawn of the oil age was fairly recent. Although the stuff was used to waterproof boats in the Middle East 6,000 years ago, extracting it in earnest began only in 1859 after an oil strike in Pennsylvania. The first barrels of crude fetched $18 (around $450 at today’s prices). It was used to make kerosene, the main fuel for artificial lighting after overfishing led to a shortage of whale blubber. Other liquids produced in the refining process, too unstable or smoky for lamplight, were burned or dumped. But the unwanted petrol and diesel did not go to waste for long, thanks to the development of the internal-combustion engine a few years later.

Since then demand for oil has, with a couple of blips in the 1970s and 1980s, risen steadily alongside ever-increasing travel by car, plane and ship. Three-fifths of it ends up in fuel tanks. With billions of Chinese and Indians growing richer and itching to get behind the wheel of a car, the big oil companies, the International Energy Agency (IEA) and America’s Energy Information Administration all predict that demand will keep on rising. One of the oil giants, Britain’s BP, reckons it will grow from 89m b/d now to 104m b/d by 2030.

Scraping the barrel

We believe that they are wrong, and that oil is close to a peak. This is not the “peak oil” widely discussed several years ago, when several theorists, who have since gone strangely quiet, reckoned that supply would flatten and then fall. We believe that demand, not supply, could decline. In the rich world oil demand has already peaked: it has fallen since 2005. Even allowing for all those new drivers in Beijing and Delhi, two revolutions in technology will dampen the world’s thirst for the black stuff.

The first revolution was led by a Texan who has just died (see article (http://www.economist.com/news/business/21582482-few-businesspeople-have-done-
much-change-world-george-mitchell-father). George Mitchell championed “fracking” as a way to release huge supplies of “unconventional” gas from shale beds. This, along with vast new discoveries of conventional gas, has recently helped increase the world’s reserves from 50 to 200 years. In America, where thanks to Mr Mitchell shale gas already billows from the ground, liquefied or compressed gas is finding its way into the tanks of lorries, buses and local-delivery vehicles. Gas could also replace oil in ships, power stations, petrochemical plants and domestic and industrial heating systems, and thus displace a few million barrels of oil a day by 2020.

The other great change is in automotive technology. Rapid advances in engine and vehicle design also threaten oil’s dominance. Foremost is the efficiency of the internal-combustion engine itself. Petrol and diesel engines are becoming ever more frugal. The materials used to make cars are getting lighter and stronger. The growing popularity of electric and hybrid cars, as well as vehicles powered by natural gas or hydrogen fuel cells, will also have an effect on demand for oil. Analysts at Citi, a bank, calculate that if the fuel-efficiency of cars and trucks improves by an average of 2.5% a year it will be enough to constrain oil demand; they predict that a peak of less than 92m b/d will come in the next few years. Ricardo, a big automotive engineer, has come to a similar conclusion.

Not surprisingly, the oil “supermajors” and the IEA disagree. They point out that most of the emerging world has a long way to go before it owns as many cars, or drives as many miles per head, as America.

But it would be foolish to extrapolate from the rich world’s past to booming Asia’s future. The sort of environmental policies that are reducing the thirst for fuel in Europe and America by imposing ever-tougher fuel-efficiency standards on vehicles are also being adopted in the emerging economies. China recently introduced its own set of fuel-economy measures. If, as a result of its determination to reduce its dependence on imported oil, the regime imposes policies designed to “leapfrog” the country’s transport system to hybrids, oil demand will come under even more pressure.

A fit of peak

A couple of countervailing factors could kick in to increase consumption. First, the Saudis, who control 11% of output and have the most spare capacity, may decide to push out more, lowering prices and thus increasing demand. Then again, they might cut production to try to raise prices, thereby lowering demand further. Second, if declining demand pushes down the oil price, drivers may turn back to gas-guzzling cars, as they did when oil was cheap in the 1990s. But tightening emissions standards should make that harder in future.

If the demand for oil merely stabilises, it will have important consequences. The environment should fare a little better. Gas vehicles emit less carbon dioxide than equivalent petrol-powered ones.
The corporate pecking order will change, too. Currently, Exxon Mobil vies with Apple as the world’s biggest listed company. Yet Exxon and the other oil supermajors are more vulnerable than they look (see article (http://www.economist.com/news/briefing/21582522-day-huge-integrated-international-oil-company-drawing) ). Bernstein, a research firm, reckons that new barrels of oil from the Arctic or other technologically (or politically) demanding environments now cost $100 to extract. Big Oil can still have a decent future as Big Gas, but that will not prove as profitable.

The biggest impact of declining demand could be geopolitical. Oil underpins Vladimir Putin’s kleptocracy. The Kremlin will find it more difficult to impose its will on the country if its main source of patronage is diminished. The Saudi princes have relied on a high oil price to balance their budgets while paying for lavish social programmes to placate the restless young generation that has taken to the streets elsewhere. Their huge financial reserves can plug the gap for a while; but if the oil flows into the kingdom’s coffers less readily, buying off the opposition will be harder and the chances of upheaval greater. And if America is heading towards shale-powered energy self-sufficiency, it is unlikely to be as indulgent in future towards the Arab allies it propped up in the past. In its rise, oil has fuelled many conflicts. It may continue to do so as it falls. For all that, most people will welcome the change.

From the print edition: Leaders
FOR years it seemed that American consumers’ demand for liquid fuel was price inelastic—whether it was to drive their cars or get their brains going in the morning. Yet $4 seems to have been the price at which demand becomes elastic, for both petrol and a frothy latte. As a result, baristas at Starbucks coffee shops around America are starting to get a taste of what it feels like to be a carworker in Detroit. On July 1st the coffee retailer, based in Seattle, said it would close a further 500 stores in America (in addition to the 100 closures it announced earlier this year), and reduce its workforce of roughly 172,000 by around 7%.

A remarkable 70% of the stores due to close were opened after 2005, which seems to confirm the comment made by Howard Schultz, when he returned to the helm of the company in January, that most of Starbucks’ wounds were self-inflicted. As it expanded at a breakneck pace, the company opened too many Starbucks in subprime locations. But the deteriorating American economy is doing further damage. As a premium-priced supplier, Starbucks is suffering from the same trading down that is sending shoppers rushing from Target to Wal-Mart. McDonald’s, it seems, has perfectly timed its decision to start selling coffee that is pleasant to drink.

Shares in Starbucks are now trading at barely one-third of their peak value from two years ago. Yet, rather than being a sign of panic, the closures may be evidence that Mr Schultz means to return the company to its focus on quality, rather than growth. After closing all its American stores simultaneously for a brief retraining session a few months ago, there are plans for further improvements in the staff’s competence and demeanour, and in the cleanliness and comfort of its shops.

There are also innovations in the works, ranging from healthy smoothies, to a mysterious (and so far unnamed) Italian drink, to further automation. In March Starbucks bought the Coffee Equipment Company, a small outfit that produces a hugely expensive coffee-making machine called the Clover. It is now testing the machines in a handful of its American shops.

Admittedly, there have been some complaints about the introduction of the milder “Pike Place” filter-coffee blend. But on the firm’s popular new customer website, MyStarbucksIdea.com (http://mystarbucksidea.com), the main concerns are about the quality of the food sold by Starbucks and, above all, its prices. Encouragingly for Mr Schultz, there are also many positive suggestions, from serving vegan food to introducing a loyalty card, which suggests that plenty of customers still care for Starbucks enough to give him a chance to win them back—recession or no recession.
ECONOMISTS have long recognised the arguments for imposing special taxes on goods and services whose prices do not reflect the true social cost of their consumption. Such taxes are known as "Pigouvian" after Arthur Pigou, a 20th-century English economist. Environmental taxes are an obvious example. There is also a Pigouvian case for duties on cigarettes, alcohol and gambling. Smoking increases the risk of cancer for those in the vicinity of the smoker; alcohol abuse and gambling are strongly associated with violence and family breakdown. Moreover, all three habits lead to higher medical costs. In theory governments can make up these costs, or "externalities", with a tax that adjusts the prices people pay to puff, booze or punt. Such a tax might also encourage consumers to live healthier lives.

Support for another such tax, on junk food, is now spreading, especially in America. Congress is considering a tax on sugary drinks to help pay for the planned expansion of health-care coverage. Some analysts would like to see broader duties on junk food. On July 27th the Urban Institute, a think-tank in Washington, DC, proposed a 10% tax on "fattening food of little nutritional value" that, it claimed, would raise $500 billion over ten years.

The logic for a tax on fattening food may seem obvious. About one-third of Americans are obese, up from 15% in 1980. Fat people are more prone to heart disease, diabetes, bone disorders and cancer. An obese person's annual medical costs are more than $700 greater than those of a comparable thin person. The total medical costs of obesity surpass $200 billion a year in America, which is higher than the bill for smoking. These costs are not all borne by the obese. When health-care costs are shared, obesity becomes a burden for everyone. Thanks to government health-care plans such as Medicare half of America's obesity-related health costs land on taxpayers. In private employer-sponsored health plans the slim pay similar premiums to the overweight.

But would a fat tax affect behaviour? Numerous studies have shown a relationship between the price of food, especially junk food, and body weight. As fast food has become relatively cheaper, so people have become fatter. A new paper* from the RAND Corporation, another think-tank, suggests that taxing calories could have a sizeable, if gradual, effect on people's weight. The authors of the study look at changes in the weight and height of a large group of Americans aged over 50 between 1992 and 2004. They then calculate food-price indices that are skewed towards calorie-dense foods (so a change in the price of butter has more impact than a change in the price of vegetables). By controlling for individual and environmental influences on weight, such as income and health, they then measure whether food-price changes affect body-mass index (BMI). BMI, the ratio of weight in kilograms to the square of height in metres, is a common, if imperfect, gauge of whether someone is over- or underweight.

A person's BMI turns out to be hard to shift in the short term. A 10% increase in the calorie-heavy price index is associated with a small decline, of 0.22, in BMI within two years. But the effects are greater over the longer term. A 10% increase in the price of calories results in a fall in BMI of one to two points over 20 to 30 years. Such a drop would eliminate about half of the observed increase in obesity in America since 1980.
Even so, the idea of tackling obesity via the tax system has some serious flaws. First, there is the question of what to tax. Sugary drinks may not be nutritious, but hamburgers contain some protein along with their fat. More important, junk food is not itself the source of the externality—the medical costs that arise from obesity. Unlike smoking, or excessive gambling and drinking, eating junk food does not directly impair the well-being of anyone else. And because obesity is determined by lack of exercise as well as calorie intake, its ultimate relationship with health costs is more tenuous than that of, say, smoking. It is possible to eat a lot of fatty food, exercise frequently and not generate any externalities. A more direct, though controversial, approach would simply be to tax people on the basis of their weight.

**Fat chance**

The distance between junk food and the medical costs of obesity means that a calorie tax could have unintended consequences. A new theoretical paper in the *Journal of Public Economics* even suggests that a tax on junk food could increase obesity, especially among physically active people. If junk food, which is quick and easy to obtain, becomes relatively dearer, people will spend more time shopping for fresh ingredients and preparing food at home. That could leave less time for exercise.

Even if perverse consequences of this type look improbable, a junk-food tax may have less impact than its advocates expect. New studies on the effect of cigarette and alcohol sin taxes suggest heavy users are less influenced by price changes than others. An analysis of data from the National Longitudinal Study of Adolescent Health shows that American teenagers who smoke more than five cigarettes a day are only one-third as responsive to cigarette prices as lighter smokers. A complementary study of data from America’s Health and Retirement Survey shows that alcohol taxes are far less effective for the large minority of heavy drinkers. The biggest consumers of fattening food may prove similarly resilient to price increases, so a fat tax may do little to improve health, at least for today’s junk-food addicts. If these same consumers are poorer on average, it would also be regressive. One reason for this is that in some poorer neighbourhoods there may be little fresh food on sale. If junk is all there is, putting up its price will reduce real incomes and make little difference to eating habits and health. Like the foods they aim at, fat taxes look appetising but can have nasty effects.

* A full list of sources is available at Economist.com/fattaxes (http://www.economist.com/fattaxes)
Schumpeter
Business and management

Microcredit

Put to the test

May 16th 2013, 13:02 by M.B. | NEW YORK

ONCE illustrated with pictures of happy village women engaged in lending circles, and celebrated as an ideal charitable activity that helps people earn their way out of poverty, in recent years microcredit has become increasingly controversial. Critics have argued that giving poor people a small affordable loan is not in fact an effective way to help them escape from poverty. And the growth in loan volume has been driven lately by a bunch of for-profit microlenders who their critics say have motives that are anything but charitable.

The most successful of these for-profit lenders is a case in point. After Banco Compartamos, a Mexican microcredit bank, had an initial public offering of its shares in 2007, it was publicly chastised by Muhammad Yunus, who had won the Nobel Peace Prize for his role in developing the non-profit microcredit industry. "Their priorities are screwed up," Mr Yunus said in an interview. Compartamos made its profit by charging its poor customers annual interest rates on their loans of around 100%. "Microcredit was created to fight the money lender, not to become the money lender," noted Mr Yunus.

Compartamos, whose founders believe they are helping the poor, responded to these criticisms by inviting three economists, Dean Karlan, Manuela Angelucci and Jonathan Zinman, to examine the evidence. They devised two randomised control tests to find out the impact of Compartamos’s lending practices. The results were published on May 14th.

A first study looked at whether Compartamos really needs to charge 100% a year. The bank argued that this rate was necessary to cover costs and make enough profit to stay in business over the long run. The study found that demand for microcredit is more price elastic than
had been thought. Cut the annual interest rate by 10 percentage points and more people will
take out a loan whilst existing borrowers will increase the size of their loans. The effect of this
extra demand equalled the cost of lowering the interest rate, so by cutting rates
Compartamos could earn just as much profit while providing better service to more people.
Apparently, it is now considering doing so.

The second study examined what happened over the three years after Compartamos began
lending to groups of between 12 and 50 women in the state of Sonora, just south of the
border with Arizona. It found that borrowers were able to grow their businesses faster and
managed their financial risks better (in particular by avoiding having to sell assets on the
cheap to get through tough times). They were also less likely to feel depressed, and more
likely to trust others.

The study found no clear evidence that microcredit helped people escape poverty by raising
their income, however. But it also did not find any evidence that taking out a loan with an
interest rate of 100% a year actually made borrowers worse off on average (although women
who had not borrowed before lost ground on average, a finding that has prompted
Compartamos to offer first time borrowers financial education). Either three years is too
short a period to measure the poverty easing effects of microcredit, or it is a much less
powerful anti-poverty tool than some of its boosters have claimed.

Perhaps the clearest impact of microlending in the study was its impact on the power of
women in the home. Female borrowers gained control over a significantly larger number of
household decisions. What did their husbands think of this? The study reports that these
more empowered female borrowers did not experience any increase in domestic conflict.
Overall, then, the studies show that microcredit, even the for-profit kind, typically benefits
borrowers in a variety of ways, even if it does not lift them immediately out of poverty.