

## **Microfinance and the New Institutional Economics in the Developing Countries**

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### **Biography of the author**

Professor Einarsson is the former dean of the Faculty of Economics and Business Administration at the University of Iceland. He obtained his PhD in Germany. He is the author of 6 books on microeconomics, business administration and cultural economics and over 50 journal articles and conference papers and over 400 shorter articles on economics, fisheries and politics in magazines, newspapers, and on websites. Professor Einarsson is a former Member of the Icelandic Parliament and Chairman of the Board of the Central Bank of Iceland and served as a delegate for Iceland at the General Assembly of the United Nations in New York.

### **Abstract**

The paper shows how the new institutional economics can be used to address microfinance in the developing countries, especially to analyze problems related to uncertain property rights. Microfinance, as a system of promoting savings and providing a basis for lending to the poor, is an important and growing aspect of the economies of many developing countries. Most of the enterprises taking advantage of microfinance are small and medium sized enterprises (SMEs) and family businesses. Microfinance takes many forms in the developing countries, which is particularly true of arrangements for securing solidarity and discipline, which take advantage of the system of informal assistance that often characterizes these communities. Moreover the new institutional economics provides useful tools for analyzing incomplete information, weak infrastructure, unreliable judicial systems and high transaction costs, all of which are common problems facing microfinance in the developing world. The new institutional economics has specialized in problems related to agency, property rights, and transaction costs, which are all relevant to developing countries. The lack of registration of assets, and thereby the lack of creditworthiness of their owners and inability to increase capital through borrowing, is directly related to property rights. A great deal of economic activity in the developing countries is carried out extralegally, outside the official economy, and one consequence of this is that assets, for instance real estate, are not registered and therefore cannot serve as security for loans. Better organization of property rights is a prerequisite for the growth of microfinance, but any reform of existing formal rules in any society must take account of its informal rules. One of the most important issues in the developing countries is to ensure the proper registration of assets, thereby creating a secure basis for lending activities suitable for the banking sector, which will strengthen the SMEs and family business in these countries.

### **Keywords**

Microfinance, microcredit, new institutional economics, property rights, developing countries

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## 1. Introduction

Section 2 of this paper contains a short description of microfinance in the developing countries, which suffer from the unequal world distribution of income and are characterized by weak infrastructure and poor coordination of effort by all sectors, private and public. Section 3 discusses why the new institutional economics (NIE) provides a useful approach for studying microfinance, particularly by applying theories of transaction costs, agency, and property rights. Microfinance, for instance, is plagued by high transaction costs. Section 4 discusses the problems of property rights in the developing countries as regards microfinance, where poorly defined property rights obstruct the creation of capital. The final section concludes.

## 2. Microfinance institutions in the developing countries

Microfinance organizations, which specialize in lending to poor clients, tend to be small, high cost, and engaged in risky lending where security is lacking. (Morduch, 1997).<sup>2</sup> 80% of the world's population have no access to banking services (Robinson, 1998). The distribution of income among the nations of the world is very unequal; of the six billion people in the world, 1.2 billion subsist on less than one dollar a day, and 10 million children died in 1999 from preventable diseases (World Bank, 2001). In 2000, the gross national income (GNI) at purchasing power parity (PPP) per capita in the world was \$7,410. In low-income countries (40% of the world's population) the GNI in PPP per capita was \$1,980, but for high-income countries (15% of the world's population) it was \$ 27,770 (World Bank, 2002). Economic growth in the developing countries is uneven but often very slow. Out of 95 developing countries, 28 actually experienced a decline in gross domestic product (GDP) per capita between 1964 and 1999 (United Nations, 2000). There were 1.3 billion inhabitants on Earth in 1900, and this number is projected to increase from today's six billion to eight billion in 2030. Future difficulties in providing access to food, water and shelter will therefore be tremendous (Einarsson, 2001). Although progress in biogenetic sciences will greatly assist in the supply of food, increased capital, particularly human capital, in the form of education and knowledge, and social capital, in the form of relationships among people contributing to economic development, is a prerequisite for success.

The evidence shows that microfinance<sup>3</sup> can give good results, e.g. in the case of the Grameen Bank in Bangladesh. The bank is operated as a member-based financial organization. Groups of five members are formed, where each owns less than half an acre of land and saves a specific amount every week. Loans granted by the bank are repaid in 50 weeks and 5% of each loan is paid into a special fund. All the members of the group are liable for the loan, and attendance is mandatory at weekly meetings of the group and at a special development center consisting of 5-8 groups (Johnson & Rogly, 1997). The Grameen Bank has over two million members; 94% of the borrowers are women, who have proven a three times better credit risk than men (Khandker, 1998). The high proportion of microfinance loans to women underscores the importance of this form of lending for women's rights in the developing countries. Increased participation of women in the economy, together with their increased education, is one of the most effective means of bringing about progress in the developing world. Microfinance has another advantage. Poor people rely on an informal system of communal assistance, and regular group meetings in member-based financial organizations contribute to social capital (Rosenweig, 1998 and Anderson, Locker & Nugent, 2002).

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<sup>2</sup> For numerous reasons, including corruption, the policy of aid to the poor in the form of subsidized loans has not given the intended results for numerous reasons.. Such loans do not guarantee access to credit, and their impact on interest rates discourages saving. (Adams, 1998).

<sup>3</sup> One of the earliest forms of microfinance is described by the Danish writer, Karen Blixen. In her book, *Shades in the Grass*, Blixen describes how villagers outside the city of Nairobi in Kenya each put 1.000 rupees into a pot, from which loans could be taken for a specified time for as long as the pot lasted. Sometimes there was a wait for the money to trickle back, and occasionally the register of borrowers preserved in the pot would be consulted and borrowers asked to speed up their repayment so that new loans could be granted.

A prerequisite for effective lending to the poor is saving. The poor people in the developing countries are quite capable of saving (Getubig, Gibbons & Remenyi, 2000) but one of the main problems of microfinance is the lack of a solid infrastructure capable of ensuring secure savings. Other factors, such as education, health care, a good justice system, efficient communications and transparent government are also of great importance. The methodology of microfinance has also been used with good results in the developed countries (Ashe, 2000, Copisarow, 2000 and Burrus, 2002). Virtually all enterprises which obtain credit through microfinance institutions are small and medium sized, in most cases microscopic. Also, the most common form of enterprise is the family business, where a family or families pool their efforts to start a business and take out a loan to do so.

### **3. The application of New Institutional Economics to Microfinance**

New Institutional Economics (NIE) addresses, *inter alia*, imperfect information and different perceptions by individuals of their environment. Institutions represent the formal and informal rules that impose constraints on individual behavior (North, 1990). Organizations, which include enterprises, are sets of actors who co-operate in production. Transaction costs are the opportunity costs of gaining control of resources. Property rights are defined as the rights of individuals to use resources (Eggertsson, 1990). Property rights can consist in the informal rights to the disposal of tangible objects or intellectual work, or they can ensue from agreements or legislation. Institutions in any economy influence transaction costs, which means that the framework underpinning the rights of individuals to the disposal of property affects outcomes in the economy. NIE addresses phenomena, such as organizations and behavior as well as cultural differences in behavior between individual countries and ethnic groups. Research in the new institutional economics emphasizes transaction costs, agency, and property rights, all of which are relevant for developing countries.

Transaction costs are divided into three types of costs, market transaction costs, managerial transaction costs and political transaction costs. Market transaction costs, i.e. the cost of using the market, can be divided into search and information costs, bargaining and decision costs and supervision and enforcement costs. Managerial transaction costs are the costs of setting up, maintaining, changing and running an organization. Political transaction costs are the costs of setting up, maintaining and changing the formal and informal organization of a system, which include the costs of establishing the legal framework (Furubotn & Richter, 1997). Transaction cost economics explains what transactions are conducted across markets and what transactions are conducted within organizations. Transaction cost economics is based on two principles of human behaviour: bounded rationality and opportunism.<sup>4</sup> Transaction cost economics can also be used to explain different forms of organization such as peer groups and simple hierarchies (Douma & Schreuder, 2002). Small enterprises are normally organized in a very simple hierarchy, i.e. a group of employees with one manager, which is the normal form of microfinance organizations and their customers.

Transaction costs arise because of incomplete information. One person may know more than another in any given transaction, e.g. the seller of a product may know more about a product than the buyer (asymmetric information). Another reason for imbalance in information is that formal, written rules of law and contracts are often modified or elaborated by unwritten, informal rules of usage. Communities with weak institutions, as in the developing countries, have fewer possibilities and less confidence in the market, which reduces specialization and prevents economies of scale. In a developed environment, enterprises have a system for resolving disputes without intervention by the courts, which is usually an expensive recourse. Such a solution can only exist in a secure

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<sup>4</sup> Bounded rationality implies that people are limited in their ability to make complex decisions that require analyzing extensive data. The rational choice model, however, does not recognize such limits on decision making. Opportunism arises because human beings will try to exploit a situation to their own advantage (Williamson O.E., 1985).

environment where the parties involved can trust each other, but trust is obviously an important factor in economic transactions (Clague et al., 1997).<sup>5</sup>

Agency theory distinguishes between a positive theory of agency and the theory of principal and agent. The positive theory of agency looks at organizations as a nexus of contracts. It explains why organizational forms are the way they are. The theory of principal and agent is the main element of the contemporary agency theory. This theory takes account of risk. In its simplest form, a relationship exists between a single principal and a single agent. The agent carries out a task for the principal and incurs some cost. The outcome is dependent on the effort he makes (Douma & Schreuder, 2002).

Microfinance is frequently implemented in the form of group lending, where relations within the group are based on certain rules. In a sense, the groups have agreed on common ownership of financial resources where the rights of disposal are restricted. Relations within the groups and the relations of lender and borrower is the subject of the agency theory. Loans granted to the developing countries by international organizations, such as the World Bank, and earmarked for specific projects fit well within the framework of NIE, that is to say within the context of contractual relations in agency theory. Under NIE, lending of this kind might be considered unfeasible because it is impossible to exclude opportunistic behavior on the part of the governments taking the loans.<sup>6</sup> A comparable situation in the context of microfinance would arise if a lender and a borrower were to contract over the use of a loan, e.g. for the establishment of a small enterprise, but owing to the high costs of monitoring, supervision by the lender would be difficult.

#### **4. The Problems of Property Rights in Microfinance**

In property rights theory a distinction is made between absolute and relative property rights. The first case involves private property rights and the second involves rights to contract. All must observe absolute property rights, which involve the rights to objects. The right to control in this analysis also extends to all rights, including the right to natural resources. Anyone who controls something must be subject to some rule of order, whether it is a national constitution, legislation or a contract. Because individuals may be expected to behave in a rational manner, it is possible to anticipate how a certain structure of property rights will affect the use of a natural resource or its disposal in a community. Relative property rights exist when there are certain undertakings or obligations attached, either under contract or under law, e.g. credit-debt relations as in microfinance. Relative property rights, in their widest sense, extend to rights arising out of a personal relationship, e.g. a business relationship or political relationship. A business relationship can make contracting parties so dependent upon one another that they are locked into a kind of contractual relationship. Thus, it can happen that a relationship which was formerly characterized by competition between a source of supply and a source of demand in a market develops into a monopoly (Furubotn & Richter, 1997).

In many parts of the world, extensive economic activity takes place outside the domestic legal order, and NIE is particularly suitable for analyzing many aspects of such extralegal activities, especially the structure of property rights. Independent economic activity which is not documented anywhere by public authorities forms a part of the system of informal rules that exist in any community. Activities outside the scope of formal rules involve high transaction costs and prevent the formation of capital because assets cannot be used as collateral since their ownership is not formally registered. The informal rules which are common in microfinance, and vary from culture

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<sup>5</sup> A study of the coffee trade in Tanzania finds that the liberalization of the coffee trade in Tanzania resulted in reduced costs (as expected), but surprisingly the transaction cost of financing activities, which had formerly been based on linked informal transactions, increased. This demonstrates that the impact of changed business procedures must be examined closely in order to secure effective implementation (Winter-Nelson & Temu, 2002).

<sup>6</sup>For instance, a government might not use the proceeds of the loan for their intended purpose, and the World Bank would have no opportunity for active surveillance or intervention. In a worst-case scenario of this kind, governments might deliberately take loans from international organizations with the premeditated intent of using the funds for purposes other than those provided for in the loan agreement (Toye, 1995).

to culture, have a direct relation to the methodology of NIE, where institutions are arrangements of human behavior which include both formal and informal rules. If changes are made to the formal side of microfinance it is important for the changes to be consistent with the informal rules. It is a general principle that if no account is taken of informal rules in the course of reform, it is likely that the reforms will fail.

In the context of NIE, the views of Hernando de Soto regarding secure titles to property are very interesting. He claims that the primary problem of the developing countries is that assets are not registered and therefore not creditworthy, and that this is the same problem that the industrial states faced 150-200 years ago (de Soto, 2000). The problem of the developing countries is primarily that they have no possibility of obtaining credit based on assets which are substantial but unregistered. This problem is compounded by the lack of rules and the great migrations from rural areas to urban areas, where a large part of economic activities is extralegal. The implementation of microfinance in the developing countries is fraught with difficulties because it is complicated to pledge assets to secure loans when ownership cannot be proven officially and definitively; at the same time, however, the importance of real estate as security for loans is growing (Gelos & Werner 2002). The analysis above relates directly to microfinance, as the difficulty of lending to the poor is due precisely to the lack of security, which in many cases is not that there are no assets to pledge, but that these assets are to a greater or lesser degree unregistered and the title to them is not even clear. This applies not only to real estate but also to movable properties which are important for poor people in the developing countries.

Proper administrative procedures for establishing property rights are extremely important, and slow, inefficient administrative procedures, e.g. registration of companies, assets and operating licenses, are a great impediment to progress. This results in higher transaction costs. Of equal importance is the legislative framework and the will of the authorities to protect and encourage saving, as reflected in measures taken to preserve the integrity of financial systems and the strength of currencies. The lack of a strong framework for saving in the developing countries, which is an integral part of microfinance, is related to inefficient property rights which include problematic external regulation and supervision. In the developed countries, the sale of real estate is regarded as a relatively simple act, although it involves a complex process which is hundreds of years old; this process and infrastructure is lacking in many developing countries.

A western entrepreneur will normally obtain capital for his enterprise through loans which are provided through the banking sector. This encapsulates the difference between the entrepreneur in the developed countries and his counterpart in the developing countries. A western entrepreneur with a project can frequently obtain a loan, for which he will usually post security, e.g. in the form of his own home or property belonging to his close family. This avenue is closed to the entrepreneur in the developing countries, even if he owns a piece of real estate, because the property is not registered to his (or anyone else's) name in any definitive manner. Banks in the developing countries do not have the same access to debtors' assets, as do banks in the developed countries. The adaptation of new ideas that recognize existing informal rules can change matters quickly; for instance, the registration of real estate or movable properties in order to make them suitable as security would transform the possibilities for obtaining credit in the developing countries. The importance of getting a grip on extralegal property rights is clearly revealed by de Soto, who points out that "the recognition and integration of extralegal property rights was a key element in the United States becoming the most important market economy and producer of capital in the world" (de Soto, 2000, p. 148).

Within the discipline of NIE there has been much discussion of the importance of property rights for the effective utilization of various types of resources, including common pool resources. (Pejovic, 1998). Property rights also govern the exchange relationships that an entrepreneur intends to establish through microcredit. If he plans to set up a small enterprise, e.g. a manufacturing plant, to sell his products on the local market, the arrangements regarding marketing makes a great deal of difference. Unclear property rights are an obstacle to economic growth and improved living standards and microfinance, as a part of development policy, must aim at creating and

implementing efficient property rights (North, 1995). Fig. 1 shows the relation between the conceptual framework of NIE and some elements of microfinance.

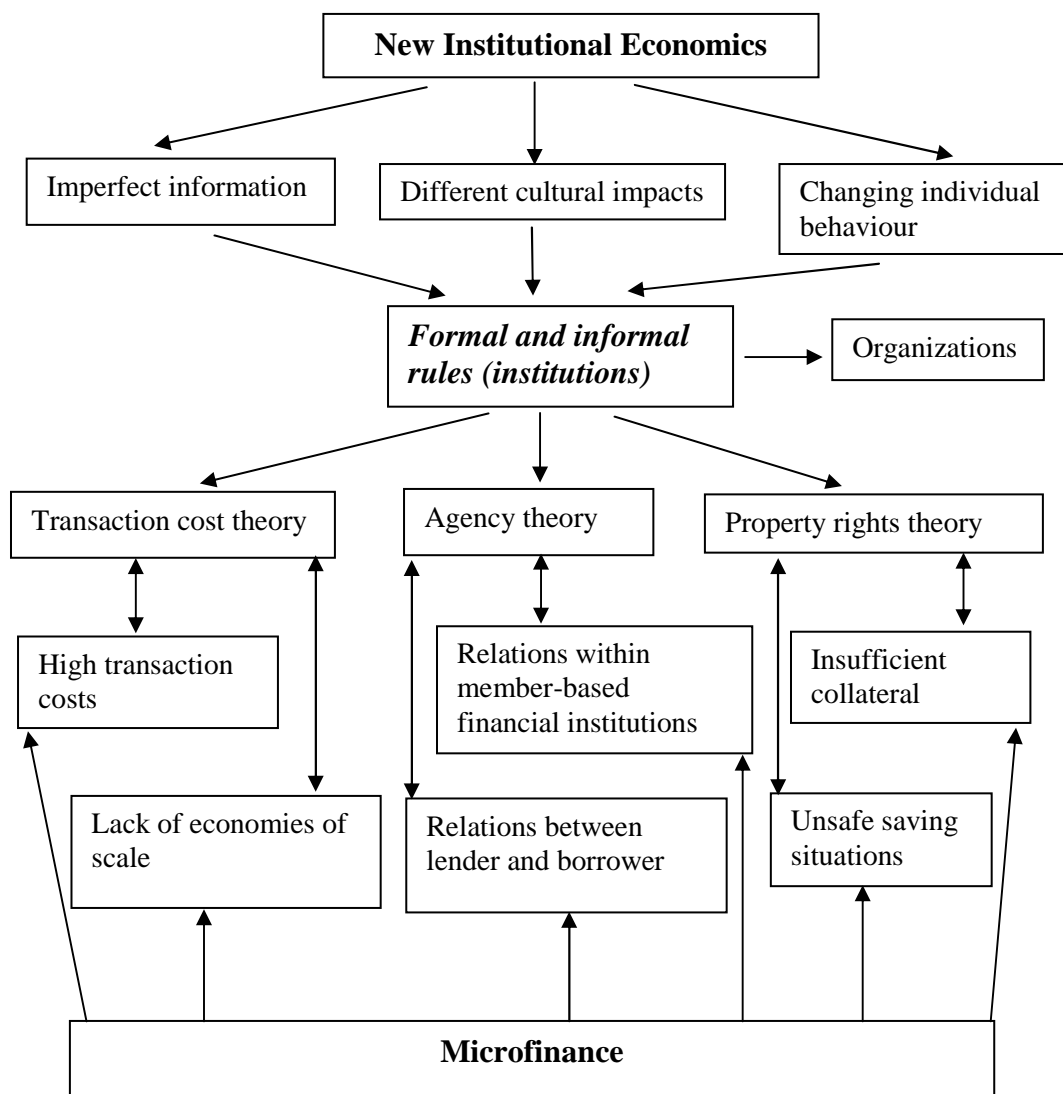


Fig. 1: The new institutional economics and microfinance

The prerequisite for economic progress is technology, which can be divided into production technologies and social technologies. One of the principal problems impeding economic progress in poor countries is their inability to apply social technologies necessary for progress, such as well designed and secure property rights. Appropriate structure of social institutions is a prerequisite for prosperity and an inadequate institutional environment combined with the inability of government to reform the environment is the major obstacle to economic progress (Eggertsson, 2002). The problems of microfinance, which we have discussed in connection with property rights, are largely caused by inappropriate institutional environments.

## 5. Conclusion

The success of member-based financial institutions, such as the Grameen Bank in Bangladesh, has demonstrated the importance of microfinance, particularly for women, small and medium sized enterprises and family businesses. Microfinance, both in the form of lending and saving, represents only a small part of what has to change in the developing countries in order to improve their living

conditions, but other matters are also important, especially more education, improved infrastructure and better health care. One advantage of microfinance through its positive effect on human capital and social capital.

The new institutional economics offer numerous possibilities for analyzing the problems of microfinance, such as the complicated agency relationships between lenders and borrowers. The absence of formal property rights is one of the principle problems of developing countries and one of the most important contributions of NIE to microfinance is the analysis of uncertain property rights. This includes activities that are outside the official system (extralegal) and the problem of unregistered assets which cannot be used to secure loans. Property rights are poorly specified in most less developed countries, and the situation is comparable to the situation one or two centuries ago in many industrial countries. A clear definition of property rights is very important for ensuring better collaterals for loans through microfinance institutions.

The study of these problems has suffered because the analytic perspective has been too narrow. As Bates put it, "... the problem itself acquires a different coloration. It is no longer one of pure economics. The new institutionalism thus stands as an important addition to the development literature. However, it will achieve its full promise only when it becomes a part of a broader field, the field of political economy" (Bates, 1995, p. 47). Whether we wish to take NIE that far is left to the reader, but one of the principal reasons for the limited success of the industrial states in promoting development in low-income countries is the "limited understanding of the relation between formal and informal institutions" (Eggertsson, 1996, p. 22). Further analysis of microfinance as a part of the framework of NIE calls, among other things, for a better understanding of why appropriate social institutions for supporting the arrangement are lacking in many countries.

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