

UN-DUE CREDIT: IS FORMAL LAW ESSENTIAL FOR DEVELOPMENT?

Peru and Bangladesh in Comparative Perspective

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Introduction

Ever since law was identified as the “elusive epsilon” in the development equation, millions of dollars have been spent each year on shiny new courts, better-trained judges and legislative reform in the developing world.¹ It stands to reason that any society, and certainly any economy, needs rules to function. But is it really clear what *form* these rules need to take? Do laws have to be formal and Western-style, involving the complex apparatus of constitutions, legislation and courts of law? Or can well-established informal norms like customs, traditions, social sanctions and codes of conduct play the same role? The presumption, in both the academic literature and in policy practice, led by the highly influential Chicago-school of law and economics, has been that formal law is indispensable for development.² But is this presumption justified?

This very question confronts China today. Despite the fact that China has evolved a framework of legal and institutional norms that has facilitated its incredible growth, there is a great deal of pressure on it to adopt a more formal legal framework- particularly with respect to economic matters. Chicago-school law and economics – emphasizing the importance of formal law for development, particularly for protecting private property and the enforcing contracts - has been very influential in this discourse.³ We argue, however, that Chicago-style law and economics makes assumptions about the economy, as well as what the law is and how it functions that are far from trivial, and mostly untrue. In particular, it holds that social norms play no role in the legal process and that we can put down a fully articulated set of rules. But, as we will see, property rights are fundamentally affected by norms of use, and contracts are never complete.

The primacy traditionally accorded to formal law is called into question by a twin set of factors in recent development experience. The first is the failure of formal law in large swathes of the developing world to effectively reach the majority of its people. Indeed, according to a recent report of the Commission for the Legal Empowerment of the Poor, 4 billion people are “excluded from the rule of law.”⁴ India, a proverbial “bottomless pit” of rights—with an elaborate written constitution, a wide array of legislative protections and a sophisticated court apparatus, but a failure to provide effective access to rights—is a case in point.⁵ The second is the unexpected success of unconventional institutional structures. The paradigmatic example of this is China itself—the greatest development success of recent times, achieving its unprecedented growth rates in the absence of clearly-assigned private property rights in the Western sense.⁶ We seek neither to dismiss the desirability of the “rule of law” regime nor to glorify it, but rather to question the singularity of both the academic and policy focus on it.

The formal-informal dichotomy may be false to the extent that most legal systems contain elements of both, but it is certainly true that in transitioning to developed markets, countries encounter important choices with regard to their strategy for institutional reform.⁷ Indeed, although the Chicago-school would argue that rapid legal formalization is imperative, there are, in fact, two very different institutional experiments underway for making this transition – one emphasizing legal formalization, in keeping with the orthodoxy, and the other taking an altogether different, more norm-based approach. The first approach is exemplified by the Hernando De Soto inspired land-titling program in Peru, and the second is illustrated by the trust-based microfinance

program of Muhammad Yunus' Grameen Bank.⁸ We contrast these two experiments to bring the lessons that we learn from them to bear on the critical institutional choices facing China, and to underscore the existence of alternatives to the monochromatic focus of the Chicago school on formal law to the exclusion of all else.

The basis for comparing the Peruvian and Bangladeshi programs may not appear immediately obvious, but a closer examination reveals uncanny similarities between them. Indeed, Yunus and De Soto concur almost entirely in substantive terms: Both emphasize the skills of entrepreneurship of the poor, the importance of the poor lifting themselves out of poverty rather than becoming dependent on charity, the responsibility of institutional mechanisms for keeping the poor impoverished and, most critically, the importance of *access to credit* for the poor as a means of alleviating poverty.⁹ Where they differ, crucially, however, is in their institutional innovations—their choice of mechanism for credit delivery. De Soto is insistent on transfer of formal legal title of land occupied by the poor to them so that they can use this land as collateral to access credit through the formal banking system.¹⁰ Yunus, on the other hand, provides credit to the poor without collateral, mediated only by trust-based peer monitoring networks whereby borrowers are organized into groups in which, broadly, the ability of group members to borrow depends on the other members repaying. After members are established, however, lending is increasingly done on an individual basis based, largely, on the borrower's desire to maintain a good reputation with the lender.¹¹ Although neither is explicitly a legal reform program, if these two schemes are seen in the light of their common goal - to enable the poor to access credit as a means of alleviating poverty - they allow us to conduct a systematic comparison of the regulatory mechanisms that underlie them: one based,

predominantly, on formal legal intervention, and the other, primarily, on informal regulation.

This comparison proves extremely significant for a number of reasons. First, the fact that the two schemes pick such dramatically different mechanisms, one substantially *informal* and the other substantially *formal*, for achieving the same goal—access to credit for the poor—allows us to compare the performance of the two mechanisms against a common benchmark. We realize that this distinction is far from absolute. Thus, while the relationship between the bank and borrower is informal within the Yunus model, the relationship between the bank and State is mediated by formal law i.e. the Grameen Bank Ordinance 1983. On the other hand, the claim that the De Soto model wants to formalize i.e. the rights of squatters through *de facto* occupation is essentially an informal one. In addition, De Soto calls for incorporating elements of the “extra-legal” into the formal legal code. Nonetheless, we argue that the thrust of the two programs is different enough to provide stylized representations of the opposing directions in which legal reform programs can go: a rapid move from informality to legal formality or a gradual building up of a code of informal norms that may subsequently be formalized. Second, the real world implementation of both models—primarily in the form of the Grameen Bank¹² in Bangladesh and the 1996 titling program in Peru¹³—provide empirical evidence on the performance of the schemes. Third, both programs have had tremendous international influence. De Soto’s Lima-based think tank, the Institute for Liberty and Democracy (ILD), has not only advised the Peruvian government’s titling program¹⁴ but is also advising governments around the world on how to replicate it.¹⁵ In addition, international organizations like the World Bank¹⁶ and the United Nations (especially through the work

of the Commission for the Legal Empowerment of the Poor)¹⁷ have taken on board De Soto's recommendations. The Grameen Bank, on the other hand, has directly supported the establishment of replicas in 34 countries (to say nothing of the hundreds of microfinance organization that it has inspired all over the world), as well as at least equal influence on international development agencies.¹⁸ The United Nations, in particular, has focused much attention on microfinance, particularly in the context of achieving the Millennium Development Goals, declaring 2005 as the Year of Microcredit.¹⁹ At the same time, the World Bank is the largest investor in microfinance worldwide.²⁰ Finally, this comparison is of enormous academic and policy significance in facilitating the formulation of successful legal reform strategies.

Indeed, it is somewhat surprising that despite the amount of academic and policy attention that these programs have attracted and their obvious commonalities, they have been operating in parallel without any systematic attempt being made to explore the equally obvious tensions between them. If we agree that access to credit is an important policy goal, what is the superior way of achieving this goal—through formal law or informal norms? More broadly, does this comparison tell us anything about the better way of achieving our developmental goals, and regulation, more generally?

Although this paper is essentially theoretical, we use illustrative evidence from the Grameen Bank and the Peruvian titling program - based on insights gathered over twenty years spent observing the programs and extensive interviews in the field, as well as the now-vast empirical literature.²¹ Additional evidence is presented from program replicas from various parts of the world in order to establish a broader generality to the results.²² We emphasize, however, that context is of the essence: the choice of the

regulatory intervention that is likely to work in a given context is bound to depend on the type of social capital more readily available.²³ Thus, it is impossible to conclude that one intervention is superior to the other *per se*, but rather, to say that a particular intervention works better given a particular set of circumstances. It may well be that a program that is very appropriate at one stage of development may cease to be at another. We return to this point later in the paper.

We will focus on four central questions: First, how does the De Soto scheme perform? In particular, as the most recent vintage of high-profile formal law reform projects, does it overcome the chronic problems faced by its predecessors – legal transplants that fail to take root in the developing world? Second, how does the more informal, community-based mode of regulation associated with the Yunus-model perform, especially in relative terms? Third, are formal law and informal norms, ultimately, substitutes or complements? And, finally, how can the relationship between law and norms be characterized? The following two sections of the paper will probe the answers to the first two of these questions in the context of the *efficiency* and *equity* impacts of the Yunus and De Soto programs. The subsequent section will summarize the *static* position. Next, we will explore the *relationship* and *dynamics* between formality and informality. The final section concludes.

Although both microfinance and titling have been studied extensively individually, this paper seeks to contribute to the literature in several different ways. First, we take a primarily *comparative* perspective – not emphasizing the assessment of either of the programs individually but, rather, on their relative merits. Second, we focus on the programs explicitly in the context of the *formality-informality debate* in law and

development. Finally, we adopt a more *legal perspective* than the predominantly economic literature has so far tended to. The central task of the paper will be to draw insights from the comparison of formal and informal means to achieve a common developmental goal—in this case, access to credit—for systems of regulation in general.

Efficiency

We begin by comparing the relative performance of the two models in terms of their levels of efficiency. Legal efficiency can be defined in many different ways, but the model adopted here will be the *contractual model*. Although this is a highly stylized model of the functioning of legal systems, it has several advantages. First, it provides analytical simplicity. Second, all law can be seen, at some level, as a binding agreement between two parties, of which one may be the State. Finally, it is the definition emphasized in the literature due to its obvious economic importance in inducing individuals to enter into mutually beneficial transactions—the very basis of economic growth.

In order for a contracting model to be effective, it must address the dual problems of design and enforcement. The design problem pertains to inducement to enter into a mutually beneficial contract, as well as other issues that pertain to the quality of the contract like risk sharing arrangements, specificity of rules and so on. The enforcement problem, of course, refers to that of effectively ensuring compliance with the terms of the contract. Specifically, in this instance, the design target is to provide access to credit for the poor, while the enforcement target is that of ensuring loan recovery. The two issues

are related (i.e. the one impacts the prospects of the other) but separable (i.e. a model may achieve one but not the other). Design and enforcement are related in the sense that individuals are unlikely to enter into a contract unless they consider the promise of enforcement credible. At the same time, if individuals aren't induced to enter into a contract at all, the question of enforcing it doesn't arise. However, they are distinct in that individuals might be lured to enter into a contract on the basis of a belief in the enforcement system, but this belief may be false. The recent subprime mortgages crisis is a paradigmatic example of this. On the other hand, individuals might be deterred from entering into a contract because the prospects of enforcement appear unsatisfactory where they might, in fact, be extremely sound. I might, for instance, be an extremely trustworthy person but, if you do not believe that I am, you will not loan me \$500 even at a 40 percent interest rate. It becomes clear, then, at the very outset that *subjective beliefs* are of fundamental importance in making or breaking the contract.

Having settled on the contract enforcement model of the law, it is informative, at this stage, to consider the kinds of institutional arrangements that would theoretically lead to the performance of mutually beneficial contracts. Dasgupta (2003) identifies four models. The first is "mutual affection" based on group members caring about each other. The second is "pro-social disposition" based on norms of reciprocity due to both evolutionary development and socialization. The third is "mutual enforcement" based on fear of social sanction in the context of long-term, settled relationships in a community where people encounter each other repeatedly in the same situation. The fourth is "external enforcement" based on enforcement of an explicit contract by an established third-party authority that is typically, but need not be, the State. This is, evidently, the

model represented by formal, Western-style legal systems. It is significant that this model rests, crucially, upon a sufficient number of individuals *opting in* to the system of authority. Another factor, of course, that might ensure compliance with the contract, is sufficient coercive force. Although an element of coercion is contained in any State legal system, unless mixed sufficiently with a voluntary acceptance of the system, the normative implications of the use of force to keep contracts is highly questionable. In addition, enforcement achieved largely through coercion, even if feasible, is highly uneconomical.

The odds of these arrangements succeeding must be weighed against the obstacles that exist to achieving coordination through contract enforcement, even if the contract is in the interests of all in the long run. This is referred to, in the literature, as a collective-action or co-ordination problem.²⁴ North (1991) characterizes the institutional conundrum as follows: Although there are obvious gains to be had from cooperation, it can often be contrary to both individual interest and to economic performance in the short run. Further, Hoff and Stiglitz (2008) show that dysfunctional institutions may persist, and a constituency for the rule of law may fail to be established, despite its being in the interests of all in the long run on the basis of short term exit costs faced by those with control rights. How actors behave in this model rests upon their expectations of whether the rule of law will be established or not. Thus, a successful institutional structure will have to set the incentives right to be able to balance the trade-off between short-term costs and long-term gains to achieve compliance and co-ordination. Key to this calculus appears to be the *beliefs* of agents within the system. In particular, with respect to credit markets, Hoff and Stiglitz (1990) have identified three problems that lending institutions

need to grapple with: selection, monitoring, and enforcement. The lower the *information costs* of overcoming each of these problems in the two models, the more efficient it is.

We turn next to the empirical evidence on the ability of the two schemes to overcome these twin problems. Although approximately 1.2 million Peruvian households received title under the De Soto scheme, it appears to have largely failed to lead to the postulated increase in access to credit, particularly from the private sector (Field & Torero, 2004).²⁵ Calderon (2004) provides further evidence of the lack of a link between titling and private-sector lending in Peru. He estimates that by 2002 only about 1 percent of titled families had obtained mortgages or mortgage loans.²⁶ Similarly, in the Argentinean context, Galliani & Schargrodsky (2005) find that effects of titling on access to credit are extremely modest.²⁷ In the case of Colombia, Gilbert (2002) finds that “possession of legal title makes little or no difference to the availability of formal finance.”²⁸ This shows evidence of problems of both design and enforcement. In stark contrast, not only has Grameen entered into informal lending contracts with over 7 million poor borrowers, but the peer monitoring mechanism has proven to be an extremely effective means of enforcing contracts, with a repayment rate of 98 percent (Grameen Bank; Hossain, 1988). Similarly, a study by Sharma & Zeller (1997) finds comparable repayment rates for several other microfinance organizations in the Sub-continent.²⁹ Thus, counter to the theoretical faith vested in formal legal systems, the relative success of the informal Grameen mechanism in inducing entry into mutually beneficial contracts and ensuring that the contracts are honored is unambiguous.³⁰

The De Soto model

The elements of the De Soto model are simple. The design innovation of the model is the attempt to use collateral to overcome the contracting problem. De Soto postulates that whereas conventional commercial banks were reluctant to enter into loan contracts with the poor, the ability of the poor to provide security in the form of land, as collateral, will overcome this problem. In enforcement terms, De Soto adopts the external enforcement model where responsibility for enforcing the contract is vested in a third party—the State legal system. There are problems with both aspects of the De Soto contract.

With regard to the design of the contract, the fundamental problem is that it fails to create a sufficient inducement to enter into the contract for both parties—the lender and the borrower—for credit flow to increase. To begin with, De Soto’s assumption that the problem of access to credit is based on the absence of collateral is doubtful. Indeed, in the developed world, most loans are made based on future cash flows rather than collateral. Second, even if collateral were a material consideration, the existence of a complete set of land markets robust enough to support the use of land as collateral is assumed as a given by the scheme, despite much evidence of their absence in most parts of the developing world (Platteau, 2000; Gilbert, 2002). A partial explanation may be that, given the constraints of affordability and housing stock, occupants consider themselves to be too poor to move up the property ladder and consider their land as family assets rather than as capital (Finmark, 2004; Tomlinson, 2005). But, even more fundamentally, De Soto may fail to comprehend the ontological meaning of land for several communities in the developing world as something almost sacred rather than a saleable asset. Third, even if the markets existed, they would have to be perfect markets

to overcome the problem of the low value of land offered as collateral. This problem is especially acute when compared with the high costs that the bank would have to incur to potentially claim the land via the formal legal system (Arrunada, 2003). Finally, Gilbert (2002) argues that titled families may themselves be reluctant to take loans, being intimidated by bank requirements or for fear of default, preferring informal sources of credit.

On the issue of the enforcement of the contract, the problem is that the promise of enforcement is not credible.³¹ To begin with, the De Soto model is extremely uneconomical in terms of information costs. Since the external enforcement model or formal law requires that breaches be both *observable* and *publicly verifiable*, the information costs associated with it are extremely high, particularly in the context of the information asymmetries of the developing world, making its prospects of success exceedingly weak (Stiglitz, 1990; Hoff and Stiglitz, 1990).

In addition, De Soto's approach to the issue of legal capacity is highly problematic. The efficacy of a formal legal system is ultimately determined by enough agents opting in to the system of authority which is, in turn, determined by the twin factors of confidence in the enforcement agency and trust in the propensity of other agents to comply.³² Consequently, in the absence of the use of pure coercive force, the determinants of the success of a formal legal system are essentially *internal* rather than external. The introduction of an isolated legal intervention, as the De Soto scheme attempts, is substantially meaningless in the absence of a "broader respect that exists for legal authority" (Andre and Platteau, 1998).³³

Closely related to the above point, it is extremely difficult for institutional reform to succeed unless it is considered legitimate. To be considered legitimate, in turn, demands some modicum of equity. The property rights reform attempted in Russia is a case in point. The highly unpopular reforms—making the wealthy elites better off at the expense of the masses—led to the rich actually taking their money out of the State rather than investing in it, as traditionally hypothesized, as a result of their insecurity (Hoff and Stiglitz, 2008). Given that the courts are likely to consider the transfer of property from the poor to the banks highly inequitable, they are unlikely to enforce the formal law in the De Soto case, thereby bringing it closer to the *de facto* informal system of regulation. Andre and Platteau (1998) further reiterate that the costs of implementing unpopular decisions by new legal bodies are likely to involve tolerating constant contestation, criticism and harassment not only from the disputant but also other stakeholders in the customary system.³⁴ Thus, the legitimacy of the reform ends up being crucial to its prospects of success.

Next, any system of contracts needs to balance the competing claims of certainty and flexibility. The theoretical benefit of De Soto's proposal harks back to the Coasian intuition of assigning property rights clearly in order to be able to achieve *certainty* in transactions and thereby efficiency. But this attempt at certainty comes at the cost of excessive rigidity. The more formal and rigid a contract, the clearer it is but also the more inflexible. The result of this inflexibility is a higher chance of default, higher concentration of land, greater inequality and more agency problems. Thus, even if the functional problems associated with the De Soto program could be overcome, it is not clear that it would achieve the most efficient outcome. Besides, even in legal terms,

property is a relative rather than absolute concept. Legal property rights may be limited in a number of situations, for instance by the rights of your neighbor or your need to trespass on someone's property if it is the only way that you can administer insulin to your highly diabetic mother.³⁵ In this sense, norms of use fundamentally impact property rights, however clearly identified. This is a dimension of property that is glossed over completely by De Soto.

Finally, the scheme may actually heighten rather than reduce uncertainty as a result of the legal dualism it is likely to create. If, due to the above reasons, the formal legal system fails to decisively trump the customary or informal system, as is likely, the central goal of the titling process—increasing certainty in transactions—is defeated. The abrupt introduction of another tier in property dealings that fails to take root leads to the speculative use of the system—formal or informal—more convenient to the party in question, thereby increasing confusion in transactions (Mackenzie, 1993; Platteau, 2000; Andre and Platteau, 1998).

The Yunus Model

The design of the implicit contract in the Yunus model is characterized by the absence of any formal barriers to entering into the contract. In stark contrast to the De Soto model, there is no collateral requirement and there is, further, no formal legal contract between the Bank and borrower. The enforcement mechanism traditionally associated with the Grameen has been the mutual enforcement model, or that of peer monitoring, where group members shared joint liability for the loan, i.e. one group member's ability to

borrow depended on the others repaying, but is shifting to the pro-social disposition model.³⁶ Peer monitoring operates essentially on the basis of social sanction within a settled community, while pro-social disposition operates by means of the reputation mechanism in the context of repeated interactions.³⁷

In design terms, the Grameen turns out to be extremely effective in inducing entry into the credit contract. This is not only due to the absence of formal constraints like a collateral requirement, but is actively aided by the informal character of the contract. On the demand side, or from the perspective of borrowers, the fact that the terms of the contract are more malleable encourages more people to borrow where they would normally have been deterred by the more strictly-constraining terms of a formal contract. But, on the supply side as well, the trust-based system turns out to be greatly advantageous. In particular, the *flexibility* of the informal system allows shocks to be internalized in a manner that would break the back of a more rigidly formal system. In the context of a more binary formal system, the terms of the contract are largely fixed, and changing them is an expensive process involving high information and procedural costs. The terms of an informal contract, on the other hand, are more easily and economically renegotiated. Thus, while a default on the formal contract is relatively inflexible, a default on an informal contract can be renegotiated as delayed repayment.³⁸ That informal systems have the latitude to absorb these shocks to quite a significant extent is demonstrated by the recovery of Grameen in the wake of its 1998 flood-induced repayment crisis where the redrawing of repayment schedules allowed losses to be recovered to a significant extent.³⁹ This is quite impressive when compared with financial crises in the formal system that, typically, results in losses being written off completely.

As an ongoing feature, Grameen retains the flexi-loans that allow individual borrowers to renegotiate their repayment schedules if they find it difficult to meet their original targets. Thus, while it has traditionally been argued that informal contracts compromise certainty, their flexibility affords them a level of complexity and nuance that would be very costly via the formal system.

In terms of enforcement, the Yunus model has significant advantages with regard to the information costs of monitoring. Since the mutual enforcement model or informal law requires that breaches be *observable* but *not necessarily publicly verifiable*, the information costs associated with it are inherently lower. Further, Stiglitz (1990) establishes that this model has significant informational advantages over formal regulation since the community is far better poised than formal institutions to monitor the actions of borrowers. Thus, peer monitoring is able to overcome both problems of moral hazard (Arnott and Stiglitz, 1991) and adverse selection (Ghatak, 1999). These informational advantages are a critical factor in allowing the flexibility of design discussed above. Since speculative defaults (i.e. an attempt at evading repayment) can more easily be distinguished from genuine ones (i.e. due to some unforeseeable circumstance such as a natural disaster or sickness in the family), not only do these contracts have an in-built insurance mechanism against risk but they allow the lender to give loans to those considered riskier borrowers as well, making the system inherently more inclusive.⁴⁰ In addition, there are certain structural features specific to Grameen, such as regular repayment schedules, that have been identified to contribute to better monitoring (Armendariz de Aghion & Morduch, 2000).⁴¹

Next, a critical factor contributing to the successful enforcement of the Yunus contract is the relative credibility of the threat of punishment within the scheme. The threats of social sanction and loss of reputation are far more credible than that of punishment by the state legal system in the context of a country like Bangladesh (Stiglitz, 1990; Besley and Coate, 1995). In particular, the threat of not refinancing borrowers who default further heightens the efficacy of the enforcement mechanism. Thus, despite the fact that no legal punishment is attached to default, borrowers have an incentive to repay in order to be able to obtain subsequent loans (Stiglitz, 1990; Besley, 1995). Further, critical to the success of the Grameen enforcement mechanism is its essentially participatory character that allows the problem of apathy of agents towards the system to be overcome and enforcement to be achieved through *internal legitimacy* rather than external force.

An increasingly important feature contributing to the desire for borrowers to maintain a positive reputation is the increasing inter-linking of markets, or, the expansion of Grameen into other markets that impact borrowers, thereby increasing the stakes in the relationship between bank and borrower (Hoff and Stiglitz, 1990).⁴² Grameen has now diversified into areas as varied as electricity generation, information technology, education, telecommunications and textiles. These enterprises are designed to permeate the lives of borrowers in a variety of different ways. Thus, a person may not only be a Grameen borrower, but Grameen may at the same time be her employer, bank, source of infrastructural facilities, provider of goods and services and run her daughter's school.⁴³ Other factors that add to the incentives of borrowers to maintain a good reputation

include the attractiveness of the support services provided by the Grameen ‘bicycle bankers’ (Edgcomb & Barton, 1998).

Equity

We turn, next, to the question of the equity aspects of the two schemes. In particular, we will consider the impact of both programs on economic outcome variables like income, investment, employment and property ownership of essentially instrumental normative interest, as well as welfare indices of inherent value like gender equity, access to education, access to healthcare, nutritional status and so on.

De Soto

The De Soto scheme does not directly address welfare indices of inherent value, but rather attempts to address these indices tangentially via economic variables of instrumental normative value. Nonetheless, we need to consider whether, in the first place, the economic variables targeted are effectively impacted and, then, whether these variables in turn give rise to improved welfare indices.

Looking first at the economic variables that the De Soto program targets, the evidence is mixed. On a positive note, the program has undoubtedly increased formal property ownership of the poor with over a million legal titles having been distributed in Peru alone. In addition, De Soto has achieved great economies in the cost and time involved in the titling process.⁴⁴ However, to the extent that this transfer of title involves

only granting formal rights over property that they already, in effect, controlled (i.e. that it is a land-*titling* rather than land-*reform* program, not, fundamentally, involving redistribution), the value of the program amounts essentially to any gains from the change in *de facto* to *de jure* rights of ownership, i.e. the benefits of legal ownership.

The economic benefits of this change in status have already been cast in doubt by its failure to have the postulated effect on access to credit. However, there is evidence of some other economic benefits. First, there is some evidence of titling leading to increased household investment (Galliani & Schargrodsky, 2005).⁴⁵ But whether overall investment actually increases, given that credit supply does not increase, has been questioned (Carter & Olinto, 2000). Second, some studies find that titling leads to increased labor force participation rates. This is hypothesized to be due to the fact that titled families need to spend less time defending their property, leaving them more time to devote to productive activities (Field, 2007; Galliani & Schargrodsky, 2005). However, the validity of the now-celebrated Field (2007) increased labor supply result, cited widely by advocates of the program, has been brought into question, especially by Mitchell (2005).⁴⁶ Indeed, many other local commentators observe that the foundations for security of occupation may be diverse, and that titling may only have made an appreciable difference in newer, more insecure communities. At the same time, titling may have certain positive social effects associated with increased security of ownership and the creation of relatively settled communities.

However, the De Soto program grants apparently more secure rights of ownership to the poor while, simultaneously, making rights of ownership far more easily alienable. Indeed, the social impacts of the potential loss of land by the poor may be grave. De Soto

suggests an all-or-nothing strategy of inducing the poor to put at stake their major asset or resource—their land. As their only means of insurance, the impact of its loss would likely be disproportionately severe, and result in the social problem of landlessness. The strategy is rendered even more risky because it is proposed in the absence of any public welfare schemes such as healthcare or food subsidies, increasing the likelihood of distress sales of land and, any training or assistance programs with regard to use of the resource. An alternative, less risky approach would be to offer a part of the produce of the land as collateral instead of the land itself.

In addition, the De Soto scheme throws up the problem of inequities of initial access. Current occupation of land by squatter families may not be an equitable way of distributing land. Indeed, endemic to the De Soto scheme is that the completely landless - the most destitute in a community - are left out of its ambit altogether. Further, it is those who were most successful in breaking the law before the De Soto reform, that are not only rewarded by it but also expected to become “law-abiding citizens” over-night.

Turning now to the welfare impacts of the De Soto problem, it is clear that it does not directly address issues of health, education, nutritional status and so on. There is some evidence of a tangential impact on school attendance of children of titled families (Galliani & Schargrodsy, 2005; Field, 2007), but no direct evidence of the other indices improving as a result of participation in the program, except through any increases in income that may result from increased labor force participation.⁴⁷ In fact, the De Soto scheme is not attached to any explicit social agenda. De Soto’s starting point is the existing power allocation. He is not concerned with existing inequities but rather attempts merely to leverage existing power allocations to achieve a more efficient outcome. His

primary concern is with the economic losses he associates with the “dead capital” of untitled land in the developing world. In that sense, both the positive and negative social effects of his program are incidental. Nor have titling programs, with their focus on achieving social change through efficiency enhancement, diversified organically into different social sectors in the way that the microfinance movement has.

Titling has been found, however, to have a positive effect on some indices of gender equity. In cases of joint titling, in particular, a positive impact has been found on the woman’s position in the household (Field, 2003; Datta, 2006). In addition, titling has been found to be associated with decreased household size. Again, this is attributed to a reduction in the need to maintain large families for reasons of security (Galliani & Schargrotsky, 2005) and to increased contraception use and decision-making power on the part of women (Field, 2003).

However, there are persuasive reasons to examine more closely the gender impacts of titling. Indeed, titling is frequently associated with the loss of the customary rights of vulnerable categories. Since, due to the complexity and nuance of customary rights, it is impossible for registration to merely recognize and record accurately existing rights, it invariably involves some *de facto* reallocation of rights (Barrows & Roth, 1989).⁴⁸ Further, since the sections likely to have the most significant interface with the formal system are the most-privileged, this reallocation is will presumably be at the cost of the most vulnerable, leading, inevitably, to a legitimacy-deficit in the reforms. In this way, customary rights and insurance mechanisms are likely to be destroyed by the registration process. Platteau (2000) and Andre & Platteau (1998) find compelling evidence of this in the context of Rwanda. Cousins et al. (2005) reiterate this in the

context of South Africa. Specifically, several studies find that titling has an adverse impact on women's rights where it formalizes already-existing inequities of power (Lastarria-Cornheil, 1997), or erodes systems of customary justice (Ensminger, 1997; Kevane & Gray, 1999; Hare, Yang & Englander, 2007). Further, although some empirical studies find that the social justice problem can be overcome by explicitly registering land in the name of vulnerable categories (such as women), there is evidence that it is particularly difficult for these categories of people to access the formal justice system to vindicate their rights (Lastarria-Cornheil, Agurto, Brown & Elisa Rosales, 2003; Fenrich & Higgens, 2001). A recent article by Joireman (2008) emphasizes both customary law and women's rights as major constraints on the De Soto proposal. Indeed, even targeted programs in general tend to benefit the best-off within the class they target, for instance, the Indian system of reservation for the Scheduled Castes and Scheduled Tribes tend to benefit the socio-economic class within the caste that least needs the reforms, frequently called the "creamy layer." Thus, despite titling targeting squatters, it may fail to impact the most needy among them.

Finally, titling may be extremely vulnerable to the appropriation of rights by the powerful. While formal registration losing the nuance of customary rights may be endemic to the process, registration may be—worse still—vulnerable to intentional manipulation by the elite. Indeed, the more unequal a society, the higher the likelihood of such exploitation of vulnerable categories by officials and others. Widespread evidence of this can be found in Thailand (Thomson et al., 1986 and Feeny, 1988); India (Wadhwa, 1989; Viswanath, 1977); Latin America and the Caribbean (Stanfield, 1990); Uganda (Doornbos, 1975); Nigera (Zubair, 1987); and South Africa (Cousins et al.,

2005). The inequities of this process are likely to be exacerbated if registration comes at a fee, as in the Peruvian case, rather than being for free.

Yunus

Although Grameen started out as a credit access program, its agenda very quickly evolved to become far more broad-based – adopting what policy-makers in Bangladesh are calling a ‘microfinance plus’ approach. Grameen targets economic variables mainly through an attempt to increase income through access to credit, but also facilitates property ownership (both through funding the acquisition of “business assets” and the provision of housing loans), engages in employment generating activities and provides direct avenues and instruments of investment and insurance. It is increasingly pro-active in its approach to welfare indices of inherent value. Its focus, so far, has most explicitly been on education—it provides both education loans and scholarships, as well as funding for schools. In addition, it has started to address nutritional concerns by getting involved in the production of high-nutrient, low-cost food products and clean, low-cost drinking water.⁴⁹ It is currently actively working to extend its reach to the healthcare sector.⁵⁰ Its commitment to gender empowerment is explicit—lending almost exclusively to women.⁵¹

We now consider the impact of Grameen on economic variables of interest.⁵² Several studies show that participation in the Grameen program leads to increased household income. Grameen reports that average household income is 50 percent higher for members in Grameen villages than residents of non-Grameen villages. These

estimates of increased income are backed up by objective third-party assessments (Khandekar, 1998, Hossain, 1988).⁵³ Second, participation in the Grameen program is associated with a decrease in poverty. Grameen reports that a significantly smaller proportion of Grameen members live in poverty (20 percent) compared with non-Grameen members (56 percent). Yunus reports that 64 percent of Grameen members decisively move out of poverty within five years of joining the program. The reach of the program heightens the magnitude of this achievement—80 percent of poor families are estimated to have access to microcredit in Bangladesh.⁵⁴ Several independent studies also find evidence of reduced poverty indices in Grameen households (Hossain, 1988) and improved socio-economic status (Wahid, 1994).⁵⁵

Let us turn, next, to the impact of Grameen on welfare indices. Grameen membership requires internalizing a number of different types of prudential practices. To begin with, potential members must learn to sign their names and memorize a list of 16 decisions (such as sending children to school, family planning, basic cleanliness and sanitation, vows of cooperation etc.) before they are eligible for a loan. In addition, although there is little substantive interference with use of loans, members are provided with ongoing assistance in the form of encouragement and trouble-shooting advice in the face of financial troubles. There is evidence of these non-credit, participatory aspects having a positive effect on self-employment profits (McKernan 2002). Indeed, the agency empowerment dimension of the scheme is one of its key assets. Moreover, Grameen is found to have specific welfare impacts. In particular, various studies have found positive effects on contraception use by women (Schuler and Hashemi, 1994; Amin, Li & Ahmed, 1996; Schuler, Hashemi & Riley, 1997). Finally, an important contribution of Grameen

has been the creation of an entire second generation of beneficiaries. At a recent talk, Muhammad Yunus reported that 100 percent of the children of Grameen families were enrolled in school. Grameen is attempting to actively promote a rapid socio-economic transition of this second wave of beneficiaries through primary school scholarships, of which there are now 64,000 recipients, and higher education loans, of which 23,000 have been distributed.⁵⁶

Moreover, the Grameen Bank is considered to have made a significant contribution to gender equity, particularly in the context of Bangladesh. The fact that 97 percent of Grameen borrowers are women is an achievement in its own right, especially in a country where a huge stigma is attached to women undertaking activities outside the home.⁵⁷ In addition, studies have found a positive impact on decision-making capacity within the household and a number of other empowerment indices (Schuler and Hashemi, 1994; Hashemi, Schuler, and Riley, 1996; Osmani, 1998; Pitt, Khandekar and Cartwright, 2003). This is unsurprising given the explicitly redistributive agenda of the Grameen with regard to women—transferring resources and power to a section of society deprived of it. For instance, to consolidate the woman's position in the household, mortgages given out by the Bank are always made in the name of the woman as a disincentive against her husband divorcing her. Moreover, although there is some evidence of increased domestic violence in the short run (Rahman, 1999), other studies find that the Grameen mechanism paves the way to greater assertiveness on the part of women and reduced domestic violence, particularly over time (Schuler, Hashemi, Riley and Akhtar, 1996; Schuler, Hashemi & Huda Badal 1998). In addition, positive impacts have been found on specific welfare indices like women's health (Nanda, 1999). Further,

as is now widely documented, targeting women is associated with normatively desirable distributional impacts. Pitt and Khandker (1998) find that annual household consumption expenditure increases by 18 taka for every additional taka borrowed by women from these credit programs, compared with 11 taka for men.⁵⁸

Finally, microcredit makes a significant contribution to releasing the untapped economic potential of the female labor supply in Banglaesh. Emran, Morshed & Stiglitz (2007) explain that microcredit works essentially due to imperfections in the capital and labor markets. Where even one of these markets functions perfectly, capital and labor move seamlessly to each other, but in the more realistic context of imperfect markets, microcredit harnesses the untapped labor power of unemployed women in the home thereby evening out capital-labor ratios. In this way, a productive section of the population, women, left out of the labor market due to market imperfections, are brought into it.

Static Analysis

Contrary to the predictions of the Chicago-school, the Yunus model outperforms the De Soto model in both efficiency and equity terms. In this section, we analyze the reasons for this result, tracing them to the fundamentally different visions of development that motivate the two programs.

The essential difference between De Soto's approach and the Yunus' is that while one adopts a *linear* model of development, the other adopts a *systemic* one. Linear models of development, of which the Washington Consensus approach is typical, assume

that there are certain critical variables in the development equation that can be isolated, and that targeting these will bring the development process into line.⁵⁹ Indeed, it is this perspective that informs De Soto's assertion that stimulating capitalism in the developing world is merely a question of implementing the strategic intervention of titling to bring "dead capital alive". The problem with this position is its failure to capture iterative and feedback effects, and to recognize crucial linkages between economic systems, legal systems and social systems. It is this pitfall that Yunus avoids with his integrated approach.

De Soto's position is premised on a set of inter-related assumptions about economic, legal and social systems. To begin with, he adopts a view of the market as perfectly functioning. It is this view that allows him to believe that the mere *procedure* of titling will lead to increased credit access. Further, his exclusive focus on economic variables of *instrumental* interest, rather than welfare variables of inherent interest, stems from this - since welfare indices are assumed to take care of themselves via economic variables. Given that markets in the developing world are riddled with imperfections – ranging from externalities to information asymmetries- these assumptions turn out to be false. But the success of the De Soto scheme rest on further assumptions still about the functionality of other parts of the system that are also over-simplistic. For instance, the working of the titling mechanism requires a well-functioning legal system but here, again, De Soto's view is top-down. De Soto's view of the law is largely *formalistic*, vesting paramount faith in law as written down in the statute books. This, however, is to assume that by merely writing laws down, we can achieve their effect. It assumes, further, that once laws are written down, they can be interpreted and applied completely

objectively, eliminating any role for norms. This is infeasible for any legal system. Finally, in both his view of markets and legal systems, De Soto fails to account adequately for social context. He ignores, for example, the fact that being able to tap into the fruits of the market mechanism requires access to certain basic social services. But most critically, he neglects the fact that the best way of implementing law is not through *external imposition* but rather through drawing agents into the system through a process of building internal legitimacy.

Yunus, while acknowledging the merits of the markets mechanism, also recognizes that markets are far from perfect, and riddled with barriers to access. Thus, his solution to the access-to-credit problem is far more *substantive*, providing loans directly, without setting up barriers to access. Further, he is focused directly on welfare variables of *inherent* normative interest as a result of both a lack of faith in the market mechanisms to provide them spontaneously, as well as in deference to their importance for the success of the market process. Towards the implementation of the program Yunus focuses not on a written code but rather adopts an *informal* view of the law as lived practice. Finally, and most crucially, the system works because it is able to effectively solicit the participation of agents in the enforcement system by drawing them into it through building up *internal* legitimacy. It is this final point that accounts for Yunus' relative success in overcoming the collective action problem.⁶⁰

There is, thus, a compelling case to be made for a focus on more informal, norm-based regulatory interventions that, being more rooted in social context and inherently more participatory, are much more likely to be seen as legitimate and, hence, be more efficient than the impersonal structures of conventional law. Indeed, the success of the

informal Grameen mechanism is not an isolated phenomenon. A host of alternative dispute resolution mechanisms, operating outside the ambit of formal courts, have been attempted in various parts of the developing world, while an emergent voice within academia is starting to call for more innovative, if less ambitious, regulatory solutions.⁶¹ Setting aside the accepted wisdom that the “rule of law” regime is the proverbial institutional “cake”, there is a pressing need to focus instead on what Gallanter (2004) calls the legal “bread for the poor.”

Dynamics

In the previous section we saw that the Yunus model performs better than the De Soto model in static terms. But in this section we turn to the dynamic aspects of the question: is it true that the informal solution is superior to the formal one under all circumstances?⁶² The arguments for the normative benefits of the “rule of law” regime are well known and have been written about extensively. We cannot do justice to that subject here, but suffice it to say that there exist arguments in favor of the “rule of law” over the, often more arbitrary, “rule of persons”.⁶³

Our focus for present purposes is, at any rate, economic. However, even in economic terms, there may be certain benefits associated with formalization in the long run. We saw that microfinance in Bangladesh appeared to be having a positive impact on welfare at the household level, but its impact on aggregate poverty was negligible.⁶⁴ The prospects of growth of the Yunus model, in terms of shifting the impact from the micro to the macro level, seem, then, to depend on successful ‘scaling up’ of operations. This

‘scaling up’ can take the form of widening reach, in terms of a proliferation of organizations providing microfinance, as well as, critically, increasing the scale of the ventures that poor families are able to tap into, thereby allowing them to access larger surpluses and thus be lifted out of poverty more effectively.

Both developments are currently underway in Bangladesh: there has, in recent years, been a massive explosion of organizations entering the fray to provide microcredit, and Grameen, along with other major microfinance providers (notably BRAC), has been increasingly diversifying into ‘social businesses’ (higher scale business ventures that poor families would be unable to establish in their own right that either provide crucial services to the poor at subsidized rates or that allocate part of their surpluses to the poor).⁶⁵ It is significant that this ‘scaling up’ of operations is accompanied by an increasing move towards formal regulation. The microfinance sector as a whole (particularly the entry of new organizations into the sector) is progressively more formally regulated – first by the Palli Karma Sahayak Foundation (PKSF) and, now, by the Microcredit Regulatory Authority (MRA), while the ‘social businesses’ sector into which the microfinance organizations are moving are, for the most part, regulated like any other business enterprise, by formal law.⁶⁶ These developments indicate that while a trust-based system seems to work effectively in regulating small transactions between the microfinance organization and a network of up to several million individuals, as the size of transactions get bigger and the unit of regulation becomes larger (i.e. organizations rather than individuals), formal law becomes more necessary.⁶⁷

These empirical insights accord with theory. Dixit (2004) has stressed that the expansion of the market may demand a more generalized form of trust that will allow

anonymous actors to transact with each other on a wider scale on the basis of a mutual trust in the institutions of the economy rather than a network in which names and faces matter. This is somewhat analogous to the move from the barter to the money economy, facilitating exchange on a wider scale. Thus, for instance, a Grameen-Phone subscriber purchases a subscription not on the basis of a personal trust in the service provider, but rather, as a more impersonal market transaction.⁶⁸ Stiglitz (2000) argues that the pressures of economic growth may, itself, limit the scope of informal regulation.⁶⁹ Thus, while the microfinance sector in Bangladesh was small - dominated by a few key players - entry into the sector did not need formal regulation, but as the number of players increased and incidents of fraud began to occur, there arose a need to regulate the sector.⁷⁰

We stated at the very outset that our goal was not to identify the transcendental institutional ideal that will hold across time and societies. Indeed, we refute the contention that such an ideal exists. We argue, rather, that the choice of institution that is appropriate depends fundamentally on the stage of development, and context, of the society in question. The trajectory of institutional development in Bangladesh illustrates this: as the process of development progresses, the institutional framework changes to adapt to it. Indeed, what is crucial is not whether the mode of regulation is formal or informal, but rather whether it is capable of influencing the actions of agents.⁷¹ Without a transmission mechanism that will allow formal law to acquire traction in a host society by altering actions and norms, legal formalization will have little or no effect - as was the case in Peru. The characteristic of the successful legal systems in the developed world, that the developing world is being advised to mimic, is that formal law and social norms

work in tandem. In particular, formal legislation has the capacity to influence action and shape norms.⁷²

In the context of the developing world, the abrupt introduction of isolated legislative interventions is bound to fail to have the same effect, given that these interventions do not emerge out of an organic process of institutional growth and thereby, by definition, lack internal legitimacy with agents within the system. This is what we observe in the Peruvian case. While we have stressed the efficiency and equity benefits of the Grameen mechanism, its key contribution in institutional terms is its capacity to make the shift to a co-operative institutional equilibrium by fostering social capital and trust i.e. by causing a revolution *within* the agents in a system.⁷³ In the framework of the Hoff and Stiglitz (2008) model, individual expectations with regard to the prospects for establishing the rule of law determines individual support for it. The Grameen mechanism can be seen to be producing a public good by altering these expectations.⁷⁴

Dowla (2006) provides a roster of ways in which the Grameen is engaged in social capital creation – by ‘forming horizontal and vertical networks, establishing new norms and fostering a new level of social trust to solve the collective action problems of poor people’s access to capital’. Social capital theory predicts that co-operation will beget further cooperation (Hirschman, 1984; Putnam, 1993; Seabright, 1997), and, in the instance of the Grameen, this is seen to be the case – both within and outside the context of the specific program.⁷⁵ A notable example of these spillovers is the election of Grameen members to local government bodies. In the 2003 local government election (the ‘Union Porishad’), 7442 Grameen members contested the reserved

seats for women and 3059 members got elected – this accounts of 24% of the total women’s reserved seats.⁷⁶

What is crucial, however, is that the social capital building initiatives of the early stages of institutional development of the Grameen paved the way for the current developments. Both the new microfinance organizations that entered the fray after the Grameen Bank and other key players (like ASA), as well as the ‘social businesses’ run by the bigger microfinance organizations, operate out of the membership base created by the ‘first generation’ microfinance experiment.

Thus, while there exists a short-term policy choice between emphasizing formal or informal institutions as a means of legal reform, in the longer term, the critical issue is not that of choosing between the two, but rather the matter of making the shift from a negative to a positive equilibrium by facilitating co-operative action, and allowing the economic benefits of this to be realized. This is, typically, achieved though a combination of the formal and informal. However, a process of informal consensus and social capital building often works to pave the way more effectively to formalization. The issue, then, ends up being not one of choosing between the formal and informal system as the Chicago school posits it, but rather one of determining which type of intervention it is more appropriate to emphasize at a particular stage of development.

Conclusion

The central question that we set out to answer in this paper was whether formal law is essential for development. The answer to this question – formulated in the context

of two high profile credit-access programs, land titling in Peru and microfinance in Bangladesh - turns out to be mixed. The Chicago-school position that, even in static terms, no developmental headway can be made without formal legal reform is certainly untrue. In fact, the more informal Yunus model proved to be both more efficient and more equitable than the legal formalization program advocated by De Soto. But it is also true that, on a more dynamic analysis, as the development process progresses there may be certain economic benefits to formal regulation of larger scale agents and transactions. On this view, the issue of legal formality or informality is not one of establishing whether one or the other is superior *per se*, but rather one of determining what mode of regulation works better in a particular context. Further, the earlier stages of social capital building through informal regulation may pave the way to more formalized regulation much more effectively than the approach of rapid, and somewhat abrupt, immediate formalization.

As China struggles to eke out its developmental pathway, it should steer clear of the false dichotomies of the Chicago-school mode of thinking, noting the failure of attempts to implement the received institutional wisdom of De Soto-style rapid formalization programs, and take inspiration from the relative success of alternative institutional experiments of the Yunus type. To encapsulate this wisdom in the words of an ancient Chinese proverb - 'He who treads softly goes far.'

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¹ The intellectual breakthrough that ‘institutions’, of which law is a crucial one, are of fundamental importance for economic growth is credited to Douglass North (1991). A classic example of a recent institutional reform program attempting to operationalize this insight is the World Bank’s Rule of Law and Development program.

² The tradition of assuming the superiority of formal law goes back a long way - to the intellectual precursor of the Chicago-school, Austrian Economics: see, for instance, Hayek (1980). The assumption of the greater efficiency of formal law is held strongly by exponents of the Chicago school, notably Coase (1988). This viewpoint has been carried forward recently by the ‘new

institutional economics' literature. See, as examples, Knack and Keefer (1994) and Kaufmann, Kraay & Mastruzzi (2005) on the World Bank's 'World Governance Indicators' (WGI).

³ In the context of China specifically, see Prosterman & Hanstead (2006). On the institutional prescription of the Chicago-school for the developing world, more generally, see Posner (1998).

⁴ Commission for the Legal Empowerment of the Poor, 2008. p. 4-5 at <http://www.undp.org/legalempowerment/>. We agree with their estimate that the quantum of 'legal poverty' is immense but not with their solution to the problem.

⁵ Various attempts have been made to explain the failure of formal legal reform in the developing world. One influential strain of literature analyses the issue in terms of 'legal transplants'. See Berkowitz, Pistor & Richard (2003).

⁶ While it is certainly not obvious that Chinese property rights operate in the same way as Western property rights, attempts have been made to explain its success in terms of setting up Western-style incentive structures at the margins. See, for instance, Qian, 2003.

⁷ Aoki (2001), for instance, entirely sidesteps the formal-informal dichotomy by classifying as an 'institution' only what actually impacts the behavior of agents. While this position overcomes many of the shortcomings of a more formalistic approach conceptually, it leaves the question of the functional choice of approach to reform unanswered.

⁸ We refer not just to the microfinance and titling programs, but their architects, Yunus and De Soto, as well, to highlight the fundamental ideological differences that these two eminent figures in development bring to their programs. Indeed, we are interested, as much in the theoretical models as the practical implementation of the reform programs.

⁹ Yunus, 1998, and De Soto, 2000.

¹⁰ It should be flagged up at the outset that De Soto's *land titling* program is distinguishable from *land reform* programs that have been undertaken in various parts of the developing world. The focus of the titling program is merely to transfer title of land already occupied by squatters, whereas the purpose of land reform programs is, typically, explicitly redistributive in that it involves transferring land to those who do not have any.

¹¹ This is the main change characterizing the shift from the "classical" Grameen model, or Grameen I, to the "generalized" Grameen model, or Grameen II. This change was put in place between 2000 and 2002 and started as a response to a repayment crisis due to severe floods in Bangladesh in 1998. The opportunity was taken, however, to incorporate structural changes to the system in order to make it more flexible. Some of the changes are as follows: (i) The various categories of loans were dispensed with and reduced to the "basic" loan, housing loan and higher education loan (with a 50 percent reservation for girls); (ii) The rigidity of loan amounts, repayment schedules and duration was removed and borrowers could now get customized loans on the basis of their repayment record and the discretion of the Banker; (iii) Group lending was replaced with individual lending and groups were retained for the purpose of positive reinforcement only (iv) The "flexi-loan" was introduced to enable borrowers to deal with repayment problems whereby borrowers facing difficulties were able to merely reschedule repayment; (v) The "Beggar Program" disbursing loans to beggars with no repayment rule attached was started; (vi) The system of positive incentives was reinforced with the "star scheme" for branches and employees that met targets and "gold membership" for borrowers with an untarnished record; (vii) The introduction of a pension and insurance scheme, in addition to obligatory savings. On Grameen II, see further, Yunus (2002) and Dowla & Barua (2006).

¹² For a brief history and overview of the functioning of the Bank, see <http://www.grameen-info.org/>

¹³ For an overview of the Peruvian titling program, see Calderon, 2004.

¹⁴ On De Soto's influence in Peru, see Panaritis, 2001 and Bromley, 1990.

¹⁵ Countries currently being advised by the ILD include Mexico, Honduras, Haiti, Egypt, Albania and the Philippines. In addition, the ILD reports that there is "demand" for its services in 47 countries. See <http://ild.org.pe/en/home>. In addition, a number of countries not directly advised by De Soto are deeply influenced by his advice like South Africa, see Cousins et al., 2005.

¹⁶ Glibert, 2002, p. 5; Panaritis, 2002, p. 22.

¹⁷ De Soto is, for instance, Co-Chair of the Commission. See further <http://www.undp.org/legalempowerment/>

¹⁸ See further Grameen Dialogue Vol. II: The Replication Experience (2005), p. 11.

¹⁹ See <http://www.yearofmicrocredit.org/>

²⁰ See, for instance, World Bank (1999).

²¹ The authors have been observing, studying and writing about these programs for over twenty years now, see, for instance, Stiglitz (1990). In addition, results reported in this paper are based on extensive field research conducted in Peru and Bangladesh between June 2008 and July 2009. Over 100 in-depth qualitative interviews were conducted with stakeholders in the implementation of the programs.

²² To say that the programs have been "replicated" is, however, to gloss over significant differences. While the microfinance model has spread like wildfire, "replicas" often change institutional aspects of the model. Further, even when the replication is faithful, in structure, to the original model, the informal, context-specific aspects cannot be directly transferred. In particular, the focus on social capital building of the initial model has been somewhat lost. Indeed, Seibel (2000), studying microfinance replicas in the Philippines, finds that the most successful replicas are the ones that are most faithful to the social capital building aspects of the original. Similarly, in the case of titling, while the formal process of titling can be replicated, other aspects integral to the program like the judicial system cannot just be transplanted.

²³ Thus, while Peru might have a better-developed market mechanism than Bangladesh, Bangladesh may have stronger community norms. This difference is crucial in determining the choice of regulatory mechanism that is more appropriate. On this, see, Besley and Coate, 1995).

²⁴ See further, Olson (1965) and Ostrom (1990).

²⁵ This study of the Peruvian titling program finds a small positive impact of titling on public sector lending when titles are asked for in the first place and a beneficial impact on interest rates -but no impact on private-sector lending. This is hypothesized to be due to the fact that a titling program detrimentally impacts the bank's perception of its ability to foreclose. As Mitchell (2005) points out, this is an interesting result since the only increase in access to credit that did occur was not through the market process, but through public subsidy.

²⁶ p. 299

²⁷ In terms of access to credit cards, bank accounts and formal credit (from banks, the government, labor unions or cooperatives), the study finds no difference between titled and non-titled households, with

both categories continuing to rely largely on informal credit sources. The small positive effect found is accounted for by 4 percent of titled households receiving mortgage loans.

²⁸ p. 14.

²⁹ This study considers the performance of the two biggest microfinance organizations in Bangladesh other than Grameen— the Bangladesh Rural Advancement Committee (BRAC) and the Association for Social Advancement (ASA), as well as the Ranjpur Dinajpur Rural Service (RDRS).

³⁰ These repayment rates are even more impressive when contrasted with the very poor repayment record of the government credit initiatives that pre-dated Grameen. See Dowla (2006), pp. 5-7.

³¹ Since, in the case of the De Soto model, the credit contract does not, for the most part, come into existence, the discussion of enforcement problems is essentially hypothetical.

³² Dasgupta (2003). Similarly, in the Hoff & Stiglitz (2008) model, a sufficient number of agents have to believe that the “rule of law” will prevail in order to support it and act accordingly.

³³ p. 43

³⁴ p. 43-4

³⁵ Indeed, the relative nature of property rights has long been stressed by property rights lawyers; see, for an excellent overview, Gray & Gray (1998).

³⁶ The shift from one model to the other is associated with the shift from Grameen I to Grameen II discussed above. While Grameen I can be seen as the “learner” microfinance model characterized by simple, rigid rules, Grameen II is meant for borrowers familiar with the microfinance philosophy but requiring greater flexibility. In addition, there is extensive evidence to suggest that even when ‘group liability’ operated in theory, the group worked more as a monitoring, motivational and support device rather than financial joint-liability being strictly enforced. See, for example, Jain (1996). This shift demonstrates the norm creating capacity of Grameen operations.

³⁷ Some academics (for instance, Rahman, 1999; Mallick, 2002; Barkat, 2008), as well as activists in Bangladesh (for example, *Nijera Kori*) argue that the use of coercive force to extract repayment is widespread. Although there does appear to be evidence of the sporadic use of force, it appears unlikely, on balance, that the membership base of Grameen could have reached millions if this were the dominant mode of enforcing repayment.

³⁸ The point here is not that formal contracts allow no flexibility. Indeed, some degree of flexibility is written into formal lending contracts. For instance you may default on an individual credit card payment at the cost of a fine on the next payment and an adverse effect on your credit rating, but to write the degree of flexibility into a formal lending contract that is relatively easily achieved by an informal one would be extremely expensive.

³⁹ On this, see further, Dowla and Barua (2006).

⁴⁰ Wydick (1999) finds evidence of this insurance dimension of group lending.

⁴¹ A recent paper by Field & Pande (2008) finds, however, that a less stringent repayment schedule does not adversely affect repayment rates.

⁴² Some of the Grameen enterprises include Grameen Shakti (energy), Grameen Communication, Grameen Trust, Grameen Fund, Grameen Shikkha (education), Grameen Telecom, Grameen Knitwear, Grameen Cybernet and, the world’s first “social-business enterprise.,” Grameen Danone. See, further, Yunus (2007).

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- ⁴³ The omnipresence of Grameen and some other leading Bangladeshi NGOs has led to speculation about their having become para-governmental organizations. See *The Economist*, 2001: ‘NGOs in Bangladesh: Helping or Interfering?’, September 13.
- ⁴⁴ The cost is estimated to have dropped from around \$2,000 to \$50 and the time taken from 15 years to 6 weeks. See Panaritis (2001), p.22.
- ⁴⁵ Despite this function of titling having been stressed greatly in the theoretical literature (see for instance, Demstz, 1967), it is not clear from the empirical evidence that it is essential for investment. A number of studies show that perceived security of tenure is more important than exact legal status. See for instance, Payne (1989), Razzaz (1993), Varley (1987).
- ⁴⁶ He attacks the Field result on a number of counts. First, he argues that she does not make the case that lack of title gave rise to a particular need to defend the property, especially in a context where legitimacy can have varied bases. Second, he contends that she fails to account for the new jobs that tiled families were absorbed into in a period of economic downturn. Finally, and most crucially, he argues that the very basis for making the comparison—the fact that the sequence of titling was random—is false. In particular, he points out that a third of the data for non-titled families is drawn from the Huancayo region—the birthplace of the “Shining Path” and the epicenter of political conflict in Peru and that this data is, consequently, not representative. See p. 309.
- ⁴⁷ Galliani & Schargrodsy (2005), however, do not find evidence of increased labor income as a result of titling.
- ⁴⁸ p. 21
- ⁴⁹ This refers to the collaboration between Grameen and the French yogurt manufacturing company, Danone, to produce low-cost yogurt high in nutrients aimed specifically at overcoming some of the nutritional deficits of Bangladeshi children. See Yunus (2007). Grameen has also recently entered into a collaboration with the French company, Veolia, to establish Grameen Veolia Ltd. – to supply low-cost, safe drinking water in Bangladeshi villages. This is particularly crucial because of the presence of arsenic in Bangladeshi water.
- ⁵⁰ Initiatives involving healthcare are mainly Grameen Healthcare Trust and Grameen Kalyan. See further, Yunus (2008).
- ⁵¹ Aspersions have been cast on the motivations of the Grameen for lending to women. Mallick (2002) argues that this choice is prudential rather than ideological, since women borrowers are easier to administer than men. This accusation is reiterated by some NGOs in Bangladesh like Nijera Kori. Whatever the initial impetus for lending to women, it does not detract from the social impact of the choice.
- ⁵² Any discussion about the impact of microfinance programs is mired in the methodological controversies of the Pitt-Murdoch debate. See Khandekar (1998), Pitt & Khandekar (1998), Murdoch (1998) and Murdoch (1999).
- ⁵³ Despite its contribution to poverty reduction, many commentators are critical of the high interest rates that it charges. See, for instance, Ahmad (2007), Ch. 5.
- ⁵⁴ Muhammad Yunus at the University of Toronto, 9th June 2008. See also, Yunus (2008), p. 18. Concerns have been expressed, however, both in the literature (see Khandekar, 1998) and in several personal interviews about the failure of microfinance to decisively impact aggregate poverty which persists at very high levels in Bangladesh.

⁵⁵ Some studies, for instance Ebdon (1995), argue that the pressures of scaling up and a pre-occupation with performance indicators lead to a reluctance on the part of the Bank to make risky loans, even if this means leaving out the most disenfranchised. Grameen II, however, attempts to address these issues through its “beggar program.”

⁵⁶ Muhammad Yunus at the University of Toronto, 9th June 2008. See also, Yunus (2008), p. 9.

⁵⁷ Accusations have, however, been leveled against the Grameen with regard to the appropriation of funds by husbands. Indeed, Rahman (1999) estimates that men, in effect, control as much as 60 percent of Grameen. However, on a relative estimate, women still have greater access to resources than under the conventional system of loans being made directly to the men in the family. In fact, studies by Van Tassel (2004) and Ligon (2000) find that, given the degree of male dominance in Bangladeshi society, the involvement of the husband in the loan venture might even be financially prudent.

⁵⁸ Taka is the Bangladeshi currency.

⁵⁹ The ILD, for instance, identifies three “crucial institutions”:—fungible property rights, legal organization reform, and identity services. In addition, it purports to provide a “5-step” bridge to the “rule of law” and an “inclusive market economy.” See <http://ild.org.pe/en/whatwedo>

⁶⁰ If anything, the Grameen model is being criticized, particularly within Bangladesh, for not adopting an even more all-encompassing approach. The Bangladeshi NGO *Nijera Kori*, for instance, argues that even the ‘microfinance plus’ model is overly simplistic in thinking that these interventions will alter the fundamental power dynamics within Bangladeshi villages without engaging more closely with structural issues at the community level. See <http://www.nijerakori.org/>. This objection is further articulated in Barkat (2008). This point is also made by Ahmad (2007).

⁶¹ Experiments with ‘alternative dispute resolution mechanism’ range from the post-apartheid Truth and Reconciliation Commission in South Africa to the *Lok Adalat* (people’s court) system in India. In academic writing, Dixit (2004) stresses the importance of the role of alternative regulation mechanisms; Sage, Adler & Woolcock (2007) make a strong case for what they call “interim institutions” based on their in-depth engagement and incremental transformations of their political-economic contexts, citing successful examples of regulatory innovation in Cambodia and Indonesia; Rodrick (2008) argues for what he calls “second-best” institutions—which work within the constraints of deep-rooted government and market failure and cannot be removed in the short run—emphasizing that these may be far removed from “best-practice institutions.”

⁶² These dynamics are often studied using a game theoretical approach. See for instance, Aoki (2001) and Greif (2006). While insights from game theory go a long way in helping us understand these institutional mechanisms, in the present situation game theory provides only a partial explanation. Game theory explains cooperative action largely as a strategy adopted based on calculated payoffs from repeated games. This does not explain, however, why some Grameen members continued to repay loans even when the threat of Grameen sinking seemed very real in the wake of the 1998 flood induced crisis. The explanation of this phenomenon may lie in the fact that the Grameen may have succeeded in fostering a positive, long-term habit. On norm-creation and ‘tipping points’, see Granovetter (1978).

⁶³ Very effective systems of informal regulation based on thick social networks can sometimes be rooted in, or perpetuate, normatively undesirable values. Instances of this include the caste system in India based on arbitrary distinctions between groups of people or systems of customary justice that, for example, see honor killings as an acceptable way of resolving disputes, see Dixit (2009). See further, for example, Khadiagala (2001). More specifically, the Grameen approach has been criticized by legal-rights activists in Bangladesh for failing to take a more procedural, rights-based approach to lending and loan collection.

⁶⁴ Khandekar (1998) estimates that the annual impact of microfinance on poverty is as little as 1 per cent.

⁶⁵ This is the 'microfinance plus' model referred to above. On 'social businesses' see Yunus (2007).

⁶⁶ See further, <http://www.pksf-bd.org/> and <http://www.mra.gov.bd/>

⁶⁷ It is well known, of course, how important non-formal aspects of business even between very large organizations are. See, for instance Macaulay (1963)

⁶⁸ Grameenphone is both one of the earliest and most successful of Grameen's 'social businesses'. It is a joint venture between Grameen Bank and the Norwegian telecommunication company, Telenor. It is now the largest telecommunications service provider in Bangladesh. The reputation of the Grameen Bank is, however, a crucial factor behind the success of the venture.

⁶⁹ It was thought that as markets get stronger and communities less close-knit—or at any rate more mobile—the settled communities on which Grameen relies may be destroyed. The experience of Grameen America, the new Grameen Bank branch in Jackson Heights, New York – belies this intuition. Despite operating in the US and in an urban context, repayment rates have been around 99 per cent. See <http://www.grameenamerica.com/>

⁷⁰ A recent incident of fraud underscoring the need for regulation was JUBOK. See, for instance, *The Daily Star*, May 25, 2006. The over-supply of microcredit in the absence of regulation is leading to the problem of overlapping – or borrowers that take loans from one microfinance organization to repay loans to another. Concern about this development was expressed repeatedly in personal interviews.

⁷¹ This is increasingly emphasized in the literature by, for instance, Aoki (2001) and Grief (2006).

⁷² A classic illustration of this is, for example, The Health Act 2006 in the UK. The passing of this legislation in Westminster altered as deep-rooted a habit as smoking, sending smokers out onto the streets from inside bars, pubs and restaurants virtually overnight. One of the biggest advantages of effective formal law is that it is able to influence norms i.e. its self-conscious ability to make a positive impact on behavior patterns.

⁷³ On the relationship between trust and co-operation, see Arrow, 1972, Coleman, 1990 and Dasgupta, 2003.

⁷⁴ As Dasgupta (2003) puts it, the generation of trust is “riddled with positive externalities”.

⁷⁵ Putnam (1993, p. 90) contends that “taking part in a choral society or a bird-watching club can teach self-discipline and an appreciation for the joys of successful collaboration.” Hirschman (1984) describes trust as a “‘moral good,’” growing with use and decaying with disuse. Seabright (1997) presents empirical evidence of cooperation begetting further cooperation. In addition, Dixit (2004), Ch. 3 stresses the continuing importance of civic associations.

⁷⁶ Yunus (2008), p. 16