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## Analyzing Legal Formality and Informality: Lessons From Land-Titling And Microfinance Programs<sup>1</sup>

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### INTRODUCTION

Despite the fact that China has experienced 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 of contracts—has been influential in this discourse.<sup>2</sup> This book has argued, 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. Kennedy and Stiglitz in their introduction to this volume, as well as Chapters 1, 4, and 5, highlight some of these limitations and analyze their implications.

Here, we focus on one particular aspect of this legal tradition: the Chicago School underestimates the difficulty of fully articulating a set of rules, as well as the role that social norms play in the legal process. As we will show, 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 by the Commission for the Legal Empowerment of the Poor, four billion people are “excluded from the rule of law.”<sup>3</sup> 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.<sup>4</sup> 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.<sup>5</sup>

The failure of formal law to reach so many in developing countries does not, of course, mean that if we could better reach them, performance (especially as

measured by the well-being of the poor) might not be better. Nor does the fact that China has succeeded so well in the past mean that more formal structures will not be necessary in the future. Every country has some institutional design for allocating resources, adjudicating disputes, etc.—designs that are always evolving. China's will too, and almost surely rapidly as it moves into the next stages of its transition to a market economy. As it does, it will be important for it not to fall prey to certain shibboleths, simplistic notions about what legal structures should or must look like for a modern economy.

This chapter looks at recent attempts to extend credit to poor people around the world. Since most legal systems contain elements of both the formal and the informal, the distinction between formal and informal law is largely a false dichotomy. However, in transitioning to developed markets countries *do* encounter important choices with regard to their strategy for institutional reform.<sup>6</sup> Indeed, although the Chicago School would argue that rapid legal formalization is imperative, there are 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's Grameen Bank.<sup>7</sup> (We refer to Yunus and the Grameen Bank, but we should emphasize that there are other, roughly contemporaneous, microfinance schemes, most notably Bangladesh Rural Advancement Committee (BRAC), headed by Fazle Hasan Abed, which have met with equal success.) We use the Peruvian and Bangladeshi programs as models of alternative trajectories of institutional evolution. Our purpose is to 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 often displayed within poor communities, the importance of poor people lifting themselves out of poverty rather than becoming dependent on charity, the culpability of institutional mechanisms in maintaining poverty, and, most critically, the importance of *access to credit* for poor people as a means of alleviating poverty.<sup>8</sup> The crucial difference between them, however, lies in their institutional innovations—their choice of mechanism for credit delivery. De Soto prescribes the assignment of formal legal title of land to the names of those who already informally occupy it,<sup>9</sup> to enable them to use the land as collateral to access credit through the formal banking system. 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 the ability of group members to borrow depends on other members repaying. After members are established, however, loans are increasingly issued on an individual basis, relying largely on the borrower's desire to maintain a good reputation with the lender.<sup>10</sup> Although neither is explicitly a legal reform program, if these two schemes are seen in the light of their

common goal—to enable poor people 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 on formal legal intervention and the other 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—allows us to compare the performance of the two mechanisms against a common benchmark. We realize, of course, that the distinction between formal and informal is far from absolute. 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—the Grameen Bank Ordinance of 1983.<sup>11</sup> 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, i.e., he advocates introducing elements of prudential informal business and other practices into the formal legal code through close observation of on-the-ground, informal norms, thereby creating a bridge between the formal law and the informal practice.<sup>12</sup> Nonetheless, 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 of a code of informal norms that may subsequently be formalized. The real-world implementation of the models—primarily in the form of the Grameen Bank<sup>13</sup> in Bangladesh and the 1996 titling program in Peru<sup>14</sup>—provides empirical evidence on the performance of the schemes. 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 program,<sup>15</sup> it is also advising governments around the world on how to replicate it.<sup>16</sup> In addition, international organizations like the World Bank<sup>17</sup> and the United Nations (especially through the work of the Commission for the Legal Empowerment of the Poor)<sup>18</sup> have taken on board de Soto’s recommendations. The Grameen Bank, on the other hand, has directly supported the establishment of replicas in thirty-four countries (to say nothing of the hundreds of microfinance organizations that it has inspired all over the world), and has had at least equal influence on international development agencies.<sup>19</sup> 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.<sup>20</sup> At the same time, the World Bank is the largest investor in microfinance worldwide.<sup>21</sup>

Not surprisingly, given the prominence that the two schemes have attained—and the claims that their advocates have made about their potential to alleviate poverty—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—through formal

law or informal norms? More broadly, does this comparison tell us anything about the better way of achieving developmental goals and, more generally, other societal objectives?

Although this chapter 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.<sup>22</sup> Additional evidence is presented from program replicas in various parts of the world in order to establish a broader generality to the results.<sup>23</sup> We emphasize, however, that context is of the essence: the choice of the regulatory intervention likely to work in a given context is bound to depend on a country's circumstances, such as the type of social capital more readily available and the development of certain market institutions.<sup>24</sup> It is impossible to conclude that one intervention is superior to the other per se, but rather, that a particular intervention works better given a particular set of circumstances. It may be that a program that is appropriate at one stage of development may cease to be so at another. We return to this point later.

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 Grameen model perform, especially in relative terms? Third, how do these two models relate to the Chinese experience? Fourth, how can the relationship between law and norms be characterized, and what insights do these two experiments have for our understanding of this relationship? To what extent should we view formal law and informal norms as substitutes or complements?

The central task of the chapter 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. The chapter is divided into four parts. The first frames the discussion, while the following section compares the two alternative models of institutional evolution—the Yunus and de Soto programs—in terms of their *efficiency* and *equity* impacts and analyzes them in static and dynamic terms. The third section examines how the two models relate to the Chinese experience and the fourth section concludes.

## TWO MODELS OF INSTITUTIONAL EVOLUTION

We view the provision of credit as a contract—implicit or explicit—between the lender and a borrower. The lender provides money today; the borrower promises to repay the money at a fixed date in the future, with interest. When the borrower doesn't comply, there are certain consequences. The adverse consequences provide (part of) the motivation for the borrower to repay the loan. The enforcement provisions are central; if there were no way of enforcing a contract (no incentive for the borrower to repay) credit markets could not exist—the lender, knowing that he would not be repaid, would never part with his money. Contracts (implicit or explicit) are never simple. Extreme punishments (such as the death penalty)

provide strong incentives for repayment; if individuals could always comply, that would be the end of the story. But events happen that make it essentially impossible for the borrower to fulfill his commitments. If the borrower knew that there would be extreme penalties, regardless of his ability to repay, that too could destroy the loan market. Thus, a well-designed credit contract has some flexibility. In practice, banks will roll over loans, and in some cases, even engage in debt forgiveness. Extreme measures (like debtor prisons) may provide strong incentives, but more flexible contracts may actually be more successful in getting repayment in adverse situations, and the knowledge of such flexibility may facilitate more borrowing.

In a formal contract, the consequences of nonrepayment are set forth; but the enforcement even of formal contracts is governed by norms, e.g., concerning rollovers.

The elements of the property rights approach to extending credit (which, for brevity, we will call the de Soto model) are simple: Property (land) registration enables individuals to put up collateral to obtain credit; the provision of credit overcomes the fundamental problem of contract enforcement—if a borrower does not repay the loan, he loses his collateral. De Soto postulates that the reason that commercial banks have been reluctant to enter into loan contracts with poor people is the lender's fear of nonrepayment; the ability of poor individuals to provide collateral in the form of land overcomes this problem. Responsibility for enforcing the contract is vested in a third party—the state legal system; the state turns over the collateral to the lender in the event of default.<sup>25</sup>

“Good” contracts have to be well-designed and effectively enforced. Well-designed contracts share risks, provide incentives for repayment, and have sufficient clarity that they do not raise problems of enforcement. Central to the success of a credit market is its ability to “solve” the critical problems of selection (who is creditworthy), monitoring (ensuring that the funds are used in the way intended), and enforcement (ensuring loan recovery). The lower the *information costs* of overcoming each of these problems in the two models, the more efficient it is (Hoff and Stiglitz 1990). Design and enforcement are related: lenders are unlikely to enter into a contract unless they consider the promise of enforcement credible.<sup>26</sup>

The two models (Grameen and de Soto) differ in how and how well they solve these problems. From a legal perspective, what is critical are the differences in their modes of enforcement. Some credit contracts that might be enforced under some circumstances in one “model” may not be in the other and vice versa. Differences in enforcement effectiveness affect not only the overall level of lending activity, but also who has access to credit.

Dasgupta (2003) has identified four systems of contract enforcement. The first, “mutual affection,” is based on group members caring about each other. The second is “pro-social disposition,” based on norms of reciprocity, such as might arise out of 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. These three enforcement mechanisms are central to “informal” legal systems.

The fourth, “external enforcement,” relies on an established third-party authority—that is typically, but need not be, the state—to enforce explicit

contracts. This is the model represented by formal, Western-style legal systems. The effectiveness of such an enforcement system may rely on a sufficient number of individuals *opting in* to the system of authority (i.e., a social norm to comply with authority, enforced in turn, perhaps, by a system of sanctions for noncompliance); or it may rely on coercive force, e.g., through state power. However, enforcement achieved largely through coercion, even if feasible, is typically highly uneconomical.<sup>27</sup> Thus, interestingly, the line between formal and informal systems is blurred by the fact that the most effective formal system is one that is sustained by the norm of compliance with it.

Although there are obvious gains to be reaped from cooperation, it can often be contrary to individual interest, especially when that interest is shortsighted. That is, cooperation may not be able to be sustained *as an equilibrium*.<sup>28</sup> 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 everyone's interests in the long run.<sup>29</sup> 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 coordination. Key to this calculus appears to be the *beliefs* of agents within the system—beliefs that are themselves affected by the system itself.

### Efficiency

We begin by comparing the relative performance of the two models in terms of efficiency. The alternative models will be evaluated in terms of their success in providing credit to low-income individuals who otherwise would not have access to credit. There is, fortunately, an abundance of data on which to base judgments regarding their success.

Although approximately 3.5 million Peruvian households received title under the de Soto scheme,<sup>30</sup> it appears to have largely failed to lead to the postulated increase in access to credit—particularly from the private sector (Field and Torero 2004).<sup>31</sup> 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 (*ibid.*: 299). Similarly, Galliani and Schargrodsky (2005) find that effects of titling on access to credit are extremely modest in Argentina.<sup>32</sup> In the case of Colombia, Gilbert (2002: 14) finds that “possession of legal title makes little or no difference to the availability of formal finance.”

In stark contrast, not only has Grameen entered into informal lending contracts with more than nine million poor borrowers,<sup>33</sup> 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 and Zeller (1997) finds comparable repayment rates for several other microfinance organizations in the subcontinent.<sup>34</sup> 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.<sup>35</sup>

*The de Soto model*

How do we understand the seeming failure of the de Soto model? First, de Soto's assumption that the problem of access to credit is based on the absence of collateral may be flawed. Indeed, in the developed world, most loans are based on future cash flows rather than collateral. Second, even if collateral were a material consideration, the scheme assumes the existence of a complete set of land markets robust enough to support the use of land as collateral, despite much evidence of their absence in most parts of the developing world (Platteau 2000; Gilbert 2002). A partial explanation may be that owners consider their land as family assets rather than as capital (Finmark Trust 2004; Tomlinson 2005).<sup>36</sup> In some places, there may be another reason for the failure of land markets to develop: in several communities in the developing world, land has an ontological meaning as something almost sacred, rather than a saleable asset. Furthermore, good risk markets are absent in many developing countries. Land ownership provides what limited security they can obtain. Third, because of high legal costs (of enforcing the debt contract and obtaining the collateral), the value of the collateral to the bank is low—much lower than the value of the land itself. Hence, the attractiveness of the collateral to the bank is limited (Arrunada 2003). Finally, Gilbert (2002) argues that titled families may themselves be reluctant to take loans—being intimidated by bank requirements or fearing default—and, consequently, preferring informal sources of credit instead.

Nor does titling ensure that enforcement is credible.<sup>37</sup> There are two problems: the information requirements for effective enforcement and legal capacity. The external enforcement model—or formal law—requires that breaches be both *observable* and *publicly verifiable*. Thus, the information costs associated with it are 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). At one level this appears trivial: breaches can be observed easily enough—it simply means that the borrower has not repaid. But within the formal system, observing the breach does not, by itself, justify punitive action. The system entails the further requirement of public verifiability established through the “due process” of the formal legal system—typically a complex and long procedure even when the breach itself is plainly obvious. Further, the formal system views breaches in a binary manner—displaying little sensitivity (especially compared with informal systems) to qualitative factors like the legitimacy (or lack thereof) of the reasons for the breach.

We noted earlier that the efficacy of a formal legal system is ultimately determined by enough agents opting in to it. This is, in turn, determined by the dual factors of confidence in the enforcement agency (in its effectiveness by lenders and in its fairness by borrowers) and trust in the propensity of other agents to comply.<sup>38</sup> Consequently, in the absence of the use of pure coercive force, the determinants of the success of a formal legal system are essentially *internal* acceptance rather than external imposition.<sup>39</sup> The introduction of an isolated legal intervention, as the de Soto scheme attempts, is of limited value in the absence of a “broader respect that exists for legal authority” (Andre and Platteau 1998: 43). Given that the courts are likely to consider the transfer of poor people's property to the banks highly inequitable, they are often reluctant to use compulsion

(i.e., seizing collateral) to enforce the formal law. Of course, if that is the case, the *formal* system becomes, in effect, an informal one, relying on norms.

The ability to enforce contracts will depend on the legitimacy of the contract and the authority that is responsible for enforcement. Andre and Platteau (1998: 43–4) note that new legal bodies are likely to face constant contestation, criticism, and harassment not only from the disputant but also from other stakeholders in the customary system, at least in the context of unpopular decisions. Thus, the legitimacy of the reform ends up being crucial to its prospects of success. It is easy for land titling to lose legitimacy; the problem is inherent. If the owner of the title was clear to everyone, titling wouldn't be a big deal. In the process of titling, large numbers of land disputes may have to be resolved. Inequitable resolutions are likely to be highly salient, when citizens have questions about the government implementing the program. Titling programs seeming to come from elites may be viewed as advancing elite interests.

Finally, formal credit contracts, by their very nature, are likely to be more rigid. Increased formality and rigidity of contracts may contribute to the clarity of the contract, but also to its inflexibility. The result of this inflexibility is a higher chance of default, which in turn can lead to higher concentration of land, greater inequality, and more agency problems. In the long run, overall efficiency may be impaired as a result of an increase in agency costs (Braverman and Stiglitz 1989). Moreover, the de Soto approach glosses over the complexities in property rights that are emphasized in Chapters 1 and 4. In particular, the scheme may actually heighten rather than reduce uncertainty as a result of the legal dualism that may be created. In the likely event that, due to these reasons, the formal legal system fails to decisively trump the customary or informal system, the central goal of the titling process—increasing certainty in transactions—is defeated. Indeed, the abrupt introduction of another tier to the property matrix can greatly increase confusion in transactions (Mackenzie 1993; Platteau 2000; Andre and Platteau 1998).

### *The Yunus model*

There are several factors that have contributed to the relative success of the Yunus model in extending credit. The absence of collateral requirements removes an important constraint. 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. 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. The terms of formal contracts are largely fixed, and changing them is an expensive process involving high information and procedural costs.<sup>40</sup> The terms of an informal contract, on the other hand, are more easily and economically renegotiated.<sup>41</sup> 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 in large part.<sup>42</sup> 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. (In this sense, informal contracts can actually manage risk better than formal contracts, even though enhanced “certainty” is allegedly one of the benefits of 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, peer monitoring (part of at least the early Yunus model) has significant informational advantages since the community is far better poised than formal institutions to monitor the actions of borrowers (Stiglitz 1990). Peer monitoring is able to overcome both problems of moral hazard (Arnott and Stiglitz 1991) and adverse selection (Ghatak 1999).<sup>43</sup> These informational advantages are critical for the flexibility of design discussed above. Since speculative (sometimes called strategic) defaults (i.e., an attempt at evading repayment by those who could make them) can more easily be distinguished from genuine ones (i.e., some unforeseeable circumstance, such as a natural disaster or sickness in the family), not only do these contracts have a built-in insurance mechanism against risk, but they also allow the lender to give loans to those considered riskier borrowers, making the system inherently more inclusive (Wydick 1999).<sup>44</sup>

The peer structure also contributes to the credibility of enforcement. The threats of social sanction and loss of reputation—amplifying the threat of not refinancing borrowers who default—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; Besley 1995). Further, the Grameen’s essentially participatory character allows the problem of borrower apathy to be overcome and enforcement to be achieved through *internal legitimacy* rather than external force.<sup>45</sup>

An increasingly important feature contributing to the desire for borrowers to maintain a positive reputation is the progressive interlinking of markets or the expansion of Grameen into other markets that affect borrowers, thereby increasing the stakes in the relationship between bank and borrower (Hoff and Stiglitz 1990; Braverman and Stiglitz 1982).<sup>46</sup> 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 act as her employer, bank, source of infrastructural facilities, provider of goods and services, and run her daughter’s school.<sup>47</sup> 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 and Barton 1998).

## Equity

Not surprisingly, the Grameen model performs better not just in terms of efficiency, but also in terms of equity, as assessed by variables such as income, investment, employment, and property ownership of essentially instrumental normative interest, as well as welfare indices of inherent value such as gender

equity, access to education, access to health care, nutritional status, and so on. This section also looks at some of the broader economic impacts, beyond increased availability of credit, that may have consequences for efficiency as well as equity.

### *The de Soto model*

Looking first at the economic variables that the de Soto program targets, the evidence is mixed. On a positive note, the program succeeded in accomplishing its objective of increasing land titling—several million legal titles having been distributed in Peru alone. (That means that if credit did not expand, it was *not* because of the lack of titling.) In addition, there were significant improvements in the cost and time involved in the titling process.<sup>48</sup> However, to the extent that this transfer of title involves granting formal rights over property already effectively controlled by poor Peruvians (i.e., it is a land *titling* rather than land *reform* program and is not fundamentally concerned with redistribution), the value of the program derives from 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 because of its failure to have the postulated effect on access to credit. However, there is some indication that there may be other economic benefits. First, there is some evidence that titling leads to increased household investment—or investment in the maintenance and improvement of titled property (Galliani and Schargrodsky 2005).<sup>49</sup> Whether overall investment actually increases, given that credit supply does not increase, has been questioned (Carter and Olinto 2003). It may be that the increase in household investment is the product of a reallocation of funds from one category to another, i.e., the increase in fixed investment (in the property) may come at the cost of movable investment (including consumption). The net welfare effects of such a shift are ambiguous.<sup>50</sup> Second, some studies find that titling leads to increased labor force participation rates. It is hypothesized that this is because titled families need to spend less time defending their property, leaving them more time for productive activities (Field 2007; Galliani and Schargrodsky 2005). However, the validity of the finding by Field (2007) on increased labor supply—cited widely by advocates of the program—has been brought into question, especially by Mitchell (2005).<sup>51</sup> 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.<sup>52</sup> This accords with studies in the academic literature that establish that titling is most useful in situations where informal rights are weak or in the case of vulnerable households (e.g., Lanjouw and Levy 2002).<sup>53</sup> Nonetheless, even if titling's economic benefits have yet to be established, it may have certain positive social effects associated with increased security of ownership and the creation of relatively settled communities.

However, there is a downside to titling, with potentially important social and economic consequences: while the program grants more secure rights of ownership to the poor, it simultaneously makes rights of ownership more easily alienable. The social impacts of the potential loss of land by poor occupiers may be grave. De Soto's model is effectively a strategy of inducing the poor to risk their

major asset or resource—land. As their only means of insurance, the impact of the loss of even a fraction of a household's land would likely be disproportionately severe, and the loss of all of their land would result in the social and economic problem of landlessness.<sup>54</sup> The strategy is rendered even more risky because it is proposed in the absence of any accompanying welfare schemes, such as health care or food subsidies or any training or assistance programs that might increase productivity, thereby increasing the likelihood of distress sales of land. (The risk is even greater in the presence of inadequately regulated lenders, who can engage in predatory lending practices, taking advantage especially of those who are less financially sophisticated.) An alternative—less risky—approach would be to offer a part of the produce of the land as collateral instead of the land itself.

Any land titling program has to confront the problem of inequities (and sometimes illegitimacy) of the initial holdings. For instance, it may be inequitable to distribute land to squatter families currently occupying it. Endemic to de Soto's 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 (squatting on others' land), that are not only rewarded by it but also expected to become "law-abiding citizens" overnight. (Titling large landholders who may have obtained their ownership rights from a colonial power may be even more problematic.)

While the economic benefits of land titling seem limited, so too are the ancillary welfare benefits. There is some evidence of a tangential impact on school attendance of children of titled families (Galliani and Schargrodsy 2005; Field 2007), but no direct evidence of other indices improving as a result of participation in the program (except, perhaps, through any increases in income that may result from increased labor force participation).<sup>55</sup>

However, some studies have found that titling has 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 and Schargrodsy 2005) and to increased contraception use and decision-making power on the part of women (Field 2003). On the other hand, at least in some contexts, titling may have adverse gender impacts. Titling is frequently associated with the loss of the customary rights of vulnerable communities. 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 and Roth 1989: 21). Further, since the sections of the population likely to have the most significant interface with the formal system are the most privileged, this reallocation is likely to be at the cost of the most vulnerable, leading to a legitimacy deficit in the reforms. In this way, customary rights are likely to be destroyed by the registration process. The erosion of customary law weakens, in turn, other aspects of the "informal" economy, e.g., with respect to risk-sharing. For instance, in many societies, women have an informal entitlement to a portion of the harvest of their husband's land, but these claims are often destroyed by the titling process—with broad implications for the welfare of not just the woman, but also the family as a whole.

Similarly, it is customary in many societies for a woman separated from her husband to be entitled to a portion of her father's land in order to avoid destitution—but again, titling often displaces these rights. The introduction of individualized formal property rights fundamentally disrupts the system of communitarian norms that bind groups (especially families), enabling them to act as an insurance and welfare net—especially in contexts where the state, and formal systems more generally, conspicuously fail to do so. Platteau (2000) and Andre and Platteau (1998) find compelling evidence of these kinds of effects 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-Cornhiel 1997) or undermines systems of customary justice (Kevane and Gray 1999; Hare, Yang, and 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 groups of people (such as women), there is evidence that it is particularly difficult for these people to access the formal justice system to vindicate their rights (Lastarria-Cornhiel, Agurto, Brown, and Rosales 2003; Fenrich and Higgins 2001).<sup>56</sup> (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 tends to benefit the socioeconomic class within the caste that least needs reform, frequently called the "creamy layer." Thus, despite titling targeting squatters, it may fail to impact the most needy among them.)

Finally, the titling process may be extremely amenable to appropriation by the powerful. The more unequal a society, the greater the likelihood of such exploitation of vulnerable categories by officials and others.<sup>57</sup> Widespread evidence of this can be found in Thailand (Thomson et al. 1986; Feeny 1988); India (Wadhwa 1989; Viswanath 1977); Latin America and the Caribbean (Stanfield 1990); Uganda (Doornbos 1975); Nigeria (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 free.

Neither the absence of broader social impacts nor the reinforcement of existing inequities is surprising. Unlike the microfinance program, 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 inequity, but rather with leveraging existing power allocations to achieve a more efficient outcome—to achieve a Pareto improvement. His primary focus is on the economic losses he associates with the "dead capital" of untitled land in the developing world. Not have titling programs, with their strategy of achieving social change through efficiency enhancement, diversified organically into different social sectors in the way that the microfinance movement has.

### *The Yunus model*

From the start, the Grameen Bank had a social agenda. Its intention was to bring credit to the very poor.<sup>58</sup> It could more easily have delivered credit to poor communities by enhancing access to the credit among the (still quite poor) local elites. But it chose not to do this, and to go the opposite direction, giving credit to the least powerful—women in very poor families. In doing so,

Yunus wanted not just to increase their livelihood, but to alter power relationships. Given these objectives, it is not surprising that, although Grameen started out as a credit access program, its agenda very quickly evolved to become far more broad—adopting what policymakers in Bangladesh are calling a “microfinance plus” approach. Grameen targets economic variables mainly by attempting to increase income through access to credit, but it 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 proactive 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 begun addressing nutritional concerns by getting involved in the production of high-nutrient, low-cost food and clean, low-cost drinking water.<sup>59</sup> It is currently actively working to extend its reach to the health care sector.<sup>60</sup> Its commitment to female empowerment is explicit, lending almost exclusively to women.<sup>61</sup> (We will discuss later a number of other aspects of its female empowerment agenda.)

The evidence is that not only did Grameen succeed in increasing the flow of credit, but that there were broader economic and social benefits.<sup>62</sup> 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.<sup>63</sup> These claims of increased income are backed by objective third-party assessments, although the magnitude of the benefits reported by these studies is typically more conservative (Khandker 1998; Hossain 1988).<sup>64</sup> Second, participation in the Grameen program appears to be associated with a decrease in poverty at the household level. Grameen reports that a significantly smaller proportion of its members live in poverty (20 percent) compared with nonmembers (56 percent).<sup>65</sup> Further, Yunus reports that 64 percent of Grameen members decisively move out of poverty within five years of joining the program.<sup>66</sup> The reach of the program heightens the significance of this achievement—80 percent of poor families are estimated to have access to microfinance in Bangladesh.<sup>67</sup> But while the objectivity of this data may be subject to question, several independent studies also find evidence of reduced poverty indices in Grameen households (Hossain 1988), as well as an improved socioeconomic status (Wahid 1994).<sup>68</sup> There is, however, some controversy about the macro-level impacts of microfinance on poverty reduction. In a well-regarded study using panel data, Khandker (1998) finds that aggregate poverty in Bangladesh is decreasing by only 1 percent per annum. Moreover, Bateman and Chang (2009) have argued more broadly against using microfinance as a systemic poverty reduction strategy on the basis that it detracts focus from a more fundamental state-driven structural transformation of the economy that would ultimately yield deeper and wider returns. But while the microfinance organizations may have overstated their impact on poverty alleviation and it appears unlikely that it can, by itself, substantially impact poverty—the data suggests that microfinance makes at least a modest contribution to poverty reduction.<sup>69</sup> There is evidence, moreover, that Grameen has had positive effects on some important welfare indicators. For instance, various studies have found positive

effects on contraception use by women (Schuler and Hashemi 1994; Amin, Li, and Ahmed 1996; Schuler, Hashemi, and Riley 1997).

There are broader economic benefits, especially to women, that arise from how the Grameen program is structured. Grameen membership requires internalizing a number of different types of prudential practices. Potential members must learn to sign their names and memorize a list of sixteen 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 (though they are limited to production, as opposed to consumption, and the focus on production itself may have broader benefits), members are provided with ongoing assistance in the form of encouragement and troubleshooting advice in the face of financial troubles. There is evidence of these noncredit, participatory aspects having a positive effect on self-employment profits (McKernan 2002). Indeed, the empowerment dimension of the scheme is one of its key assets.

An important contribution of Grameen has been the creation of an entire second generation of beneficiaries. Reportedly, 100 percent of the children of Grameen families were enrolled in school. Grameen is attempting to actively promote a rapid socioeconomic 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.<sup>70</sup>

It is not surprising that, given its focus on empowering women, 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 women undertaking activities outside the home is itself stigmatized.<sup>71</sup> In addition, studies have found a positive impact on a number of other empowerment indices. Using surveys, Pitt, Khandker, and Cartwright (2003) find that participation in credit programs leads women to take a bigger role in household decision-making, greater access to financial and economic resources, better social networks, improved bargaining power vis-à-vis their husbands, greater mobility, and better spousal communication.<sup>72</sup> Moreover, Hashemi, Schuler, and Riley (1996) find that even the most “minimalist” credit programs—or those that do not emphasize female empowerment—have an emancipating effect on women.<sup>73</sup> Though the impact of microfinance on female empowerment arises partly from the additional economic resources that it puts at the disposal of women, the structuring of the program strengthens these effects. 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, and Badal 1998). In addition, positive impacts have been found on specific welfare indices such as women’s health (Nanda 1999). The emphasis on women may not just be a matter of equity. 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.<sup>74</sup>

Finally, microfinance contributes to releasing the untapped economic potential of the female labor supply in Bangladesh. Emran, Morshed, and Stiglitz (2007) explain that microfinance works essentially because of imperfections in the capital and labor markets. As long as two of these markets function perfectly, mobile factors move to the immobile one, ensuring overall efficiency. In the more realistic context of imperfect capital and labor markets, microfinance 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, have their productivity enhanced. We should emphasize that many of the ancillary benefits of Grameen bank are not the inevitable consequence of microfinance schemes, but depend on the particular way the program has been structured; but some are intrinsic to the trust-based approach that emphasizes group lending and peer monitoring. Still, the fact that other Bangladeshi microfinance schemes, most notably BRAC, have not only replicated Grameen’s success, but in some dimensions may have exceeded it, suggests both that the model’s success is not just the fortuitous result of having good leadership (Yunus), and that it may be replicable. Indeed, BRAC’s programs in female legal and health education and its innovative schooling programs have enhanced social benefits and female empowerment; and its economic programs entailing vertical integration (e.g., not just giving members loans to raise chickens, but also entering into the production of chicken feed and the like) have increased its economic impact. All of this suggests that there is something to the traditional not-for-profit microfinance programs that makes for their successes.

### Static analysis

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

One of the essential differences between de Soto’s and Yunus’s approaches is that the latter takes a more *integrated* view of development. By contrast, de Soto’s approach falls into the category of linear models of development (of which the Washington Consensus approach is typical)—assuming that targeting certain critical, albeit isolated, variables will bring about development.<sup>75</sup> 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 recognize crucial linkages between economic, legal, and social systems.<sup>76</sup>

Further, his exclusive focus on economic variables of *instrumental* interest, rather than welfare variables of inherent interest, stems from a seeming belief that overall efficiency and the well-being of poor people will follow almost automatically, once life is given to the dead capital. There are further distinctions, discussed below, in conceptions of the dynamics of development.

The notion that land titling (and the rule of law more generally) would be decisive in changing the course of development is predicated on the belief that

markets in general work well—or would work well—if only there were a rule of law. But market failures are pervasive even in countries with reasonably good legal systems. Given that markets in the developing world are riddled with imperfections—ranging from externalities to information asymmetries—it is not surprising that simply titling, or bringing a rule of law, does not, on its own, bring development.

It was not only the economic assumptions underlying the de Soto scheme that were flawed. As the Introduction to this book and Chapter 4 point out, the assumptions about “law” and “property rights” were overly simplistic and unrealistic. For instance, while the working of the titling mechanism is predicated on a well-functioning legal system, the view of the law he adopts is highly *formalistic*—vesting paramount faith in law as written down in the statute books, as well as the formal structures of the law. On one hand, de Soto advocates incorporating into the formal code elements of successful informal practice, thereby paying homage to the dynamism of the informal economy and the informal norms that make such an economy function. On the other, he makes a definitive formalist leap by assuming the inevitability of the need to formalize these norms and practices—irrespective of how well the informal system may be working. This takes for granted, contrary to much empirical evidence, that the process of writing rules down dramatically improves their efficacy. For example, he asks us to “listen to the barking dogs” or to heed evidence of informal delineation of property rights in the developing world—boundaries, he argues, that are well, if informally, established. But, as we have discussed at length, the formalization process is far from trivial—and frequently introduces distortions in the system in its own right. It assumes, further, that once laws are written down, they can be interpreted and applied completely objectively, eliminating any role for norms. Language inevitably entails ambiguity,<sup>77</sup> disputes arise, and those resolving disputes will rely partially on norms. Moreover, he ignores the transaction costs associated with implementing the formal legal system—and the fact that in almost every society, there are costs in getting full access to its benefits. The poor are at a disadvantage. Though the rule of law may protect against some abuses of power, the formal legal system itself favors those who are better off, and especially so in the context of property disputes. (Public legal assistance redresses the imbalance, but only partially, since the quality of legal assistance is almost always markedly less than that available to the rich.)

Finally, and most critically, de Soto neglects the fact that the best way of arriving at a good legal system is not through *external imposition* but rather through drawing agents into the system through a process of building internal legitimacy. Too often, it is foreign experts and the country’s own elites that push most strongly for titling programs, and this in itself arouses suspicion and can undermine the legitimacy of the whole process: is the objective of the program really to empower poor citizens or to provide another tool through which the wealthy can accumulate more wealth for themselves?

Yunus, while acknowledging the merits of the market mechanism, also recognizes that markets are far from perfect and riddled with barriers to access. Indeed, his whole approach is premised on a set of market failures (access to credit, access to jobs) and the recognition that political and economic inequalities could be self-perpetuating. Thus, his solution to the access-to-credit problem is far more *substantive*, providing loans directly, not just removing what was viewed as the (only) barrier to access, the absence of collateral.

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. He realized that among the market failures was lack of effective competition; but the imbalance of market power was matched by an imbalance of political power. It would be elites who design the formal legal system, and it is they who implement it. It is they who adjudicate disputes. Inevitably, a formal legal system works to the disadvantage of the poor. Grameen was designed to improve the well-being of the poorest of the poor, in a context in which they lacked both economic resources and political power.

Rather than relying on formal law and coercion to enforce contracts, Yunus constructed a system in which social and economic incentives sufficed to ensure repayment. 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. This final point accounts for Yunus's relative success in soliciting cooperative behavior on the part of program participants—all the more laudable in a context in which the formal legal system has found it notoriously hard to establish a framework for cooperative action.<sup>78</sup>

The Grameen experiment showed that informal, norm-based regulatory interventions—more rooted in social context and inherently more participatory—are much more likely to be seen as legitimate and, hence, to be more efficient than the impersonal structures of conventional law. (They are more efficient in that they enabled more individuals to have access to credit and more efficient in having a lower default rate.)

Indeed, the success of the informal Grameen mechanism is not an isolated phenomenon. Earlier, we referred to other successful microfinance schemes. There are a number of other examples where “informal” law replaces formal legal structures. A host of alternative dispute resolution mechanisms have been successfully implemented in various parts of the developing world, illustrating the flexibility, responsiveness, and accessibility of these systems relative to more formal ones.<sup>79</sup> While they may operate in the broader context of a more formal legal framework, their ability to tap into informal resources, such as shared values, community norms, and networks, and their emphasis on consensus-driven conflict resolution enable them to deliver cheaper and more expedient justice than their formal counterparts. At the same time, an emergent voice within academia is starting to call for more innovative—if less ambitious—regulatory solutions.<sup>80</sup> The “rule of law” regime may be the proverbial institutional “cake”—a luxury in the context of much of the developing world that is unattainable, even if it is desirable. But there is a pressing need to focus instead on what Galanter and Krishnan (2004) call legal “bread for the poor”—functional institutional solutions that are realistic in the context of the developing world.

## Dynamics

In the previous section we saw that the Yunus model performs better than the de Soto model, at least in the short run: It has been more successful in extending credit, increasing incomes, and advancing a variety of social goals.

These successes come in spite of arguments in favor of the rule of law over the often more arbitrary “rule of persons.”<sup>81</sup> But if the Yunus model is to succeed in reducing poverty at a macro-level, it must “scale up” its operations. This can take the form of widening reach in terms of a proliferation of organizations providing microfinance, as well as increasing the scale and range of the ventures that poor families are able to tap into, thereby allowing them to access wider resources and be lifted out of poverty more effectively.

Both developments are currently under way in Bangladesh. In recent years, there has been an explosion of organizations entering the fray to provide microfinance, 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 poor people.<sup>82</sup> This scaling up of operations has, not surprisingly, been accompanied by an increasing move toward formal regulation. The microfinance sector as a whole (particularly following 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). At the same time, the social businesses sector into which the microfinance organizations are moving are mostly regulated as any other business enterprise, by formal law.<sup>83</sup> These developments indicate that while a trust-based system seems to work effectively in regulating small lending 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 may become more necessary.<sup>84</sup> While the microfinance sector in Bangladesh was dominated by a few key players, entry into the sector did not need formal regulation (they had an incentive to behave well, and so long as they were small, the consequences of misbehavior were limited), but as the number of players increased and incidents of fraud began to occur, there arose a need for regulation.<sup>85</sup>

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 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 Grameenphone subscriber purchases a subscription not on the basis of a personal trust in the service provider, but rather as a more impersonal market transaction.<sup>86</sup> Moreover, changes brought about by economic growth and development may themselves undermine the effectiveness of informal regulation, which depends, for instance, on stable communities (repeated interaction). With development, individuals move easily in and out of communities, undermining the effectiveness of the social and economic sanctions that can be applied against a party that has broken “trust” (Stiglitz 2000).<sup>87</sup>

The appropriate choice of institution 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 progressed, the institutional framework changed to adapt to it. Indeed, what is crucial

is not whether the mode of regulation is formal or informal, but rather the influence exerted over the actions of agents.<sup>88</sup> Without a transmission mechanism allowing 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. In successful legal systems, formal law and social norms work in tandem. Formal legislation has the capacity to shape norms and influence action;<sup>89</sup> but if they are to do this successfully, they cannot be imposed from above or from the outside.

In the context of the developing world, abruptly introduced and isolated legislative interventions are bound to fail to have the same effect that they might in a developed country that adopted them after lengthy political debate and consensus formation, given that these interventions do not emerge out of an organic process of institutional growth and thereby lack internal legitimacy. 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 cooperative institutional equilibrium by fostering social capital and trust, i.e., by causing a revolution *within* the agents in the system.<sup>90</sup> In the framework of the Hoff and Stiglitz (2008) model, individual expectations with regard to the prospects for establishing the rule of law determine individual support for it.<sup>91</sup>

The Grameen mechanism can be seen to be producing a public good by creating social capital, changing perceptions about social interactions, and possibly altering expectations about the rule of law.<sup>92</sup> This was especially the case for BRAC, which has had explicit programs enhancing participants' knowledge of, and access to, "the law," especially in domains that are vital to their lives.<sup>93</sup>

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 cooperation will beget further cooperation (Hirschman 1984; Putnam 1993; Seabright 1997), and in the instance of the Grameen, this has been the case—both within and outside of the specific program.<sup>94</sup> 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 were elected—this accounts for 24 percent of the total women's reserved seats.<sup>95</sup>

The social capital building initiatives of the early stages of institutional development of the Grameen paved the way for current developments. The successes of both the newer microfinance organizations that entered the fray after the Grameen Bank and BRAC (like ASA, now the third biggest microfinance provider in Bangladesh) and the social businesses run by the bigger microfinance organizations was enabled by the foundations laid by the first-generation microfinance experiment. The familiarity established vis-à-vis the "technology" of microfinance and the improved norms inculcated by the older microfinance institutions greatly reduced the investment of time and effort required of the newer institutions in establishing themselves. At the same time, the positive reputation of the bigger microfinance institutions has been critical both in attracting the investment and creating the client base that has fuelled the social business sector in Bangladesh.

However, a process of informal consensus and social capital building often works to effectively pave the way to more formal legal systems, which will play a more important role in later stages of development. 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 is more appropriate to emphasize at a particular stage of development.

We end this section on a note of caution: evolutionary processes do not always work in the ways that we would hope. It is not always easy to distinguish the crucial aspects of an institutional arrangement. Consider microfinance. We have argued that its success was dependent not just (or even so much) on the provision of credit to the poor, but there were those who thought otherwise. They thought that microfinance had proven so successful that it could be converted into a profit-making institution, which would provide incentives to extend its reach, providing more finance to more poor people. But the change from a not-for-profit model to a for-profit model fundamentally changes incentives. Many microfinance schemes outside of Bangladesh have been for profit. In that context, the same incentives for predatory lending that marked the US subprime market arise in developing countries. Private firms have recognized that there is money at the bottom of the pyramid, and rather than freeing it up for the benefit of the poor, have done what they could to move it to themselves. Such concerns are central to the de Soto approach, which relies on private markets. If legal systems are controlled by those who profit from the poor, they will do little to stop predatory lending. The legal system will then become an instrument for increasing inequality.

#### IMPLICATIONS FOR CHINA

The previous section describes and analyzes two alternative models of institutional evolution. One advocated the rapid Westernization and formalization of law; the other adopted an approach of institutional gradualism—building slowly on informal networks. In this section, we return to our original focus and consider the relevance of the foregoing discussion for China.

It is clear that formal law has *not* been a major contributing factor in China's remarkable economic growth (Qian 2003; Clarke, Murrell, and Whiting 2008; Upham 2009). At the point at which China embarked on the reform process in the 1970s, few of its legal institutions had survived the Cultural Revolution and it possessed little substantive law for the courts to enforce, particularly in the realm of private property rights (Lubman 1999). Even though the government started promulgating lawlike rules and regulations in the 1980s, there was no comprehensive protection of private property until the Property Law of 2007 (Lubman 1999). Chinese courts are well known for "local protectionism"—or their refusal to rule against the interests of entities within their own localities. Moreover, they are known to be even less inclined to go against the interests of politically strong entities—and the party-state has the formal power to intervene when important interests are at stake (Liebman 2007). Thus, Chinese courts are unlikely to protect

private property against the Party, the state, or even private entities with whom they have close ties (Upham 2009).

How, then, can the Chinese experience be understood? What mechanisms—in the absence of legally defined property rights enforceable in courts—allow economic agents to form the reliable expectations that are the cornerstone of economic transactions? Different authors stress different aspects of the Chinese legal and institutional structures to explain this process. Some have argued China's success demonstrates the irrelevance of property rights. Some argue that there really is a system of private ownership “dressed-up” as public ownership. What is clear is that China's experience is at odds with the claims of those like de Soto who contend that well-defined property rights (in the de Soto sense) are necessary (and almost sufficient) for robust and sustained economic growth.<sup>96</sup>

*Guanxi* is one important, albeit intangible, factor in Chinese economic processes. *Guanxi*—which can be loosely translated into “connections” or “relations,” but means, in essence, “particularistic ties”<sup>97</sup>—is acknowledged to be an essential, pervasive, and resilient lubricating factor in Chinese social relations and economic transactions (Gold, Guthrie, and Wank 2002). There persist debates about whether *guanxi* is a uniquely Chinese concept or essentially the same as the more generic social capital but, as with social capital, *guanxi* is understood to have both positive and negative connotations.

Much of the literature has tended to take a negative view of it, considering it to be synonymous with corruption and an impediment to the establishment of the formal rule of law. A more positive view can see it as playing a crucial role in Chinese economic processes—providing consistency in transactions that would otherwise be missing in the absence of formal rules. Some view *guanxi* as a substitute for formal law (Wang 1989; Zheng 1986). Indeed, it is argued by some scholars that despite attempts at legal formalization in China, Chinese business practices still view Western-style contracts as a “cage” that the appropriate *guanxi* can unlock (Lubman 1998).

Most significantly, the changing character of *guanxi* in the era of reforms is debated. There is speculation with regard to whether its importance will persist or even expand, or whether it will wither and be replaced by the formal rule of law. Potter (2001) takes that the view that with the emergence of formal law in China, the complementarities between the formal rules of the legal system and the informal rules and norms of *guanxi* relations are starting to be strengthened. *Guanxi* serves to provide predictability and stability in a legal system that is new, in flux, and incomplete.

That China achieved its remarkable growth in the absence of Chicago-style formal legal structures appears uncontroversial. Although debate persists about the precise institutional mechanisms that enabled this growth, it is safe to say that both institutions rooted in China's particular context (such as TVEs, whose “ownership structure” does not fit neatly into the standard law and economics property paradigm) and informal mechanisms such as *guanxi* played an important role. While the pressures of sustaining growth and further integration into the global economy may impose some pressures to follow the conventional path of legal formalization, some caution should be exercised to ensure that this process does not erode the institutional structures that have served China so well for so

long and that the formal structures that are adopted are appropriately adapted to China's distinctive circumstances today, as well as to its history.

## CONCLUSION

In the context of the policy choices currently confronting China, this chapter critically examines the Chicago School's assertion that formal law is essential for development. This claim was examined by comparing two high-profile credit-access programs—land titling in Peru and microfinance in Bangladesh—representing two alternative models of institutional evolution that China could follow. A close analysis of the two models revealed that contrary to the claims of the Chicago School, informal norms and codes of conduct can support productive economic exchange, and thereby be conducive to development. 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 a system that might work well at one stage of development may not do so at a later stage. We suggest not only that at later stages of development, formal systems may have distinct advantages, but also that earlier stages of social capital building through informal regulation may pave the way to more formalized regulation more effectively than the approach of rapid, and somewhat abrupt, immediate formalization. In reconciling the static and dynamic analysis, the focus of the legal reform process is no longer that of choosing between legal formality and informality as traditionally posited, but, rather, becomes that of determining the pacing and sequencing of reforms, and what mode of regulation works better in a particular context. We have shown the critical role played by the interactive dynamics between the formal and informal systems.

A hallmark of China's development strategy is recognizing this—and constantly adapting its strategy. We have identified arguments suggesting that, over the long run, there may be certain economic benefits associated with formal regulation. But the critique of the de Soto model is of particular relevance to China, as it proceeds in formalizing property rights. We have shown the risks of growing inequality, especially in the context of a society with an inadequate system of social protection; we have seen too the risk of formal legal systems that are disjointed from social norms; we have shown how the rule of law can protect existing inequities, and differential access to legal redress can be used to increase those inequities. By contrast, we have seen how informal institutions can help create “social capital” that promotes equality (a harmonious society) and actually enhances efficiency, with spillovers into other contexts.

Applying the lessons of this analysis to China, we see that as China negotiates 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 draw on the experience of relatively successful 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.”

NOTES

1. An earlier version of this paper was presented at the Initiative for Policy Dialogue's China Task Force Meeting in Manchester (June 25–6, 2008). The authors are indebted to David Kennedy, the participants at the meeting, and to anonymous peer reviewers for their valuable comments and suggestions, as well as to interviewees in both Peru and Bangladesh for their help and participation.
2. See, on China, Prosterman and Hanstead (2006). On the institutional prescription of the Chicago School for the developing world, more generally, see Posner (1998). Some scholars, while recognizing that China has done remarkably well without the kinds of legal system (property rights) that they argue are essential, suggest that without legal reforms, China's growth will not be sustainable.
3. Commission for the Legal Empowerment of the Poor (2008: 4–5). We agree with their estimate that the quantum of "legal poverty" is immense, but not with their solution to the problem.
4. See further Haldar (2007) and Pistor, Haldar, and Amirapu (2009). Various attempts have been made to explain the failure of formal legal reform in the developing world; for instance, one strain of literature analyzes the issue in terms of "legal transplants." See Berkowitz, Pistor, and Richard (2003).
5. While it is 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).
6. Aoki (2001), for instance, entirely sidesteps the formal–informal dichotomy by classifying as an "institution" only things that actually impact 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.
7. We refer not just to the microfinance and titling programs, but also to their architects, Yunus and de Soto, 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.
8. Yunus (1998) and de Soto (2000). We do not evaluate whether increased access does in fact lead to development or whether differences between the two systems regarding *who* gets access to credit shapes economic evolution differently. There is growing consensus that both Yunus and de Soto exaggerated the importance of credit availability, especially for long-term development, though microfinance has had significant achievements in poverty alleviation.
9. It is not, in that sense, a land or property redistribution reform. An important part of the program in Peru dealt with squatters (on land otherwise "unowned") who were giving formal rights to the land (housing) that they occupied. (One of the problems discussed below is that there are often ambiguities in "ownership," and resolving these may be no easy matter.)
10. 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 2000–2 and started as a response to a 1998 repayment crisis resulting from severe floods in Bangladesh. 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 were

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 and Barua (2006).

11. This law was used to remove Yunus from his position as head of Grameen Bank in 2011. See *The New York Times*, March 8, 2011.
12. For instance, ILD bases institutional reform on “proposals . . . that will build on well-established local legal and ‘extralegal’ practices that all citizens can identify with and respect, streamlining the rules and procedures that govern real estate and business activities, reducing the time and cost to operate in the legal sector.” See further, <<http://ild.org.pe/>>. The modalities of achieving this may, however, be more complex than it initially appears.
13. For a brief history and overview of the functioning of the Bank, see <<http://www.grameen-info.org/>>.
14. For an overview of the Peruvian titling program, see Calderon (2004).
15. On de Soto’s influence in Peru, see Panaritis (2001) and Bromley (1990).
16. Countries currently being advised by ILD include Mexico, Honduras, Haiti, Egypt, Albania, and the Philippines. In addition, ILD reports that there is “demand” for its services in forty-seven countries. See <<http://ild.org.pe/en/home>>. In addition, a number of countries, such as South Africa, not directly advised by de Soto, are deeply influenced by his advice; see Cousins et al. (2005).
17. See further, Gilbert (2002: 5); Panaritis (2002: 22).
18. De Soto is, for instance, co-chair of the Commission. See further <<http://www.undp.org/legalempowerment/>>.
19. See Sharma (2005a, 2005b).
20. See <<http://www.yearofmicrocredit.org/>>.
21. See, for instance, World Bank, 1999.
22. More than twenty years ago, Stiglitz provided the intellectual foundations of the Grameen peer-monitoring system, explaining why it was an effective system of contract enforcement (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. More than 100 in-depth qualitative interviews were conducted with stakeholders in the implementation of the programs.
23. 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 form—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. Some of the replicas of the microfinance scheme shifted from a nonprofit to a for-profit basis, a change that Yunus and others have suggested put at risk the entire program (Yunus 2011). Similarly, in the case of titling, while the formal process can be replicated, other aspects integral to the program, such as the judicial system, cannot just be transplanted.

24. Thus, while Peru might have a better developed market mechanism than Bangladesh, Bangladesh may have stronger community norms. This difference is crucial in determining which regulatory mechanism is more appropriate. See further Besley and Coate (1995).
25. As the problems in America's mortgage markets make clear, matters are somewhat more complicated than this simplistic rendering would suggest. The debt contract has to specify whether the loan is recourse or nonrecourse. A recourse loan means that the collateral serves as a minimum guarantee (one that might have uncertain value, however). The borrower is still liable for repayment, unless he goes bankrupt. Thus, there are background legal structures behind land titling, specifying the terms of enforcement of contracts and bankruptcy. Norms inevitably play some role in enforcement, though the legal structure itself determines the extent to which that is so.
26. Note that lenders might be lured into entering a contract on the basis of a belief in the effectiveness of the enforcement system, but this belief may be false. The recent subprime mortgages crisis is a paradigmatic example of this. On the other hand, lenders might be deterred from entering into a contract because the prospects of enforcement appear unsatisfactory where they might, in fact, be extremely sound. An extremely trustworthy person might not get a loan of \$500, even at an excessive interest rate, if others don't believe that the person is trustworthy. But, if you do not believe that I am, you will not lend me \$500 even at a 40 percent interest rate. It is clear that subjective beliefs are of fundamental importance in determining whether contracts are undertaken.
27. 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 are highly questionable. This is especially so if the contract is viewed as "unfair," either because of an imbalance of economic power at the time the contract was entered into or because of deception (real or perceived) on the part of one party to the contract. Note that today, sovereign debt contracts have to rely on one of the first three modes of enforcement, though in the nineteenth century, military force was used to enforce them (Stiglitz 2006, 2010). The theory of repeated games shows how cooperation can be sustained in contexts in which it could not be in a one-shot game. See Abreu (1988) and Abreu et al. (1990).
28. See Olson (1965), Ostrom (1990), and North (1991). However, in the context of repeated games (repeated interactions), it may be much easier to achieve cooperative outcomes. See, e.g., Abreu (1988, 1990).
29. How actors behave rests upon their expectations of whether the rule of law will be established. This affects whether contracts will be enforced; and beliefs about enforcement affect where loans will be made. There can exist multiple equilibria.
30. COFOPRI (2008).
31. This study of the Peruvian titling program finds (when titles are asked for in the first place) a small positive impact on public-sector lending and a beneficial impact on interest rates—but no impact on private-sector lending. More specifically, the bulk of this positive impact is accounted for by increased in-kind lending of housing construction materials by the publicly funded Materials Bank (MB). Various hypotheses are put forward for this discrepancy, although the cause remains unclear. While the paper suggests that the MB generally issues large loans and therefore faces relatively lower transaction costs of dealing with titled property, it appears more likely that the differential impact is inherent in the MB being a government bank and adopting an explicit policy of lending on the basis of the titles distributed. 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 most likely through public subsidy.

32. 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 nontitled households, with both groups 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.
33. Grameen Bank Annual Report (2009).
34. 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).
35. 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: 5–7).
36. There is an implicit contract across generations; using land as collateral risks losing the land (if a bad outcome occurs), and thus violating the implicit contract.
37. 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.
38. Dasgupta (2003). Similarly, in the Hoff and 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.
39. Alternatively, reliance on external enforcement can be very costly.
40. Indeed, the fact that new contract language is often interpreted in a way that is disadvantageous to the party introducing the deviation from the standard contract deters modifications. See Stiglitz (1992).
41. 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.
42. On this, see further, Dowla and Barua (2006).
43. Theoretically, at least, peer monitoring may reduce the costs of screening, but it does not eliminate the desire of individuals not to subsidize others; that is, groups of similar individuals—equal risk of default—will form, to eliminate or at least reduce cross-subsidization.
44. There are other specific features of the Grameen model that may contribute to its success, e.g., regular repayment schedules (Armendariz de Aghion and Morduch 2000). A recent paper by Field and Pande (2008) finds, however, that a less stringent repayment schedule does not adversely affect repayment rates. The high repayment rates mean that the default premium built into the interest rate can be negligible for *all* individuals, thus making these loans more widely accessible than under the conventional market system, where, even with collateral, loans viewed as having a high default rate bear a very high premium.
45. More generally, there is a large literature arguing the greater effectiveness of systems of intrinsic rewards rather than extrinsic rewards. See Stiglitz (2001) and the references cited there.
46. 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 Yunus (2007).
47. 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).

48. The cost is estimated to have dropped from around \$2,000 to \$50 and the time taken from fifteen years to six weeks. See Panaritis (2001: 22).
49. Despite this function of titling having been stressed greatly in the theoretical literature (see for instance, Demsetz 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), and Varley (1987). It is common that lenders rely more on their judgments of the borrowers “creditworthiness,” as judged by the security of income flows, than on collateral itself. Before the crisis, many lenders switched to more emphasis on the value of collateral, at great cost to themselves and the economy.
50. That is, the possibility of using credit as collateral may distort investment allocations toward the potential asset, even if the social marginal return on this investment is lower than that to the asset.
51. 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 how the new jobs that titled families were purportedly absorbed into were generated—especially 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 nontitled 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.
52. For further evidence see Haldar (2011).
53. Notice that in some such situations, land titling is simultaneously a land reform program, i.e., giving title to property over which others might have legitimate claims. Thus, squatters may be given secure property rights to public land that they have occupied. This is consistent with the remark made in the introductory chapter and in Chapter 4, that typically property rights assignments are *reassignments*, since claims (however ambiguous and uncertain) still have value.
54. Landlessness is an economic problem, because of the presence of agency costs. But when farmers have limited land, even a loss of part of their land may lead to an increase in agency costs, as they turn to other sources of income or seek additional land to work.
55. Galliani and Schargrodsy (2005), however, do not find evidence of increased labor income as a result of titling.
56. Joireman (2008), for instance, emphasizes the displacement of both customary law and women’s rights as major drawbacks of the de Soto program.
57. There is evidence, for instance, of ministers in various developing countries using land titling programs to title substantial tracts of land in the names of members of their families rather than the intended beneficiaries. Given the disproportionate power that the wealthy in the developing world wield over formal law, and the fact that formal law is far more removed from social realities than informal norms, it is easier for the wealthy to manipulate *de jure* rights than it is *de facto* ones.
58. Microfinance was originally thought to target the poorest of the poor, but it emerged over time that conventional microfinance works best for those who are slightly better off than those in extreme and abject poverty. In response, dedicated programs aimed at the poorest of the poor have been introduced. Examples include Grameen’s “Beggar Program” and BRAC’s “Challenging the Frontiers of Poverty Reduction.”
59. This refers to the collaboration between Grameen and the French yogurt company Danone to produce low-cost high-nutrient yogurt 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 in order to supply low-cost, safe drinking water in Bangladeshi villages. This is particularly crucial because of the presence of arsenic in Bangladeshi water.

60. Initiatives involving healthcare are mainly Grameen Healthcare Trust and Grameen Kalyan. See Yunus (2007).
61. Aspersions have been cast on the motivations of 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 Bangladeshi NGOs such as Nijera Kori. Whatever the initial impetus for lending to women, it does not detract from the social impact of the choice.
62. Any discussion about the impact of microfinance programs is mired in the methodological controversies of the Pitt–Morduch debate. Using the same dataset, Morduch (1998) arrived at a very different (and largely, much more negative) set of conclusions about the impact of microfinance from Pitt and Khandker (1998). Morduch explicitly challenged their findings, mainly on grounds that were based on a number of methodological flaws (e.g., Pitt and Khandker’s calculation of land ownership by beneficiary households, village fixed effects, and so on). Pitt (1999) responded, in turn, with a defense of the original methodology. The exchange illustrates the difficulties that underlie “impact assessments” of development programs in general, including large-scale quantitative studies based on substantial datasets and rigorous econometric analysis, and the consequent difficulty of arriving at a definitive pronouncement on the success or failure of a program. See also Khandker (1998) and Morduch (1999).
63. Grameen Bank website: <[http://www.grameen-info.org/index.php?option=com\\_content&task=view&id=25&Itemid=128](http://www.grameen-info.org/index.php?option=com_content&task=view&id=25&Itemid=128)>, accessed June 19, 2011.
64. Pitt and Khandker (1998) attempted to correct for selection bias, but Morduch (1998) has questioned whether they were fully successful in doing so. 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).
65. Grameen Bank website.
66. Yunus (2007: 24).
67. Yunus (2007: 18).
68. Some studies, for instance Ebdon (1995), argue that the pressures of scaling-up and a preoccupation 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 attempts to address these issues through its “Beggar Program.”
69. Even critics of the program concede some modest impact of microfinance on poverty alleviation, for instance Morduch (1998).
70. Yunus (2007: 9).
71. Accusations have, however, been leveled against the Grameen with regard to the appropriation of funds by husbands or other male relatives (Goetz and Sen Gupta 1996). Indeed, Rahman (1999) estimates that men, in effect, control as much as 60 percent of Grameen loans. These results have failed to be validated by other studies. However, on a relative estimate, even if that were true, women still have greater access to resources than under the conventional system of loans being made directly to men. In fact, studies by Van Tassel (2004) and Ligon (2002) find that, given the degree of male dominance in Bangladesh, the involvement of the husband in the loan venture might even be financially prudent.
72. See also Osmani (1998).
73. Using a combination of ethnographic and survey methodology, the paper measured women’s empowerment in terms of eight indicators: mobility, economic security, ability to make small purchases, ability to make larger purchases, involvement in major household decisions, relative freedom from domination within the family, political and

legal awareness, and involvement in political campaigns and protests. See also Schuler and Hashemi (1994).

74. Taka is the Bangladeshi currency.
75. 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>>.
76. The disappointment with the first approach led the World Bank, at the end of the 1990s, to formulate its Comprehensive Development Framework. The conviction that successful development required active engagement of those in the country was key to both the CDF and the IMF’s Participatory Poverty Reduction Strategies. See Wolfensohn and Fisher (2000) and Stiglitz (1998, 1999).
77. As we have emphasized, just as markets are incomplete, so are contracts and laws. It is impossible to specify what should be done in every contingency.
78. 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) and has also been made by Ahmad (2007).
79. An example of an effective alternative dispute resolution mechanism is the Lok Adalat (people’s court) system in India.
80. Dixit (2004) stresses the importance of the role of alternative regulation mechanisms; Sage, Adler, and 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; Rodrik (2008) argues for what he calls “second-best” institutions—which work within the constraints of deep-rooted government and market failure that cannot be removed in the short run—emphasizing that these may be far removed from “best-practice institutions.”
81. 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 (Dixit 2009; 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.
82. This is the “microfinance plus” model referred to above. On “social businesses” see Yunus (2007).
83. See further, <<http://www.pksf-bd.org/>> and <<http://www.mra.gov.bd/>>.
84. It is well known, of course, how important nonformal aspects of business even between very large organizations are. See, for instance Macaulay (1963).
85. Fraudulent practices on the part of the Bangladesh microfinance organization Jubo Karmasangsthan Society (Jubok), for instance, underscored the need for regulation. The organization attempted to embezzle the Tk. 10 billion that it collected in deposits from 0.15 million clients. See, on this, *The Daily Star*, May 25, 2006. The oversupply of microcredit in the absence of regulation is leading to the problem of overlapping—borrowers who take loans from one microfinance organization to repay loans to another. Concern about this development was expressed repeatedly in personal interviews, see Haldar (2011). The expansion of services, e.g., toward deposit-taking, may

- also necessitate greater regulation. There are more opportunities for fraud in taking money from people than in giving them money.
86. 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.
  87. 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 hypothesis. Despite operating in the US and in an urban context, repayment rates have been around 99 percent. See <<http://www.grameenamerica.com/>>.
  88. This is increasingly emphasized in the literature by, for instance, Aoki (2001) and Grief (2006).
  89. A classic illustration of this is, for example, the Health Act of 2006 in the UK. The passing of this legislation in Westminster altered deep-rooted habits such as smoking, sending smokers to 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.
  90. On the relationship between trust and cooperation, see Arrow (1972), Coleman (1990), and Dasgupta (2003).
  91. And so too systems of sanctions for violations of norms in informal systems require broad consensus. Almost by definition, norms are social conventions supported by broad consensus, which may not (and often is not) the case for formal legal structures, especially when they come from (or are supported by those from) the outside or elites.
  92. As Dasgupta (2003) puts it, the generation of trust is “riddled with positive externalities.”
  93. BRAC's Human Rights and Legal Aid Services program is, for instance, the largest legal aid program in the world.
  94. Putnam (1993: 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.
  95. Yunus (2007: 16).
  96. Various scholars have cited other critical features, including the design of appropriate incentive structures that are consistent with China's specific conditions. See Qian (2003) and Oi and Walder (1999) for alternative interpretations.
  97. See Jacobs (1979).

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