FOSTERING SUSTAINABLE COMPLEXITY IN THE MICROFINANCE INDUSTRY: WHICH WAY FORWARD?

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Abstract: The microfinance movement has gained tremendous popularity over the past thirty years, but it is still far from meeting its full potential. The industry stands at a crossroads between increased commercialization and increased philanthropic aid. Standard economic discourse does little to resolve the debate. F. A. Hayek's concept of the "extended order" sheds new light on how we might understand the future development of microfinance.

> *Whenever you are in doubt . . . apply the first test. Recall the face of the poorest and weakest man whom you may have seen, and ask yourself if the step you contemplate is going to be of any use to him. Will he gain anything from it? Will it restore him to a control over his own life and destiny? True development puts those first that society puts last.*
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> —Mahatma Gandhi

> *An order in which everyone treated his neighbor as himself would be one where comparatively few could be fruitful and multiply. If we were, say, to respond to all charitable appeals that bombard us through the media, this would exact a heavy cost in distracting us from what we are most competent to do. . . . It would not provide a proper cure for misfortunes about which we are understandably concerned.*
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> —F. A. Hayek (1988, 13)

Introduction

At the close of the colonial era, the dominant thinking among economic development theorists and policymakers was that poor countries would be lifted out of poverty through top-down, state development planning efforts. Governments could create prosperity, so the thinking went, by replicating the West's industrial revolution in the developing world. Sector-wide development planning was considered the state of the art in the 1950s and 1960s, and despite abysmal results (in terms of economic decline, rampant corruption, and human rights atrocities), policies favoring heavy-handed state control of the economy persisted into the 1970s.

It was in the mid-1970s that frontline development organizations started to take notice of microenterprise[1] and the informal sector in general as the primary mechanism by which poor people sustained themselves, met their day-to-day needs, and often improved their material conditions. BancoSol in Bolivia, the Grameen Bank in Bangladesh, and Bank Rakyat Indonesia (BRI) are just a few celebrated examples of how microfinance took off in the 1980s and continues to attract attention and funding. The growth of the microfinance movement marks a profound shift in how development theorists, practitioners, and policymakers think about economic development. Gone are discussions of how the state will fill the "entrepreneurial gap." We now understand that the entrepreneurs have been there all along. What they need is an institutional environment that will allow them to play their part in the development process.

The appeal of the microfinance movement is that it seems to reverse all the mistakes of the old top-down paradigm. Rather than funneling resources through large (often corrupt) government bureaucracies that favor the political elite, microfinance offers capital-poor entrepreneurs (usually women) the small loans they need so that they can leverage their time and talent into a profitable enterprise. Furthermore, because microcredit organizations can mobilize savings among borrowers and lend at a market rate of interest, the microfinance industry has the potential to be self-sustaining, reducing dependence on foreign aid.

Since those early projects in the 1970s, microfinance has gathered steam both in the number of programs offering microfinance services and in the level of international financial support. In its 2003 annual summary, the Microcredit Summit Campaign reported that over 2,500 organizations, serving more than 67 million clients, submitted data to their campaign (Daley-Harris 2004). Though support for microfinance is still a small portion of international assistance overall, the microfinance movement has become a significant "player" in national and international politics. In 1998, the General Assembly of the United Nations adopted a resolution declaring 2005 as the International Year of Microcredit. In 2003, the United States Congress passed a law requiring all programs funded by the U.S. Agency for International Development (USAID) to use poverty assessment tools to ensure that at least 50 percent of the microcredit funds distributed by the organization reach clients living on less than US$1 per day. In 2003, more than six hundred parliamentarians from Australia, Canada, Japan, Mexico, the United States, and the United Kingdom signed a letter to the leaders of the World Bank; the Asian, African, and Inter-American Development Bank; and the United Nations Development Program (UNDP) to adopt similar measures and to double current spending on microfinance programs to US$1 billion annually.

Despite the growth of the movement to this point, however, the realities suggest that much work remains to be done. Microfinance in its current state is nowhere close to reaching its potential. Though tens of millions of clients are served through microcredit organizations, more than a billion people around the world are effectively locked out of the formal financial sector. As impressive as the record of growth has been to this point, if the industry is to serve the majority of poor people in the world, it will have to expand at much more dramatic rates.

Furthermore, with the exception of several dozen organizations, the industry is far from delivering on its promise of sustainability, if what we mean by sustainability is independence from the support of philanthropic donors. Though many organizations claim "operational sustainability," the vast majority still require donor subsidies to cover their capital costs. Between 1985 and 1996 the Grameen Bank, for example, reported "profits" of $1.5 million. But as Morduch (1999) observes, when modest adjustments are made to standardize Grameen's accounting practices and philanthropic subsidies on capital are considered, the bank is shown to have actually incurred $34 million in losses during the same period.

The point of raising these concerns is not so much to criticize the industry as to recognize that its success has brought it to a critical crossroads. The path forward will determine whether the great potential of microenterprise to serve the billion or so people who are currently locked out of the traditional financial sector can be realized.

So, the question arises: which way forward? In the microfinance community (donors, microfinance organizations, and consulting groups serving both) a general consensus prevails on two points: (1) donor support will continue to play a vital role in the future of microfinance in the foreseeable future, and (2) sustainability will continue to be a key component of the microfinance ideal. That being said, simultaneously committing to both these principles creates an ongoing tension within the microfinance community. This tension is manifest in debates about the appropriate role of donors and in the movement to link microfinance organizations to the commercial banking sector.[2] No one involved in these debates advocates one end of the spectrum to the exclusion of the other, but there is a marked difference in emphasis between what we might call (for lack of a more nuanced distinction) the "commercialization advocates" at one end and the "social mission advocates" at the other.[3]

Though the distinction runs the risk of portraying the debate as more sharply and ideologically divided than it may actually be, the difference in emphasis here is well-recognized within the microfinance community, and it is significant enough to point to two distinct possible paths for the future of the industry.[4] Will the development of microfinance in the first half of the twenty-first century be advanced most effectively by significant increases in donor support or by a massive commercialization of the industry? Though the public face of the microfinance movement denies this either/or dualism, beneath the surface a contest is heating up over which emphasis will dominate the future direction of the industry.[5]

Standard economic discourse does little to alleviate the current tensions. Nevertheless, there are forms of economic thinking that can shed light on the issues. The primary focus of this paper will be to introduce into the debate F. A. Hayek's insights regarding the nature of economic knowledge. In particular, we will consider the nature of the knowledge embedded within the social and economic networks of the poor, and we will examine how that knowledge is often disconnected from the economic development process. Finally, we will begin an exploration of how a Hayekian perspective on the debate offers fresh insight into the role donor subsidies play in either fostering or hindering effective use of that embedded knowledge.

Incentive and Efficiency in Microfinance

When considering the intersection between programs (public or private) designed to serve the poor and the development of market institutions that may (or may not) serve the poor, standard economic discourse generally gravitates to issues of incentives and efficiency. The discourse surrounding the microfinance movement is no exception. Understanding the nature of the incentives and efficiency tradeoffs involved in microfinance provides an essential first step when grappling with the challenges facing the industry. Yet both the commercialization advocates and social mission advocates can claim economic wisdom on their side.

Social mission advocates generally point to the lack of incentives on the part of commercial banks to serve the poor. The very emergence of the microfinance movement stems from this gap. The cost of administering one thousand $100 loans far exceeds the cost of administering one $100,000 loan. In most environments, serving the poor simply isn't profitable for the commercial sector, and therefore nonprofit organizations committed to poverty alleviation often step in to play this role. While such organizations are often capitalized by a blend of philanthropic donations and commercial finance, many social mission advocates fear that rapid commercialization may create a steep price for the reduced dependence on donor support. As microfinance merges and competes with commercial banks, the argument goes, the drive for profits will force organizations to leave behind their poorer clientele in search of less risky borrowers, and lenders will move "up market" by not offering the small loans needed by the poor.[6] Social services that are often offered in connection with microcredit schemes may be cut, as bank managers attend to the bottom line. Social mission advocates argue that sustainability ought to remain an eventual goal but not at the expense of losing the movement's social mission to assist the poorest of the poor. Social mission advocates often invoke the Gandhian principle that policy decisions be guided by their effect on the poorest members of society (Padmanabhan 2001). Although it promises sustainability, commercialization strikes many working within the microfinance industry as running counter to this principle.

In addition to attending to incentives, social mission advocates point out that on efficiency grounds, too, subsidies spent on microfinance organizations are money well spent. Instead of functioning as mere transfers, donor subsidies may generate Pareto efficient outcomes when funneled through microcredit organizations (Schreiner 2003a). In a study of Grameen Bank clients, Khandker

(1998) reported a cost-benefit ratio of 0.91, meaning a net social gain of $0.09 for every dollar spent in the program (as measured by improvements in household consumption). This result is particularly impressive when compared to the cost-benefit ratios of other poverty alleviation programs in Bangladesh, such as the World Food Program's Food-for-Work, or CARE's food assistance program, with cost-benefit ratios of 1.71 and 2.62, respectively, meaning that it costs $1.71-$2.62 to deliver $1's worth or relief (Pitt & Khandker 1998). In addition, the efficiency gains of microfinance efforts are even greater when we consider that the benefits to the household extend into the future as a stream of income (Morduch 1999).

Those who advocate the social mission approach to microfinance argue that if subsidies can support programs that serve the very poor (and not just those near poverty), this is further justification for continued subsidies, because according to standard social welfare analysis a dollar in the hands of someone at 50 percent of the poverty level has greater impact than a dollar in the hands of someone at 90 percent of the poverty level (Morduch 1999). Donor subsidization, typically in the form either of outright grants or of loans provided on concessionary terms, allows microfinance organizations to offer their clients loans at subsidized rates and deepens their outreach to the very poor (Khandker 1998). Social mission advocates thus argue that while sustainability ought to remain a goal for the long term, in the short term subsidization gives development organizations a significant "bang" for the poverty alleviation "buck."

On the other side of the debate, advocates for commercialization of microfinance point to the perverse incentives associated with continued reliance on donor support. They argue that commercialization is the only means by which the interests of borrowers, lenders, and private investors can come into alignment. Access to ongoing donor support reduces the incentive for organizations to adhere to commercial standards of transparency and accountability (Christen 2001b). As long as microfinance organizations can receive donor funds at concessionary rates, there is no incentive to pay market rates for commercial sources of capital, perpetuating the dependence on donor support (CGAP 2002a). Furthermore, while microfinance organizations curry favor with the donor community for continued sources of funds, they have less incentive to attend to the real needs of their clients, who demand greater diversity of services and could play a far more significant role in providing funds for the organization's operations (CGAP 2003).

Commercialization advocates see the efficiency argument in favor of continued subsidization as premised on a static view of resource allocation. They argue that while microfinance may have efficiency advantages relative to other poverty alleviation programs, the industry should not ignore the benefits that might accrue if microfinance organizations were forced to seek out commercial sources of funding and respond more directly to client demand.

Both social mission and commercialization advocates utilize standard economic discourse, but their typical discussion gets us no closer to an answer as to which path we ought to take. Market incentives may make organizations more responsive to the economic environment, but this response may require them to move away from meeting the needs of the very poor. As Morduch (1999) points out, the counterfactual scenario of reducing donor subsidies is important to consider in that although it may result in efficiency gains, there is no guarantee that such efficiency gains will be realized.

The Informal Sector and the Extended Order

In order to advance the discussion, we may find it useful to step outside the standard economic discourse. The insights offered by Austrian economist F. A. Hayek, in particular, provide another lens through which we might search for some direction.

Hayek's Concept of the "Extended Order"

Hayek's (1988) concept of the "extended order" refers to the process by which a human society develops the capacity to cope with increasing degrees of complexity. A complex society is one in which, for example, the producers and consumers of the same good have little (if any) direct knowledge of one another. More complex still is a society in which producers at different stages of production of the same good, or financiers and entrepreneurs involved in the same project, have little or no direct knowledge of one another. This complexity of economic relations is not created for its own sake, of course, but emerges in service of greater productivity as knowledge is divided and specialized across the market.

This growing complexity is built on the foundations of social and moral rules that coordinate the disparate interests, actions, and knowledge of individuals across society. Rules of contract, property, accountancy, moral conduct, and third party enforcement are among the social institutions that save individuals from having to solve anew the coordination and moral hazard problems that arise with every repeated transaction (Hayek 1973). Given the right institutional environment, the growing complexity of economic relationships feeds on itself, generating further specialization and division of knowledge across space and time.

Echoing Adam Smith's observations, Hayek (1973, 1988) points to the unintended benefits that result from such complexity. Though the rules of the extended order increase the number of impersonal connections, the benefits that accrue to society as a whole far surpass the benefit that could have been intentionally bestowed by charitable giving, even in the most selfless communities. The point is not that human beings are not charitable enough to benefit others directly, but rather that human beings, even if we take them to be sufficiently charitable, simply aren't smart enough to design a more benevolent system, if we measure benevolence by the outcomes produced rather than the intention to do good.

This is the central contribution Hayek makes to our understanding of development processes. The extended order and the rules upon which it is based extend the reach of our cognitive abilities beyond what we know directly. When we enter into standard contractual arrangements without thinking twice (how many of us actually read the detail provided in a typical real estate transaction, for example?) we are making use of knowledge accumulated through time. We are the beneficiaries of the trials and errors made by previous generations. The knowledge embedded within social institutions such as contract and law reduces risk, lowers transaction costs, saves time, and helps us anticipate and avoid pitfalls.

Essentially, the extended order expands our cognitive reach by transforming dispersed, private, local knowledge into usable signals that guide our actions in environments that would otherwise be too confounding for us to make meaningful choices (Hayek 1948). Market prices are certainly of particular importance to this process, not just because they provide incentives and allocate resources to competing ends, but also because they serve the vital cognitive function that makes economically rational choice possible (Mises 1981 [1932]; see also Lavoie 1995). Prices summarize in relatively clear form the subjective evaluations of countless consumers and producers. They also serve as meaningful guides to action in what would otherwise be unnavigable territory.[7]

Beyond Price Signals— Tacit, Local, and Embedded Knowledge

Prices are not the only tools that extend our cognitive capabilities beyond our own direct knowledge. Although prices provide invaluable information for rational economic decision making, Hayek (1948; 1935a, 1935b, 1940) was clear that it is market prices as situated in the larger institutional context that serve as effective guides to action. Much of the knowledge that guides our behavior is tacit in nature, embedded within social networks, intimately connected to the fleeting context of time and place, dispersed across members of society, and often not easily conveyed to others. Examples of this sort of embedded knowledge (and ways to effectively send the right signals to others) abound. Members of particular religious or ethnic groups, for example, might benefit from internal bonds of kinship or "brotherhood" that make readily available a network for employment opportunities, investment, lending and borrowing, and business advice.

Consider European and immigrant Jewish communities, for example, or overseas Chinese and other ethnically homogenous groups throughout the Western and developing worlds (Kotkin 1994; Sowell 1996; Landa 1995). It was no coincidence that trade and Islamic conversion emerged simultaneously across Africa, as Islamic values gave traders, merchants, and suppliers a moral code by which to organize their financial dealings and settle disputes. By offering financial tribute to the local mosque or by making the pilgrimage to Mecca, members could signal their commitment to higher values and enhance their reputation as someone who could be trusted (Ensminger 1992).

Membership within such groups might also afford benefits in dealings with the larger society. Consider, for example, the high reputation Quaker merchants enjoyed in the eighteenth and nineteenth centuries in England and North America. Believing that the "Light of God" resided in all people regardless of their heritage or faith, Quaker merchants gained a reputation for fair business dealings (Tolles 1948; Emden 1939). Some religious and ethnically homogenous groups continue to enjoy the reputation effects of experience and expertise in particular industries (such as Amish furniture makers in the Midwest or Mennonite volunteers in disaster response). In some such cases, the distinctive manner, dress, or speech maintained primarily by an ideological commitment may also carry economic benefits by providing the right set of signals to outsiders.

If the institutional environment allows individuals to make productive use of the private and local knowledge to which they have access, that local knowledge can then feed into and advance the extended order. Immigrant groups who have enjoyed economic success in the United States, for example, illustrate how the knowledge embedded within informal social networks can be mobilized to generate economic prosperity, but only if they can connect to the larger, extended order. For instance, Korean-American communities famous for offering savings and credit services to one another have facilitated the rapid rise of a merchant class (MacDonald 1995) within that group. Today, Koreans often arrive with substantial resources already in hand, but in the 1970s new immigrants were generally capital-poor, had no credit history with Western banks, and had limited English-language skills. Compared with the formal financial sector, community members were in a much better position to engage in mutual monitoring and enforcement and were better able to offer the kinds of services newly arrived immigrants needed. As Korean-American entrepreneurs cultivated expertise within particular industries, such as the construction, restaurant, and grocery industries, the community was able to provide another source of local knowledge not necessarily available from mainstream banking institutions.

Informal networks of support are undoubtedly beneficial to young and newly arrived members of a community, but it is the community's ties to the larger, often more formal aspects of the extended order that generate a marked record of success. If no one within the Korean-American community had ever been able to hold a bank account, secure a business license, or own property, the mutual assistance afforded within the group would have transferred resources to members in need, but it would not have translated into impressive, communitywide increases in prosperity. Established members of a community serve a vital bridge function by mobilizing the knowledge embedded within the social network and connecting it to the larger, extended order in the form of property ownership and the establishment of aboveground businesses, and by linking them to the commercial financial industry.[8]

Sociologists have explored a similar linking phenomenon in the literatures known as "network analysis" and the "strength of weak ties" (Burt 1992, 2001; Granovetter 1973, 1985; Lin 2001; Wuthnow 2002). Certainly social and economic benefits can be conveyed between and among people closely linked in a tight-knit social network, but if that network is poor and if members have no way to make links beyond the local network, the group as a whole is likely to remain poor. The Hayekian version of this story would emphasize not so much the personal connections (though these are certainly important), but would instead emphasize the mechanisms by which the knowledge embedded within the social and financial networks of the poor gets trapped and cannot be effectively mobilized to generate widespread prosperity. This disconnection between the knowledge embedded within the informal sector and the larger, extended order characterizes the circumstance of much of the world's poor.

Tapping the Knowledge Embedded Within the Informal Sector

When we grope for reasons why commercial banks in the developing world fail to serve the poor, we often write it off as an aloof disregard or a remnant of colonial enculturation. But this does little to solve the mystery. Economists and industry analysts are quick to point to the high information and transaction costs of lending to informal entrepreneurs, but this only backs the question up one more level. A good deal of the world's economic history (or at least that portion that is marked by increasing prosperity) can be told as the emergence of methods and mechanisms that allow human beings to more effectively tap and make use of knowledge embedded within local contexts. Double-entry bookkeeping, insurance and credit bureau ratings, and flexible interest rates are just a few among many examples of how dispersed and otherwise inaccessible knowledge can be summarized in forms that are ready at hand (Rosenberg & Birdzell 1986). So why the persistent gap between the formal financial sector and the billion or so people who have unmet demand for financial services?

When viewing these questions from a Hayekian perspective, we can see that the task before us is to understand better the barriers that keep the informal sector and the knowledge embedded within it from connecting to the knowledge system we are calling the extended order. Just as the formal commercial sector provides financial services to middle class and wealthy segments within the developing world, the poor also have access to financial services (Chamlee-Wright 1997, 2002). Systems of saving (such as the mobile saving agents known as susu men in Ghana), credit acquisition (such as the many different variations of the rotating credit organization [ROSCAs] and informal money lenders), venture capital and business finance (often from family members already established in trade), and even insurance and pension schemes (in the form of kinship bonds, fraternal organizations, mutual assistance societies, church organizations, and intergenerational tribute) serve the poor on a daily basis.

Embedded within these systems is a wealth of local knowledge regarding individuals' saving capacity, credit worthiness, business history, and insurability. Most of the relevant knowledge, however, is in a form that remains inaccessible to anyone who does not know the savings agent personally, does not know one or more members of a trader's ROSCA, or has no direct knowledge of a trader's business and family history. Certainly schemes similar to these have served the poor throughout time. But prior experience suggests that such informal mechanisms morphed or were absorbed into the larger, extended order (Lamoreaux 1986). What keeps the same thing from happening in the developing world?

The most obvious culprit may be the sheer size of the informal sector relative to the extended order in any given developing country. Unlike the example of the Korean-American community, which represents a tiny segment within a much larger population that is connected to the extended order, the poor operating within the informal sectors of the developing world represent a significant portion of any one country's population, making the search for connections beyond the informal sector that much more difficult. It is in this regard that the microfinance movement has the greatest potential benefit, in its ability to create catalysts for connecting the world's poor to the larger national and international extended order, a benefit to which we will return below.

Another critical point of disconnection is the fact that in much of the developing world, assets that belong to the poor on an informal level cannot serve as robust signals of creditworthiness and mechanisms of accountability, because their ownership rights are not well-defined. Hernando De Soto (2000) and his colleagues have provided detailed analyses of the phenomenon he calls "dead capital," in which the assets of the poor are held in ineffective forms.[9] For our present purposes, the critical point is to emphasize that well-defined ownership rights make a person a credible party in a contractual agreement. Property ownership allows a borrower, a co-signer, or an entrepreneur seeking equity investors to effectively signal that credibility to unknown outsiders. The problem of poorly defined property rights is not merely a relic of soviet-type economies, nor is it only an occasional policy debacle (such as the well-publicized confiscation of commercial farms in Zimbabwe). Poorly defined property rights are a fact of life for much of the world's poor, a condition that severs one of the most promising links that might otherwise connect the knowledge embedded within the informal sphere to the larger, extended order.

Related to the issue of poorly defined property rights is the uncertainty created by unnecessary and often arbitrarily imposed restrictions on local traders. The burden here is particularly onerous on urban market traders. Though some restrictions in the interest of safety and traffic flow may be required, the arbitrary and often violent way in which traders are removed from their selling areas imposes dramatic hardships. Confiscation of a trader's stock and destruction of fixed assets can wipe out an entrepreneur's capital overnight (Chamlee-Wright 1997). Furthermore, the expectation of governmental crackdowns on informal traders reduces the incentive to invest in fixed assets, likewise severing an essential link between the informal sector and the extended order (De Soto 1989).

Another barrier between the poor and the extended order is the tight control many governments retain over telecommunications. Even in the most formal economic environment, "word of mouth" plays an important role in conveying local knowledge across markets. Word of mouth is all the more important in the informal context in which so much of the useful knowledge of a community is embedded within tight-knit social networks. In regions where cellular technology has been able to take hold, word of mouth can travel and inform others far more widely than it otherwise could. A boy raised in a rural town has a better chance of leveraging his local social network if his uncle can use a cell phone to tell his business associates in the city about his promising nephew. Close-knit affiliations can be leveraged more effectively if the flow of communication outside of the local network is made cheaper and easier. Furthermore, cellular technology has enabled farmers and other producers distant from larger markets to connect to the knowledge flows of the extended order. For those in search of the best price for supplies and the best markets for their output, the technology often pays for itself, cutting down transportation costs by hours or even days and speeding up response times to fleeting market opportunities. Government monopoly or excessive regulation, however, makes telephone communication prohibitively expensive and cumbersome for the average entrepreneur, once again severing a powerful link between the informal sector and the extended order.

The point in raising these issues in the context of microfinance is to draw out the common theme shared among so many causes of persistent poverty. If the goal of the microfinance movement is to alleviate poverty, the key will be to find ways to connect the knowledge systems possessed by the poor to the larger, extended order. It is not for a lack of creditworthy borrowers, or a lack of people willing to save their resources, that the disconnection persists, but for the lack of ways the poor can effectively signal their demand and capacity to use financial services. In recognizing the failure of the commercial banking sector to respond adequately, the microfinance movement has stepped in, often with positive results. But it has stepped in without a clear sense of what long-term role it ought to be serving.

By emphasizing only the lack of incentives on the part of commercial banks to serve the poor, it may appear that the appropriate role for the microfinance industry is to provide an effective substitute for commercial banks, and then to compare its effectiveness against other poverty alleviation tools. If we look upon microfinance as just another policy intervention, however, the expansion of the industry will be severely limited. The resources available in the donor community are miniscule in comparison with what would be required to meet the potential demand for microfinance (CGAP 2003). Even if by some miracle donor funds available for microfinance increase by a thousand fold, the industry will remain limited unless effective links are more intentionally and more widely forged to the larger, extended order, fostering a knowledge system that is in effect far more "intelligent" (in its capacity to coordinate disparate interests, actions, and knowledge) than even the brightest minds in the donor community.

How Donor Support Can Help . . . And How It Often Gets in the Way

Utilize Risk Capital to Create Connections

Clearly, there is a positive role for the donor community to play in helping the microfinance industry to reach its full potential. Some of the most successful, financially sustainable microcredit organizations (BancoSol in Bolivia, for example) started as traditional NGOs. As Christen and Miller (2004) argue, the donor community can be particularly important in providing start-up capital to promising new programs (those that have the technical support and expertise ready to launch a successful program) but that might otherwise find it difficult to secure funding (because, for example, the target group is not yet tested). Donor support can also assist by helping to absorb some of the financial risk when established programs want to test new products and services. The guiding principle for the donor should not be primarily to provide services to a particular known group but rather to create the first, crucial connection that spontaneously generates many more connections. By assisting a promising upstart, the aim is to create a demonstration effect that inspires others to follow. By subsidizing promising innovations, the aim is to spread new ideas that reduce the cost and improve the effectiveness of microcredit services.

Improve Informatics

Another way the donor community can provide leadership is by promoting standards of transparency and accountability, helping to foster an environment in which potential investors, borrowers, savers, and other consumers of microfinance services can more easily compare various organizations' records of performance. Such transparency, in turn, would allow well-managed organizations to more effectively attract funding from a variety of private sources—sources which in the current context are reluctant to commit because of the lack of clear signals coming out of the microfinance industry. The Consultative Group to Assist the Poor (CGAP)—a consulting group serving donor members—is attempting to fill this gap by developing industry standards and best practices and distributing this information to donors and microfinance providers (CGAP 2003). The high profile the organization enjoys[10] has helped CGAP to play the role of "industry leader" and bodes well for its potential to set industry standards. In addition to improving transparency within microfinance, CGAP is attempting to push the donor community to adopt standards and practices that will reassert the centrality of financial sustainability as a core principle (and not just something that would be nice to have down the line). Many of the best practices developed and promoted by CGAP are directed at making the commitment to sustainability a credible one. As will be discussed below, however, the industry as a whole often generates pressure that undermines this commitment.

Promote Innovation and Infrastructure Development

Another important role for the donor community is in tapping embedded knowledge by facilitating the development of an information-sharing infrastructure among microfinance organizations, something akin to a credit bureau rating system. Such innovations are being tried within organizations; for example, client "scoring" that uses an organization's lending history to sort clients by known risk factors (Schreiner 2003b). As yet, however, there is no widespread use of technologies that will allow organizations to share information about specific clients with each other. This deficiency can have a disastrous effect in areas where many organizations offer microcredit. The primary disciplining mechanism in microfinance is the promise of future loans if past loans have been repaid. As more and more organizations compete in the same area, clients know that they can always borrow from another organization if they fail to repay their loan (Morduch 1999). This would not be the case if methods of information sharing across organizations emerged. In principle, this service could be provided on a commercial basis once the microfinance market matured enough to support it or by linking to consumer credit rating systems once they emerged. In the interim, donor subsidies might support initiatives that would fill this gap.

Consider Policy Reform

Perhaps the most important role the donor community might play is to use its considerable political leverage to reverse policies that effectively sever links between the poor and the extended order. By supporting reforms that formalize informally owned assets, reduce unnecessary regulations that impede trade, and demonopolize key industries such as telecommunications and transportation, the donor community can help create an environment in which the poor could more effectively signal their creditworthiness to people outside their own immediate circles.

Don't Perpetuate the Divide

Productive philanthropy connects people to systems so that beneficiaries eventually no longer need support. This is the promise the microfinance movement offers when it commits to fostering self-sustaining organizations, and, as noted above, there are ways the donor community can support the sustainable growth of microfinance. Unfortunately, however, much of the thinking in microfinance circles is nudging the industry away from this central principle. Though no one is opposed to sustainability as such, much of the donor support that is available has the unintended effect of undermining the industry's potential sustainability.

Avoid Political and Philanthropic Bandwagons

The popularity of the microfinance movement has created problems for it by forcing it onto the political stage and creating political pressure to move money even in the absence of appropriate outlets. Donor support of organizations that do not have the expertise or capacity to run an effective program creates havoc for well-run organizations operating in the same market that might otherwise be sustainable. By propping up ineffective programs, donors reduce the incentive for clients to repay their loans, and that makes it harder to attract private funding. Further, apexes (wholesale mechanisms designed to fund microfinance programs), especially those under government control, often face political pressure to fund organizations poorly suited to manage those resources. According to Levy (2002), the principal barrier impeding microfinance development is not the lack of resources but rather the lack of retail outlets capable of absorbing the resources that are available. Campaigns targeting increased funding for microfinance will have little positive effect if there is no capacity to absorb the resources at the retail level.

Adhere to the Principle of Sustainability

When it de-emphasizes the goal of sustainability, donor support can sever the link between the microfinance industry and the clients it serves. Rather than developing new products to serve poor consumers of financial services (e.g., insurance, savings, remittances, pensions, consumer credit) or finding innovative ways to deliver financial services at lower costs (e.g., rural delivery trucks, remittance services), or connecting to homegrown sources of financial services (e.g., susu men, ROSCAs), organizations can often let donors captain the ship (CGAP 2002b, 2003). Though the knowledge accumulated within the donor community can serve many purposes, donors should encourage microfinance providers to rely on their most valuable source of knowledge, that which is embedded within their client base. It is in the success of the borrower rather than the wishes of the donor where the greatest potential for sustainability lies.

Encourage Entrepreneurship

By its very nature, donor support in the form of one-way grants often shields organizations from having to think entrepreneurially and thereby delays their evolution into the next stage of microfinance development. Given that the microfinance movement emerged out of an NGO environment, it is not surprising that most of the organizations offering microcredit have a social service orientation. This “non-corporate” corporate culture is perfectly appropriate for many organizations working with the poorest clientele, many of whom lack even the most basic literacy and bookkeeping skills (Chamlee-Wright, 2005). This third-party payer system, however, is clearly not the most appropriate orientation for organizations serving experienced entrepreneurs and people with significant savings and investment capacity. Donor support can have the unintended effect of delaying this cultural transition by institutionalizing a system in which NGO directors are rewarded more for securing the next $100,000 grant than for cultivating an understanding of what products and services their clients need and for which (and how much) they are willing to pay. The result is that organizations can come to focus more on philanthropic fundraising than on the entrepreneurial business development and refinement that are at the very core of their social mission.

Conclusion

Traditional economic analysis can inform the way forward for the microfinance industry, but we need to go beyond the discussion of incentives and efficiency tradeoffs. We need to consider also how the complexity and dispersed nature of the knowledge embedded within informal economies, social networks, and indigenous methods of savings, credit, and risk management can be turned from a hindrance to an asset. A Hayekian understanding of the nature of knowledge in the extended order helps us to see the debate between social mission and commercialization in a new light. In contrast to the Gandhian approach of ensuring that the poorest members of society are directly benefited by our policies, a Hayekian reinterpretation would ask whether the policy under consideration would allow the poorest members of society to make better use of the knowledge embedded within their own social and economic networks, whether the policy would allow the poor to more effectively signal their attributes to unknown outsiders, and whether the policy is likely to inspire the spontaneous creation of new (though unknown in their details) connections between the poor and the extended order. When we consider these criteria, we see that the best way for the movement to fulfill its social mission is to pursue the path of commercialization.

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ENDNOTES

[1] The term "microenterprise" was coined by Accion International as it launched what is widely considered the first microcredit organization in Recife, Brazil.

[2] See, for example, discussions posted on the website of the Consultative Group to Assist the Poor (CGAP) at http://www.microfinancegateway.org/.; See also Morduch (2000).

[3] Alternatively, one might refer to the "BancoSol model" that promotes commercialization and the "Grameen model" that pursues continued subsidization on the grounds that it can then provide social services to clients and loans at subsidized interest rates.

[4] The language is problematic in that it might suggest that "commercialization advocates" are unconcerned with the social impact of microfinance, or that "social mission advocates" see no role for commercialization, both of which would be inaccurate.

5 Contrast, for example, the emphasis Christopher Dunford, president of Freedom from Hunger, places on "deep outreach" (as opposed to sustainability), and the emphasis Brian Branch, vice president of the World Council of Credit Unions, places on commercialization in the Microfinance Gateway discussion on the U.S. Poverty Mandate.

6 Empirical analysis of this question is in its infancy. See Christen and Miller (2004) and Christen (2001a) for discussions of mission drift among commercial microfinance providers. The authors point to the mixed nature of the evidence and the difficulty of drawing clear conclusions at this stage of the industry's development.

7 We should point out that even price signals rarely dictate an obvious and unquestionable course of action. Rather, prices need to be assessed within the context of past experience, knowledge of possible alternative courses of action, and expectations of future outcomes. Reading price signals is more an exercise of complex interpretation rather than a robotic response (Lavoie 1991, Ebeling 1986).

8 When considering the differences among informal social networks within the industrialized context and informal sectors within the developing world, it is tempting to say that the differences in economic prosperity can simply be attributed to the fact that the former are within the context of wealth and the latter are not. But many immigrant groups within the industrialized world remain poor for generations. This is particularly true in countries where restrictive policies essentially lock immigrant groups out of the larger, extended order. See Lynch and Simon (2003).

9 According to De Soto (2000), acquiring legal authorization to build a house in Peru is a seven-year process involving 207 legal or bureaucratic steps and 52 government agencies. Acquiring legal title to the land itself requires an additional 728 steps. In the Philippines, acquiring legal title to land involves 168 separate steps and fifty-three government agencies, and can take thirteen to thirty-five years. In Haiti, residents seeking legal title must first lease the land from the government for five years. This involves sixty-five separate steps and can take up to two years. Purchasing the property requires another 111 steps and another twelve years.

10 The World Bank is one among many prominent members.