The Dialectics of Law and Development:

On Implementing Institutions –

Yunus and De Soto Compared

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[DRAFT]

I. Introduction

It is now well established that law and legal institutions have an important role to play in the development process. There is, however, an ongoing debate with regard to the *type* of law that is needed to stimulate development. Does it have to be formal, Western-style law involving constitutions, legislation and courts of law? Or can well-established informal norms like customs, traditions, social sanctions and codes of conduct play the same role? Or does the answer lie somewhere in between? Imperfect though the conceptual distinction between the two categories[1] may be and although most systems of regulation may rely on elements of both, the issues of emphasis and sequencing are of crucial strategic importance in policy terms.

The overwhelming focus in the literature, drawing on the Austrian-Chicago school, has been on formal law.[2] Even North and the new-institutionalists tend to be predisposed to formal law.[3] In particular, they have emphasized two crucial functions that a legal system must perform to facilitate development – protect private property and enforce contracts. This traditional wisdom is, however, called into question by a twin set of factors. The first is the failure of formal law in large swathes of the developing world to achieve its

[1] The English legal system, widely regarded to be a highly sophisticated legal system, is a case in point – a bulk of the 'law' that makes up the system takes the form of customs and traditions.

[2] See for instance, Posner, 1998

[3] See for instance, North, 1995

underlying purpose – the effective provision of rights to the many. Indeed, according to a recent report of the Commission for the Legal Empowerment of the Poor, 4 billion people are 'excluded from the rule of law'.[4] India, with 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. The second is the unexpected success of unconventional institutional structures. The paradigmatic example of this, of course, is the greatest development success of recent times – China – that achieved its unprecedented growth rates in the absence of the clearly assigned property rights theoretically prescribed.[5] This paper proposes to revisit the formality-informality question through a comparison of two programs that have emerged as being of central importance on the current development horizon – the program of legal formalization through titling advocated by Hernando De Soto and the trust-based microfinance program of Muhammad Yunus' Grameen Bank.

While the basis for comparing the two may not appear immediately obvious, a closer examination reveals an uncanny overlap between the programs. Indeed, Yunus and De Soto concur almost entirely in substantive terms: both emphasize the skills of entrepreneurship of the poor, the importance of the poor lifting themselves out of poverty rather than being helped out of it through charity, the responsibility of institutional mechanisms for keeping the poor impoverished and, most importantly, the importance of *access to credit* for the poor as a means of alleviating poverty.[6] Where they differ, crucially, however, is in their institutional innovations – their choice of mechanism for providing credit to the poor. De Soto is insistent on transfer of formal legal title of land occupied by the poor to them so that they can use this land as collateral to access credit through the formal banking system.[7] Yunus, on the other hand, provides credit to the poor

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[4] *The Economist*, 5th June 2008

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

[6] Yunus, 1998 and De Soto, 2000.

[7] It should be flagged up at the outset that De Soto's *land titling* program is distinguishable from *land reform* programs that have been undertaken in different parts of the developing world. The focus of the titling program is merely to transfer title of land already occupied by squatters

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 the other members repaying. After members are established, increasingly a shift is being made to individual loans based on the borrower's desire to maintain a good reputation with the lender[8]. Although neither is explicitly a legal reform program, if these two schemes are seen in the light of their common goal, to enable the poor to access credit as a means of alleviating poverty, they allow us to conduct a systematic comparison of the regulatory mechanisms that underlie them – one based entirely on formal legal intervention and the other on informal regulation.

This comparison is extremely significant for a number of reasons. First, the fact that the two schemes pick such dramatically different mechanisms, one entirely informal and the other entirely formal, for achieving the same goal – access to credit for the poor – allows us to compare the performance of the two mechanisms against a common benchmark. Second, the starkness of the differences in choice of mechanism – De Soto is completely *formal* and Yunus completely *informal* - makes for interesting comparison.[9] Third, the

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whereas the purpose of land reform programs is, typically, explicitly redistributive in that it involves transferring land to those who do not have any.

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

[9] This is not, of course, absolute – the Grameen mechanism operates within the context of a formal legal system while De Soto advocates incorporating some elements of the 'extra-legal' system into the formal legal code.

'real world' implementation of both programs – primarily in the form of the Grameen Bank in Bangladesh and the 1998-titling program in Peru – provide empirical evidence on the performance of the schemes. Fourth, both schemes have had tremendous international influence. De Soto's Lima-based think tank, the Institute for Liberty and Democracy, has not only advised the Peruvian government's titling program but is also advising governments around the world on how to replicate it.[10] In addition, international organizations like the World Bank and the United Nations (especially through the work of the Commission for the Legal Empowerment of the Poor) have taken on board De Soto's recommendations. The Grameen Bank, on the other hand, has replicas in over a 100 countries, as well as at least equal influence on international development agencies. 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 Microfinance'. At the same time, the World Bank is the largest investor in microfinance worldwide. Finally, this comparison is of enormous academic and policy significance in order to be able to formulate successful legal reform strategies. Indeed, it is somewhat ironic that despite the amount of academic and policy attention that these programs have attracted and their obvious commonalities, no systematic attempt has yet been made to explore the equally obvious tensions between them. If we are indeed decided on the point that access to credit is an important policy goal, what is the superior way of achieving this goal - through formal or informal law? Further, outside the context of credit access, does this comparison tell us anything about the better way of achieving our developmental goals and regulation more generally?

Although the discussion will largely be in terms of the specific performance of the Grameen Bank and the Peruvian titling program, the results should be generalizable since both schemes have been replicated in various different parts of the world with broadly similar results.[11] Indeed, the evidence drawn upon is from both the specific experience of

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[10] Countries currently being advised by the ILD include Mexico, Honduras, Haiti, Egypt, Albania and the Phillippines.

[11] To say that the programs have been 'replicated' is, however, to gloss over significant differences. While the microfinance model has spread like wildfire, 'replicas' often change institutional aspects of the model. Further, even when the replication is faithful, in structure, to

these programs, as well as microfinance and land titling programs more generally. Nonetheless, it is important to make explicit that the paper holds context specificity to be key. A central tenet of the paper is that choice of the regulatory intervention that is likely to work in a particular context is bound to depend on the *type of social capital* more readily available in that context. Thus, while Peru might have a better-developed market mechanism than Bangladesh[12], Bangladesh may have stronger community norms. This difference is crucial in determining the choice of regulatory mechanism that is more appropriate (Besley and Coate, 1995).

The paper will compare the performance of the Yunus scheme and the De Soto scheme in terms of their *efficiency* and *equity* effects, keeping in mind some critical questions: Has De Soto been able to overcome the problems traditionally attached to formal legal reform in the developing world? If not, can a case be made for more informal, community-based regulation at a relatively early stage of development? If informal regulation is adopted, how can the problems of scale endemic to it be overcome? Finally, and crucially, are the two models ultimately competing or complementary options? It is in the context of addressing the final question of the relationship between the two models that the issues of trust and social capital, continuing themes through the paper, will be explored.

Although both microfinance and titling have been studied extensively individually, the paper will seek to contribute to the literature by (a) taking a primarily *comparative* perspective; (b) explicitly applying the comparison to the *formality-informality debate* in law and development, and, finally; (c) adopting a more *legal perspective* than the predominantly economic literature has so far tended to. The central task of the paper will be to draw insights from the comparison of formal and informal means to achieve a common developmental goal, in this case, access to credit, for systems of regulation in general.

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the original model, the informal, context-specific aspects cannot be directly transferred. On the contrary, in the case of titling, while the formal process of titling can be replicated, other aspects of integral to the program like the judicial system cannot merely be transplanted.

[12] In the year 2007, for instance, per capita income in Peru was $ 7, 600 compared with $ 1,400 in Bangladesh.

II. Efficiency

Let us first compare the relative performance of the two models in terms of their levels of efficiency. Legal efficiency can be defined in many different ways, but the model adopted here will be the *contractual model*. Although this is a highly stylized model of the functioning of legal systems it has been chosen for reasons of a) analytical simplicity, b) the fact that all law can be seen, at some level, as a binding agreement between two parties, of which one may be the State, and, c) that it is the definition emphasized in the literature due to its obvious economic importance in inducing individuals to enter into mutually beneficial transactions - the very basis of economic growth.

In order for a contracting model to be effective it must address the problems of 'design' and 'enforcement'. The 'design' problem pertains to the issue of inducement to enter into a mutually beneficial contract as well as other issues that pertain to the 'quality' of the contract like risk sharing arrangements, specificity of rules and so on. The 'enforcement' problem, of course, refers to that of effectively ensuring compliance with the terms of the contract. Specifically, in this instance, the 'design' target is to provide access to credit for the poor, while the 'enforcement' target is that of ensuring loan recovery. The two issues are related (in that the one impacts the prospects of the other) but separable (in that a model may achieve one but not the other). 'Design' and 'enforcement' are related in the sense that individuals are unlikely to enter into a contract unless they consider the promise of enforcement credible. At the same time, if individuals aren't induced to enter into a contract at all, the question of enforcing it doesn't arise. However, they are distinct in that individuals might be lured to enter into a contract on the basis of a belief in the enforcement system, but this belief may be false. The subprime mortgages crisis is a paradigmatic example of this. On the other hand, individuals might be deterred from entering into a contract because of the prospects of enforcement appear unsatisfactory where they might, in fact, be extremely sound. I might, for instance, be an extremely trust-worthy person but, if you do not believe that I am, you will not loan me $ 100 even at a 20% interest rate. It becomes clear, then, at the very outset that subjective beliefs are of fundamental importance in 'making or breaking' the contract.

Having settled on the contract enforcement model of the law, it is informative, at this stage, to consider the kinds of institutional arrangements that would theoretically lead to the keeping of mutually beneficial contracts. Dasgupta (2003) identifies four models. The first is 'mutual affection' based on group members caring about each other. The second is 'pro-social disposition' based on norms of reciprocity due to both evolutionary development and socialization. The third is 'mutual enforcement' based on fear of social sanction in the context of long-term, settled relationships in a community where people encounter each other repeatedly in the same situation. The fourth is 'external enforcement' based on enforcement of an explicit contract by an established third-party authority that is typically, but need not be, the State. Clearly, it is this fourth model that is identified with the formal legal systems of the developed world. It is of great significance that this model rests, crucially, upon a sufficient number of individuals '*opting in*' to the system of authority. Another factor, of course, that might ensure compliance with the contract, is sufficient coercive force. Although an element of coercion is contained in any State legal system, unless mixed sufficiently with a voluntary acceptance of the system, the normative implications of the use of force to keep contracts is highly questionable.

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

monitoring and enforcement. The lower the *information costs* of overcoming each of these problems in the two models, the more efficient it is.

Turning to the empirical evidence on the ability of the two schemes to overcome these twin problems, the evidence is categorical. Although approximately 1.2 million Peruvian households received title under the De Soto scheme, it *did not lead to increased access to credit* (Field, 2007; Galliani & Schargrodsky, 2005). This shows evidence of problems of both design and enforcement. In stark contrast, not only has the Grameen entered into *informal lending contracts with over 7 million poor borrowers but the peer monitoring mechanism has proven to be an extremely effective means of enforcing the contracts with a repayment rate of 98%* (the Grameen Bank; Hossain, 1988). Thus, counter to the theoretical faith vested in formal legal systems, the relative success of the informal Grameen mechanism in inducing entry into mutually beneficial contracts and ensuring that the contracts are honored is unambiguous.

The De Soto model

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

With regard to the 'design' of the contract, the fundamental problem is that it fails to create a sufficient inducement to enter into the contract for both parties – the lender and the borrower – for credit flow to increase. To begin with, De Soto's assumption that the access to credit problem is based on the absence of collateral is questionable. Indeed, in the developed world, most loans are made based on future cash flows rather than collateral. Second, even if collateral turned out to be a material consideration, the

functioning of the collateral mechanism is premised on the existence of a complete set of land markets. But the existence of robust-enough land markets to support the use of land as collateral is assumed as a 'given' by the scheme despite much evidence of their absence in most parts of the developing world (Platteau, 2000). Third, even if the markets existed, they would have to be perfect markets to overcome the problem of the low value of land offered as collateral. The problem of the low value of this land is especially acute when compared with the high costs that the bank would have to incur to potentially claim the land via the formal legal system (Arrunada, 2003).

On the issue of the 'enforcement' of the contract, the problem turns out to be that the promise of enforcement is not credible.[13] To begin with, the De Soto model turns out to be very uneconomical in terms of information costs. Since the 'external enforcement' model or formal law requires that breaches be both *observable* and *publicly verifiable*, the information costs associated with it are extremely high, particularly in the context of the information asymmetries of the developing world, making its prospects of success exceedingly weak (Stiglitz, 1990; Hoff and Stiglitz, 1990).

In addition, De Soto's approach to the issue of legal capacity turns out to be highly problematic. The efficacy of a formal legal system is ultimately determined by enough agents 'opting in' to the system of authority which is, in turn, determined by the twin factors of 'confidence' in the enforcement agency and 'trust' in the propensity of other agents to comply.[14] Consequently, the determinants of the success of a formal legal system are *internal* rather than external. The introduction of an isolated legal intervention, as the De Soto scheme attempts, is substantially meaningless in the absence of a 'broader respect that exists for legal authority' (Andre and Platteau, 1998[15]).

Closely related to the above point, it is extremely difficult for institutional reform to succeed unless it is considered legitimate. To be considered legitimate, in turn, demands

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[13] Since the experience with the De Soto model is that the credit contract does not, for the most part, come into existence, the discussion of enforcement problems is essentially counter-factual.

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

[15] p. 43

some modicum of equity. The property rights reform attempted in Russia is a case in point. The highly unpopular reforms - making the wealthy elites better off at the expense of the masses - led to a the rich actually taking their money out of the State rather than investing it, as traditionally hypothesized, as a result of their insecurity (Hoff and Stiglitz, 2008). Given that the courts are likely to consider the transfer of property from the poor to the banks highly inequitable, they are unlikely to enforce the formal law in the De Soto case thereby bringing it closer to the *de facto* informal system of regulation. This was, for instance, seen to happen in Thailand where, even in the case of the bankruptcy of local firms, courts were unwilling to transfer assets to international investors.[16] Andre and Platteau, (1998) further reiterate that the costs of implementing unpopular decisions by new legal bodies are likely to involve tolerating constant contestation, criticism and harassment not only from the disputant but also other stakeholders in the customary system.[17] Thus, the legitimacy of the reform turns out to be crucial with regard to its prospects of success.

Next, any system of contracts needs to balance the competing claims of certainty and flexibility. The theoretical benefit of De Soto's proposal harks back to the Coasian intuition of assigning property rights clearly in order to be able to achieve *certainty* in transactions and thereby efficiency. But this attempt at certainty comes at the cost of excessive rigidity. The more formal and rigid a contract, the clearer it is but also the more inflexible. The result of this inflexibility is a higher chance of default, higher concentration of land, greater inequality and more agency problems. Thus, even if the functional problems associated with the De Soto program could be overcome, it is not clear that it would achieve the most efficient outcome.[18]

Further, the scheme may actually heighten rather than reduce uncertainty as a result of the legal dualism it is likely to create. If, due to the above reasons, the formal legal

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[16] Reference

[17] p. 43-4

[18] Legal systems have traditionally had to balance the competing claims of equity and efficiency. In fact, the English courts of equity came in to being to mitigate the harshness of the strict application of English contract law.

system fails to decisively trump the customary or informal system, as is likely, the central goal of the titling process - increasing certainty in transactions - is defeated. The abrupt introduction of another tier in property dealings that fails to take root leads to the speculative use of the system – formal or informal - more convenient to the party in question thereby increasing confusion in transactions (Mackenzie, 1993; Platteau, 2000; Andre and Platteau, 1998).

The Yunus Model

The 'design' of the 'implicit' contract in the Yunus model is characterized by the absence of any formal barriers to entering into the contract. In stark contrast to the De Soto model, there is no collateral requirement and there is, further, no formal legal contract between the Bank and borrower.[19] The 'enforcement' mechanism traditionally associated with the Grameen was the 'mutual enforcement' model or that of peer monitoring where group members shared joint-liability for the loan i.e. one group member's ability to repay depended on the others repaying, but is shifting, increasingly, to the 'pro-social disposition' model.[20] 'Peer-monitoring' operates essentially on the basis of social sanction within a settled community, while 'pro-social' disposition operates by means of the 'reputation' mechanism in the context of repeated interactions.

In 'design' terms, the Grameen turns out to be extremely effective in inducing entry into the credit contract. This is not only due to the absence of formal constraints like a collateral requirement, but is actively aided by the informal character of the contract. On

[19] Although technically, the unique law under which the Grameen Bank was established in Bangladesh, technically, allows legal action to be taken against borrowers but there is an overwhelming norm of not taking legal action and, indeed, no precedent of a borrower having been taken to court.

[20] The shift from one model to the other is associated with the shift from Grameen I to Grameen II discussed above. While Grameen I can be seen as the 'learner' microfinance model characterized by simple, rigid rules, Grameen II is meant for borrowers familiar with the microfinance philosophy but requiring greater flexibility. The great asset of Grameen II is its ability to take advantage of its informational economy to internalize shocks in a way that a more rigid sytem cannot.

the 'demand' side, or from the perspective of borrowers, the fact that the terms of the contract are more malleable encourages more people to borrow where they would normally have been deterred by the more strictly constraining terms of a formal contract. But, on the 'supply' side as well, the trust-based system turns out to be greatly advantageous. In particular, the *flexibility* of the informal system allows shocks to be internalized in a manner that would 'break the back' of a more rigidly formal system. In the context of a more binary formal system, the terms of the contract are largely static and changing its terms a costly process involving high information and procedural costs. The terms of an informal contract, on the other hand, are more easily and economically renegotiated. Thus, while a default on the formal contract is relatively inflexible, a default on an informal contract can be renegotiated as delayed repayment.[21] That informal systems have the latitude to absorb these shocks to quite a significant extent is demonstrated by the recovery of the Grameen in the wake of it 1998 flood-induced repayment crisis where the redrawing of repayment schedules allowed losses to be recovered to a significant extent.[22] This is quite impressive when compared with financial crises in the formal system that typically results in losses being written off completely. As an ongoing feature, the Grameen retained the 'flexi-loans' that allow individual borrowers to renegotiate their repayment schedules if they find it difficult to meet their original targets. Thus, while it has traditionally been argued that informal contracts compromise certainty, their flexibility allows them to achieve a level of complexity and nuance that would be very costly via the formal system.

In terms of 'enforcement', the Yunus model has significant advantages with regard to the information costs of monitoring. Since the 'mutual enforcement' model or informal law requires that breaches be *observable* but *not necessarily publicly verifiable*, the information costs associated with it are inherently lower. Further, Stiglitz (1990)

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[21] 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 in to a formal lending contract that is relatively easily achieved by an informal one would be extremely expensive.

[22] On this, see further Dowla and Barua (2006).

establishes that this model has significant informational advantages over formal regulation since the community is far better poised than formal institutions to monitor the actions of borrowers. Thus, peer monitoring is able to overcome both problems of 'moral hazard' (Arnott and Stiglitz, 1991) and 'adverse selection' (Ghatak, 1999). These informational advantages are a critical factor in allowing the flexibility of 'design' discussed above. Since 'speculative' defaults (i.e. an attempt at evading repayment) can more easily be distinguished from 'genuine' ones i.e. due to some unforeseeable circumstance (e.g. a natural disaster or sickness in the family), not only do these contracts have an in-built insurance mechanism against risk but allows the lender to give loans to 'riskier' borrowers as well. In addition, there are certain structural features specific to Grameen like regular repayment schedules that have been identified to contribute to better monitoring (Armendariz de Aghion & Morduch, 2000).

Next, a critical factor contributing to the successful 'enforcement' of the Yunus contract is the relative credibility of the threat of punishment within the scheme. The threats of social sanction and loss of reputation are far more credible than that of punishment by the State legal system in the context of a country like Bangladesh (Stiglitz, 1990; Besley and Coate, 1995). In particular, the threat of not refinancing borrowers who default further heightens the efficacy of the enforcement mechanism. Thus, despite the fact that no legal punishment is attached to default, borrowers have an incentive to repay in order to be able to obtain subsequent loans (Stiglitz, 1990; Besley, 1995).

Another feature contributing to the desire for borrowers to maintain a positive reputation is the increasing inter-linking of markets, or, the expansion of the Grameen into other markets that impact borrowers, thereby increasing the stakes in the relationship between bank and borrower (Hoff and Stiglitz, 1990).[23] The 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

[23] Some of the different 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 enterprise' Grameen Danone.

borrowers in a variety of different ways. Thus, a person may not only be a Grameen borrower, but Grameen may at the same time be her employer, bank, source of infrastructural facilities, provider of goods and services and her daughter's school.[24] Other factors that contribute to the incentives of borrowers to maintain a good reputation include the complementary services of 'bicycle bankers' (Edgcomb & Barton, 1998).

III. Equity

Let us now turn to the question of the equity benefits of the two schemes. In particular, we will consider the impact of both programs on 'instrumental' outcome variables like income, investment, employment and property ownership, as well as welfare indices of 'inherent' value like gender equity, access to education, access to healthcare, nutritional status and so on.

De Soto

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

Looking first at the 'economic' variables that the De Soto program targets, the evidence is mixed. On a positive note, the program has undoubtedly increased formal property ownership of the poor with over a million formal legal titles having been distributed in Peru alone. However, to the extent that this transfer of title involves only granting formal rights over property that they already, in effect, controlled (i.e. that it is a land *titling* rather than land *reform* program, not, fundamentally, involving redistribution), the value

[24] In theory, a person's relationship with the welfare State is meant to be akin to this. Thus, in the context of the developed world, a person would not want to default on a loan for the all-encompassing impact that the effect on her credit rating would have on her ability to operate in any market whether renting a flat or getting a mobile phone. The efficacy of the State system in Bangladesh, however, casts in doubt whether the public provision of a loan would be as effective.

of the program amounts essentially to any gains from the change in *de facto* to *de jure* rights of ownership i.e. the benefits of legal ownership.

The economic benefits of this change in status have already been cast in doubt by its failure to have the postulated effect on access to credit. However, there is evidence of some other economic benefits. First, there is some evidence of titling leading to increased household investment (Galliani & Schargrodsky, 2005). But whether overall investment actually increases, given that credit supply does not increase, has been questioned (Carter and Olinto, 2000). Second, some studies find that titling leads to increased labor force participation rates. This is hypothesized to be due to the fact that titled families need to spend less time defending their property, leaving them more time to devote to productive activities (Field, 2007; Galliani & Schargrodsky, 2005). However, the validity of the celebrated Field (2002) increased labor supply result has been brought into question. Mitchell (2005), in particular, questions the methodology by which the result was arrived at. At the same time, titling may have certain positive social effects associated with increased security of ownership and the creation of relatively settled communities.

Somewhat ironically, however, the De Soto program grants apparently more secure rights of ownership to the poor while, in one fell swoop, proposing to make their rights of ownership far more easily alienable. Indeed, the social impacts of the potential loss of land by the poor may be grave. De Soto suggests an ‘all or nothing’ strategy of inducing the poor to put at stake their major asset or resource – their land. As their only means of insurance, the effects of its loss are likely to be disproportionately severe and result in the social problem of landlessness. The strategy is rendered all the more risky because it is proposed in the absence of (a) any public welfare schemes like healthcare or food subsides, increasing the likelihood of distress sales of land and, (b) any training or assistance programs with regard to use of the resource. An alternative, less risky approach would be to offer a part of the produce of the land as collateral instead of the land itself.

In addition, the De Soto scheme throws up the problem of inequities of initial access. Current occupation of land by squatter families may not be an equitable way of distributing land. Further, somewhat ironically, it is those who were most successful in

breaking the law before the De Soto reform that are rewarded by it and vested with the role of opting in, suddenly, to the legal process.

Turning now to the welfare impacts of the De Soto problem, it is clear it does not address issues of health, education, nutritional status and so on directly. There is some evidence of a tangential impact on school attendance of children of titled families (Field, 2007; Galliani & Schargrodsky, 2005), but no direct evidence of the other indices improving as a result of participation in the program, except through any increases in income that may result from increased labor force participation. In fact, the De Soto scheme is not attached to any explicit social agenda. De Soto's starting point is the existing power allocation. He is not concerned with existing inequities but rather attempts merely to leverage existing power allocations to achieve a more efficient outcome. In that sense, both the positive and negative social effects of his program are incidental. Nor have titling programs, with their focus of achieving any social change through efficiency enhancement, diversified organically into different social sectors in the way that the microfinance movement will be seen to.

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

However, there are compelling reasons to not take the 'good news' on gender equity at face value. Indeed, titling is frequently associated with the loss of the customary rights of vulnerable categories. Since, due to the complexity and nuance of customary rights, it is impossible for registration to merely 'recognize and record' accurately existing rights (Barrows and Roth, 1989)[25], it invariably involves some *de facto* reallocation of rights. Further, since the sections likely to have the most significant interface with the formal

[25] p. 21

system are likely to be the most privileged, this reallocation is likely to be at the cost of the most vulnerable, leading inevitably to a legitimacy deficit of the reforms. In this way, customary rights and insurance mechanisms are likely to be destroyed by the registration process. Particularly compelling evidence of this phenomenon is found by Platteau (2000) and Andre and Platteau (1998) in the context of Rwanda. Specifically, several studies find that titling has an adverse impact on women's rights where it formalizes already-existing inequities of power (Lastarria-Cornheil, 1997), or erodes systems of customary justice (Kevane & Gray, 1999; Hare, Yang & Englander, 2007). Further, although some empirical studies find that the social justice problem can be overcome by explicitly registering land in the name of vulnerable categories (like women), there is evidence that it is particularly difficult for these categories of people to access the formal justice system to vindicate their rights (Lastarria-Cornheil, Agurto, Brown and Elisa Rosales, 2003). Indeed, targeted programs in general tend to benefit the best-off within the class they target, for instance, the Indian system of reservation for the Scheduled Castes and Scheduled Tribes tend to benefit the socio-economic class within the caste that least needs the reforms, frequently called the 'creamy layer'. Thus, despite titling targeting squatters, it may fail to impact the most needy.

Finally, titling may be extremely vulnerable to the appropriation of rights by the powerful. While formal registration losing the nuance of customary rights may be endemic to the process, registration may be – worse still – vulnerable to intentional manipulation by the elite. In fact, the more unequal a society, the higher the likelihood of such exploitation of vulnerable categories by both officials and others. Widespread evidence of this can be found in Thailand (Thomson et al., 1986 and Feeny, 1988); India (Wadhwa, 1989; Viswanath, 1977); Latin America and the Caribbean (Stanfield, 1990); Uganda (Doornbos, 1975) and Nigera (Zubair, 1987). The inequities of this process are likely to be exacerbated if registration comes at a fee rather than being entirely subsidized as in the Peruvian case.

Yunus

Although the Grameen started out as a credit access program, its agenda very quickly morphed to become far more broad-based. The Grameen targets 'economic' variables mainly through an attempt to increase income through access credit, but also provides housing loans to facilitate property ownership, engages in employment generating activities and provides direct avenues and instruments of investment. In addition, it is increasingly pro-active in its approach to welfare indices of inherent value. Its focus, so far, has most explicitly been on education – it both provides education loans and scholarships, as well as funding schools. In addition, it has started to address nutritional concerns through attempts at getting involved in the production of high-nutrient food products.[26] It is currently actively working to extend its reach to the healthcare sector.[27] Its commitment to gender empowerment has, of course, been explicit from the start, lending primarily to women.

Looking first at the impact of the Grameen on 'economic' variables of interest, several studies show that participation in the Grameen program leads to increased household income. The Grameen reports that average household income is 50% higher for members in Grameen villages than residents of non-Grameen villages. These estimates of increased income are backed up by objective third-party assessments (Hossain, 1988, Kantor, 2005). Second, participation in the Grameen program is associated with a decrease in poverty. The Grameen reports that a significantly smaller proportion of Grameen members live in poverty (20%) compared with non-Grameen members (56%). Yunus reports that 64% of Grameen members decisively move out of poverty within 5 years of joining the Bank. The reach of the program heightens the magnitude of this achievement – 80% of poor families are estimated to have access to microcredit in Bangladesh.[28]

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[26] This refers to the collaboration between Grameen and the French yogurt manufacturing company, Danone, to produce low cost yogurt high in nutrients aimed specifically at overcoming some of the nutritional deficits of Bangladeshi children.

[27] Yunus (2008).

[28] Muhammad Yunus at the University of Toronto, 9th June 2008.

Several independent studies also find evidence of reduced poverty indices in Grameen households (Hossain, 1988) and improved socio-economic status (Wahid, 1994). [29]

Turning, next, to the impact of the Grameen on welfare indices. Membership of the Grameen requires internalizing a number of different types of prudential practices. To begin with, potential members must learn to sign their names and memorize the 'sixteen decisions' (a list of prudential norms including sending children to school, family planning, basic cleanliness and sanitation, as well as vows of cooperation) before they are eligible for a loan. In addition, although there is little substantive interference with use of loans, members are provided with ongoing assistance in the form of encouragement and trouble-shooting advice in the face of financial troubles. There is evidence of these 'non-credit aspects' and 'participation' having a positive effect on self-employment profits (McKernan 2002). In addition, the Grameen is found to have specific welfare impacts. In particular, various studies have found positive effects on contraception use by women (Schuler and Hashemi, 1994; Amin, Li & Ahmed, 1996; Schuler, Hashemi & Riley, 1997). Finally, an important contribution of the Grameen has been the creation of an entire 'second generation' of beneficiaries. At a recent talk, Muhammad Yunus reported that 100% of the children of Grameen families were enrolled in school. Grameen is attempting to actively promote a rapid socio-economic transition of this second wave of beneficiaries through primary school scholarships, of which there are now 64,000 recipients, and higher education loans, of which 23,000 have been distributed.[30]

Finally, the Grameen Bank is considered to make a significant contribution to gender equity, particularly in the context of Bangladesh. The fact that 97% of Grameen borrowers are women is an achievement in its own right, especially in a country where a huge stigma is attached to women undertaking activities outside the home. In addition, studies have found a positive impact on decision-making capacity within the household

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[29] Despite its contribution to poverty reduction, accusation had been leveled against the Grameen with regard to its 20% interest rates are 8-10% higher than the commercial rates. Although the comparison with commercial lenders was inherently faulty given their inability to permeate rural credit markets, this criticism has been addressed by the Grameen II model that reduces interest rates to 10%.

[30] Muhammad Yunus at the University of Toronto, 9th June 2008.

and a number of other empowerment indices (Schuler and Hashemi, 1994; Hashemi, Schuler, and Riley, 1996; Osmani, 1998; Pitt, Khanderkar and Cartwright, 2003). This is unsurprising given strategic attempts on the part of the Grameen to consolidate the women position in the household. For instance, mortgages given out by the Bank are always made in name of the woman. Further, credit programs are found to have a larger impact on household welfare when loans are made to women rather than men. 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.[31] Moreover, although some evidence of increased domestic violence in the short run (Rahman, 1999), other studies find that the Grameen mechanism paves the way to greater assertiveness on the part of women and reduced domestic violence, particularly over time (Schuler, Hashemi, Riley and Akhtar, 1996; Schuler, Hashemi & Huda Badal 1998). In addition, positive impacts have been found on specific welfare indices like women's health (Nanda, 1999).

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

VI. Dynamics

The Yunus mechanism was see to perform better than the De Soto mechanism both in terms of (a) efficiency and (b) equity. Despite this, there are some systemic drawbacks to informal regulation. Most notable among these are efficiency constraints in terms of

[31] The 'taka' is Bangladeshi currency

limits of scale[32] and equity limitations in terms of the normative undesirability of values that community-based regulation may reinforce[33]. The Grameen has already started to develop a way to address the second of these problems by means of capitalizing on the norm of trust established to make a shift to individual lending. It will be argued in this section that the Grameen model may point the way ahead to overcoming the first problem – that of scale - as well.

There can be little doubt that as a society develops economically, its social capital must adapt as well, allowing interpersonal networks to be partially replaced with formal institutions of a market-based economy, such as a structured system of laws imposed by representative forms of governance. To the extent that the Grameen system relies on community-based, personalized social capital, as markets get stronger and communities weaker, it will cease to be able to play the same role. At the same time, the expansion of the market will demand a more generalized form of trust that will allow impersonal actors to transact with each other on a wider scale on the basis of a mutual trust in the institutions of the economy i.e. 'where social relations are embedded in the economic system rather than vice versa' (Stiglitz, 2000[34]). Indeed, the ideal situation is one in which the formal mechanism is the underlying sanction but compliance is widespread and the threat of formal enforcement is credibly present but not invoked. The central point, however, is that this development from an entirely informal system to a more formal one must be gradual and organic - it is not possible to jump discreetly from one end of the spectrum to the other.

Given the state of development of Bangladesh and several other parts of the developing world, the main merit of the Yunus scheme is the substantial amount that is allows us to achieve on the basis of existent social capital over reliance on a dysfunctional formal

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[32] As a society transitions from a community-based system to a market-based one, it is doubtful whether these systems of informal regulation will continue to be as effective.

[33] Although, despite accusations (Mallick, 2002 and Rahman, 1999) to the contrary, the use of community monitoring has been substantially positive in the context of the Grameen. At a more general level, social networks may be thick and effective while preserving destructive social structures like the Indian caste sytem.

[34] On this transition, see further Stiglitz 2000, p. 64-5.

legal system. But even more significantly, its benefits may go beyond static gains to *dynamic gains***.** Indeed, it may pave the way for the transition from the sub-optimal position, or personalized informal regulation restricted to limited networks, to the optimal one, the bedrock of impersonal formal sanction supporting a culture of compliance, by building up a norm of trust.

The Grameen mechanism, premised fundamentally on trust, facilitates successful cooperation (Dasgupta, 2003; Arrow, 1972; Coleman, 1990). This co-operation, in turn, begets further cooperation (Putnam, 1993, Hirschman, 1984 and Seabright, 1997) bringing about a slow change in the 'culture of cooperation' or beliefs within the society. If changes in the 'culture' reach critical mass, a 'tipping point' may be arrived at when enough people 'opt in' to the authority of the formal legal system to render legal reform successful, since the success of this system was seen to rely primarily on a sufficient number of people 'opting into' or believing in it. Alternatively, within the paradigm of the Hoff and Stiglitz (2008) model, it was seen that the expectations of individuals with regard to whether the 'rule of law' will be established or not will determine whether they support it. The Grameen system helps to change this framework of expectations. As Dasgupta (2003) puts it, the generation of trust is 'riddled with positive externalities'. In that sense, the role of the Grameen can be seen as that of helping to generate a public good.

Evidence of this evolution can be seen in the development of the Grameen model itself. The original Grameen model, although resoundingly successful, became the object of criticism for the normatively undesirable impacts of using social pressure to enforce repayment. However, once the norm of trust was internalized, the Grameen was able to relax the rules of group lending and peer monitoring with all its negative consequences and move on to individual loans while maintaining its astounding repayment rates. This movement from social coercion to the operation of an individuated reputation mechanism is progress in itself and bodes well for further evolution of the system on the strength of the establishment of the norm of trust.

Thus, on this analysis, the formal and informal models turn out to be *complementary* rather than competing options. The question, then, turns out to be not one of choosing

between the formal and informal system, but rather one of determining which type of intervention is more appropriate at a *particular stage of development*. Indeed, to the extent that a dynamic relationship exists between social capital and the market, it stands to reason that the choice of institutional innovation that is likely to succeed, dependent as it is on a particular type of social capital, cannot be made independent of the stage of development of the market. At a relatively early stage of development, it is greatly advantageous to tap into the large stocks of community-based social capital in designing effective regulation mechanisms. Apart from the immediate gains this will provide, it may even pave the way to the easier establishment of a more formal system of regulation. Hoff & Stiglitz (1990) arrive at a similar conclusion with regard to rural credit markets i.e., that the most successful formal innovations are likely to be the ones that tap into the inherent advantages of informal system.

V. Conclusion

Despite the desirability of a well-functioning legal system, it was seen that the De Soto scheme was unable to overcome the problems typically associated with legal formalization in the developing world. Thus, it was unable to achieve efficiency due to the highly *procedural* approach it adopted on the basis of its unrealistic assumptions about perfectly functioning markets and also due to the *formalistic* view of the law it adopted. Further, although the empirical evidence on its equity impacts is ambiguous, it is clear that the intervention is of *instrumental* rather than inherent value.

In stark contrast, the Yunus mechanism was seen to be not only efficient in its ability to overcome the problems of selection, monitoring and enforcement associated with credit markets, essentially due to it *substantive* approach to overcoming problems of market imperfections and legal capacity, but was also seen to incorporate welfare measures of *inherent* value in addition to the distribution of loans. Thus, there is a strong case to be made for informal, context specific, community-based regulation at a relatively early stage of economic development.

Nonetheless, informal models are likely to encounter limits in the wake of the expansion of the market and normative objections at some stage of the development process. But even here the Grameen may point the way ahead by actually paving the way to more successful formal legal reform by building up social capital. In this sense, the formal and informal models turn out to be *complementary* rather than competitive.

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