The Ethics of Microfinance and Cooperation*

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1. Introduction

One of the most successful innovations of microfinance is "group lending" and the ability to use group-based incentives to disburse credit to the poor, who would not obtain credit otherwise (since they lack collateral). Economic theorists, funding agencies, policy makers, and NGOs have embraced microfinance as a means to achieve poverty reduction. The idea of harnessing group solidarity to provide credit and enhance wellbeing, however, has a long and checkered history. One of the earliest and most well known implementations of this idea was in the context of "traditional" cooperatives. In fact, some authors (e.g. Morduch 1999, Aghion and Morduch 2005, p. 69) have claimed that in some contexts where microfinance has been successful (e.g. Bangladesh), its roots can be traced to these cooperatives. The objective of this paper is to contrast the ethical principles underlying these two arrangements and show that they are radically different.

We use the adjective "traditional" to refer to the kind of cooperatives initiated by Raiffeisen and other pioneers of the cooperative movement in nineteenth century Europe. These cooperatives were implemented in other contexts (e.g. in India, see Vaidyanathan 2004; in Quebec, see Sriram 1999) and are premised on an irreducible principle of cooperation that entails not merely the use of joint liability but also of safeguarding autonomy and self-reliance, terms that we describe below.[1] Microfinance, on the other hand, uses multiple organizational forms, cooperatives being only one of them (Zeller and Johannson 2006). In the literature, while some observers (e.g. Sriram 1999) distinguish between traditional and

* We thank Marek Hudon, Peter Dietsch and an anonymous referee for their comments on a previous version.

[1] Birchall (2003) presents a brief history of cooperatives and some case studies. In some contexts (e.g. India) the state played an activist role in promoting cooperatives, whereas in others (e.g. Quebec) it played the role of a facilitator (Sriram 1999).

microfinance cooperatives, others (e.g. Patibandla and Sastry 2004) do not.[2] While both kinds of cooperatives use the notion of joint liability, microfinance organizations need not privilege autonomy and self-reliance, given our argument below about the different ethical principles that underlie them. This can lead to different ways in which cooperation in these organizations is conceptualized and operationalized, thereby making it imperative to distinguish the two. To elucidate our argument, we use the term microfinance to capture its myriad organizational forms and cooperative to refer to a traditional cooperative.

What is the relevance of this exercise comparing the ethics of microfinance and cooperatives? First, ethical concerns may not be the central focus of the funding agencies and governments[3] that have the option of promoting either microfinance or cooperatives to meet their objectives (e.g. to address the agrarian crisis in the developing world, see Motiram and Vakulabharanam 2007). However, ethical concerns are frequently central to the actors (e.g. farmers and workers) involved in these initiatives, therefore deserving serious attention.

Second, the literature is unclear as to the distinctions between microfinance and traditional cooperatives. Studies on these matters (some are mentioned above) have largely focused on outcomes and organizational forms rather than on ethics. By making the ethical distinctions clear, this paper brings to the fore a dimension neglected in the literature.

The central argument of this paper is that microfinance and traditional cooperatives are motivated by different kinds of approaches to ethics. With regard to microfinance, since it is still evolving and uses a wide diversity of institutions, our focus in this paper is on the microfinance *movement*. We wish to argue that the ethical principle that gives unity to this movement is “consequentialism,” by which we mean that the emphasis is on the outcomes of its various initiatives. It is largely neutral about the means (organizational forms and incentive structures), so long as the stated goals are achieved. On the other hand, the traditional cooperative movement privileges certain values and organizational forms prior to the outcomes. This is the fundamental distinction we develop below. We wish to add an important qualification in that our exercise is not meant to pass a value judgment or rank these two sets of approaches to ethics on an objective scale. Rather, we wish to throw light on the neglected ethical dimension of microfinance and cooperatives.

In our discussion of cooperatives, we draw upon the work of Russian agronomist Chayanov[4] for the following reasons. First, he synthesized and further developed the ideas of the

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[2] Sriram’s (1999) use of the adjective “mainstream” is similar to our use of “traditional.” Sriram (1999) also throws light on the differences between traditional and microfinance cooperatives in terms of legal status (also see Rangarajan 2005).

[3] e.g., the Indian government has been involved in schemes promoting both microfinance and traditional cooperatives. See the budget for the year 2006-07 (http://indiabudget.nic.in/ub2006-07/bh/bh1.pdf).

[4] Chayanov was a Russian agronomist of the early 20th century who was a contemporary and critic of Lenin. He is famous for arguing that peasant family farms are evolutionarily stable over long phases of history, withstanding severe competition even from capitalist farms. He argued for a different conceptual vocabulary to understand the economics of peasant farms and advocated cooperation

pioneers of the cooperative movement (e.g. Raiffeisen), thereby enhancing the theory of cooperatives. Second, using concrete experiences of cooperatives from different countries, he played a key role in the evolution of the cooperative movement in early 20th century Russia. Third, while a lot has been written on cooperatives after Chayanov, we believe that the fundamental ideas about cooperatives are captured in his work.

The paper is organized as follows. Sections 2 and 3 discuss the principles underlying microfinance and cooperatives, respectively. Section 4 compares and concludes.

2. THE ETHICS OF MICROFINANCE

Microfinance is a movement to provide financial services (e.g. credit, savings, insurance) to the poor, who are excluded by conventional financial institutions.[5] At the core of conventional banking is the idea that the poor cannot be provided credit or other financial services due to lack of collateral. By using innovative practices (e.g. group lending, dynamic incentives, taking the bank to the poor) microfinance tries to overturn this idea. The overarching objective of microfinance is poverty reduction,[6] although it also aims to promote education, health, gender empowerment and improved social consciousness.[7]

Microfinance can be seen as shaping and being shaped by a new "developmentalist" discourse that has arisen in the wake of disenchantment with state-led development planning. Important components of this discourse include a larger reliance on NGOs and the private sector (instead of the state), a retreat from the belief that transformation of property relations (e.g. land reform) is necessary for poverty reduction, and the explicit incorporation of gender.[8] At its core, microfinance embodies the vision of multilateral organizations (e.g. World Bank), aid agencies, and policy makers about development, although it entails the participation of the "subjects" of development. We can describe it as a strategy based on "civil society" to achieve development, albeit one conceived from above. We discuss below three central features of microfinance that rely on a common ethical principle.

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among peasant farms as a way of improving the welfare of peasant families. (Chayanov 1966 [1925], 1991 [1927], Gatrell 1986).

[5] The microcredit summit defines microcredit as "programs extending small loans, and other financial services such as savings, to very poor people for self-employment projects that generate income, allowing them to care for themselves and their families." (http://www.microcreditsummit.org/Aboutmicrocredit.htm)

[6] The microcredit summit proclaims the objective of "…Working to ensure that 100 million families rise above the US$1 a day threshold adjusted for purchasing power parity (PPP), between 1990 and 2015."

[7] See the 16 decisions of the Grameen Bank (http://www.grameen-info.org/bank/the16.html), which speak to small families, education for children and clean environment.

[8] On gender, see Escobar (1995), pp. 171-192.

Primacy of Poverty Reduction

Absolute poverty, broadly conceived to include non-income forms of deprivation (e.g. education or health) is unacceptable in microfinance. However, microfinance is silent and therefore neutral on relative poverty/deprivation and inequality in ownership and wellbeing. As a means to incorporate the goal of poverty reduction, microfinance looks at “access” to efficient credit (explained below) and other financial services.

There are now for-profit microfinance institutions, for which poverty reduction is a consequence of the integration into the market economy and for which business motives are paramount. The emergence of these does not dilute the consequentialist dimension of microfinance. Even for such institutions, poverty reduction still provides the impetus.[9] Moreover, poverty reduction is the goal that gives legitimacy to the movement in the eyes of policy makers, funding agencies, multilateral organizations and the general public.[10]

The right to credit

Microcredit is motivated by the belief that all (especially the poor) have a right to access credit.[11] However, two issues need to be clarified. First, this right differs from rights in other settings (health care, education, work), where some agent (usually the state) is obliged to guarantee rights and fulfill entitlements. It is not clear, in the context of credit, as to who is obliged to fulfill this entitlement since microfinance is posited against the direct involvement of the state. Second, this right does not exist in conjunction with a notion of affordability, since the interest rate can be arbitrarily high (and/or unfair).[12]

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[9] See, e.g. Luigi Zingales’ introduction to a recent conference: “…microfinance is becoming an important business of the future. However, the more socially minded should not panic. Business interests will not come at the expense of social goals, but rather will be the necessary enablers of these very goals…a profit goal is necessary if we want to transform microfinance from a successful, but small, cottage industry to a powerhouse able to lift hundreds of millions of people out of poverty.” One can glean a similar message from other presentations at this conference (see http://www.chicagogsb.edu/capideas/microfinance/overview.aspx).

[10] We can give several examples to support this claim. For some of these, see the international year of microcredit web page: http://www.yearofmicrocredit.org/.

[11] Yunus, the founder of Grameen bank has elevated this to a human right, although to the best of our knowledge, no supranational organization has endorsed this.

[12] See Hudon (2006). Interest rates can have practical consequences e.g. by influencing clients’ choice of financial institutions, affecting demand, leading to differential impacts for rich vis-à-vis poor (Hudon 2006).

Efficient Credit

Efficiency of recovery and guaranteeing a viable financial system are privileged goals in microfinance. There can be a contradiction between the imperative for high recovery rates and certain other values that microfinance aims to cherish (e.g. helping poor with dignity, reducing dependence upon informal moneylenders). In theory, this contradiction has not been resolved, yet in practice it has been resolved in favor of recovery. For example, attempts have been made to recover loans at the expense of the loss of "honor" of members (Rahman 1999) and the system of small payments in installments has prevented members from investing in long-gestation projects and made them dependent upon informal lenders (Ramachandran and Swaminathan 2002; Jain and Mansuri 2003).

All three of these features of microfinance are consequentialist in outlook.

3. THE ETHICS OF COOPERATIVES

In this section, we discuss the ethical principles that underlie the organization of production and the distribution of the product in the Chayanovian view of cooperatives (Chayanov, 1991[1927]).[13] In his discussion of different types of cooperation, Chayanov contrasts horizontal collective forms with what he calls vertical cooperatives (*ibid*., Chapter 1). The former entail collectivization of land, technology, resources, market activities, and a division of labor across the entire farm. The latter entail cooperation in market processes (credit, output, and input), while peasant families use family labor to produce separately on their land. He generally advocated the latter in view of the superior incentives available to peasants as residual claimants. However, he also articulated a continuum of cooperation with the basic unit of production ranging from a peasant family to a collective of peasant families, and these basic units cooperating in market intermediation ("Cooperative Collectivization", *ibid*. p. xxxi). The particular form of cooperation that would be adopted depended upon economies of scale and incentives.

[13] For Chayanov, both the organizational forms and the social goals/objectives (and in turn, the ethical views underpinning these goals) of cooperatives were equally important and he observed (ibid, Chapter 1) that there was a diversity of both of these prevailing at that time. The ethical principles that we highlight below were the ones that he himself privileged out of the ones that were available.

Cooperatives and Peasant Autonomy

A dominant ethical principle in Chayanov's conception of cooperatives is the notion of autonomy of the peasant household, which we can interpret as calling for self- governance.[14] Chayanov theorized cooperatives at a time when commodity production had penetrated much of rural Europe. Yet, only some of these rural contexts had made a transition to capitalist relations of production (e.g. England), while several contexts (including Russia) still operated in the peasant mode. There was a strong sense among scholars of agriculture at that time (e.g. Lenin, Engels) that the peasant mode would be unable to withstand competition from its more capital-intensive and technologically advanced capitalist counterpart and would be replaced. Yet, the peasant mode defied these expectations and showed a remarkable durability during the late 19th century. Chayanov observed that peasants resort to increased exploitation of their family labor in the face of competition instead of giving up their autonomy and working for an employer. Autonomy was a deeply cherished value among peasant households even if it implied precarious economic survival. Chayanov and other pioneers of the early cooperative movement placed it at the very heart of their conceptualization of peasant cooperatives.

Does cooperation itself erode autonomy? Chayanov is very clear that this is not the case (*ibid*., pp. 17-18). Cooperatives protect and promote peasant autonomy, as is reflected in decisions about cropping pattern, technology use, resource use, credit procurement, and marketing. In other words, autonomy is prior to and inviolable in cooperation.

Designing self-reliance

Chayanov was explicitly opposed to a "romantic" defense of cooperatives[15] and believed that self reliance was crucial. In his view, self reliance has two dimensions. First, cooperatives have to compete and survive without being propped up. He recognized that peasant households have needs that are defined by their respective hands-to-mouth ratios. The second dimension is that to satisfy the above needs, peasants should not depend on sources of credit or marketing mechanisms outside the cooperative. Both the above dimensions require a careful design of incentive and punishment mechanisms that encourage effort and discourage free rider behavior or willful default. These mechanisms and the particular form of cooperation[16] would be chosen by the peasants themselves depending upon the local

[14] See discussion in ibid, Chapter 1. Chayanov is not alone in this and autonomy plays a central role in the work of several prominent thinkers (e.g. Immanuel Kant). For references on both classic and recent views on autonomy, see Taylor (2005).

[15] "What matters to us is not the psychology or ideology of the members of a collective farm but the economic realities of its existence and the kinds of collective which really are able to exist in the conditions of a commodity economy and competition without being propped up and without needing any shield to protect them" (ibid, p. 220).

[16] As mentioned above, this refers to whether cooperation occurred among households or among collectives of households.

cultural context, nature of the product and the available means of production (including labor).[17]

On the distributional dimension, Chayanov believed that the then widely held principle "from each according to ability, to each according to needs," was unsustainable due to incentive problems. He argued that while cooperatives/collectives should include all those[18] who voluntarily participate, the basis of distribution had to be the labor contribution of different members. Given the small group nature of the cooperatives, this issue could be resolved by carefully devising productivity measures according to time or output (*ibid*., p. 221).

It is important to note that Chayanov privileges the value of self-reliance for both the cooperative and the households and that the careful design of a self-reliant institution is both a means and an end in itself. Moreover, the incentive structures and organizational forms that can be adopted were not allowed to violate the basic idea of the embedded autonomy that is inherent in cooperation as a voluntary group activity.[19] This is the "non-consequentialist" dimension of his thought, principles being privileged prior to outcomes.

These ethical principles (autonomy and self-reliance) underlay Chayanov's notion of a cooperative. They emerged out of a rigorous investigation of the deeper motivations of peasant households and a study of both successful and failed cooperatives in different contexts such as Germany, Ireland, Italy and Russia between 1850 and 1920.

4. COMPARISON AND CONCLUSIONS

We argue below that microfinance and cooperatives may converge in certain aspects of implementation. However, given differences in their ethical principles, this convergence is contingent. Microfinance has a "consequentialist" view of ethics that allows it to adopt various organizational forms, incentive structures and means, whereas cooperatives privilege certain principles prior to outcomes. The former emphasizes features such as absolute poverty reduction, efficient banking, and credit as a basic right - all of which are consequentialist in their orientation, whereas the latter privileges autonomy and self-reliance prior to their effect on the welfare of their members. We show below how these two can diverge in the real world.

[17] In matters related to credit disbursement, Chayanov anticipated the advantages that small groups have in solving informational problems (e.g. moral hazard, adverse selection).

[18] However, he believed that cooperatives would do better when they possess a reasonably homogenous membership in terms of values, agricultural knowledge, and socio-educational status.

[19] Chayanov writes that "a co-operative represents an element, organized on collective principles, of an economic activity of a group of individuals; and that its purpose is to serve the interests of this group and this group alone," ibid., p. 17.

As argued above, microfinance privileges absolute poverty reduction. It is ethically neutral about notions of autonomy and self-reliance, in particular in its mainstream practice of stand-alone credit. We present a realistic example from an agricultural context to clarify this. First, consider a poor peasant household, which uses its land, family labor and inputs (e.g. seed, fertilizer) to produce a crop that is not very capital intensive, with the input credit being obtained from a peasant based cooperative that also sells the crop at the end of the year. The principles of autonomy and self-reliance are adhered to here. Now consider another realistic situation wherein the peasant household cultivates a capital intensive crop partly using microfinance and partly using loans from an agribusiness,[20] with the agribusiness controlling production techniques and operations. From the perspective of microfinance this loss of autonomy or self-reliance is not relevant. In particular, if the income is higher under the second situation, it is strictly preferable.[21] This neutrality with respect to autonomy is directly derived from the consequentialist ethics of microfinance.[22]

Microfinance, in its emphasis of efficient credit supply and recovery, may end up choosing lending and recovery schemes that do not involve group-based incentives at all. In recent times, there is an increased emphasis on providing dynamic incentives to individuals to avoid default. In this case, microfinance completely does away with notions of cooperation in small groups and moves into a realm of individual entrepreneurial advancement. Chayanovian cooperatives, on the other hand, underscore the importance of cooperation among their members in order to sustain their privileged values of autonomy and self-reliance. Here again, we can see the consequentialist element of microfinance at play: cooperatives cannot do away with cooperation *even if* this leads to an increase in the welfare of its individual members, whereas microfinance can and does.

Finally, we want to emphasize the divergence of the larger worldviews between these two arrangements, without endorsing the underlying politics of one or the other. In the vision of Chayanov and some other pioneers of the cooperative movement, cooperatives were seen as an alternative to capitalism in the countryside.[23] This is different from Yunus and other advocates of microfinance, whose vision is congruent with the framework of global capitalism.

[20] This practice is referred to as “contract farming” in the literature and is prevalent in many countries in Asia, Latin America and Africa (Motiram and Vakulabharanam 2007). Such examples were observed during fieldwork conducted by the authors in South India in 2001.
[21] Microfinance privileges empowerment, especially of women. Autonomy and empowerment are conceptually different, since empowerment can occur without an increase in autonomy and vice-versa, e.g. a household can feel empowered due to a rise in income, but this rise can occur at the expense of autonomy.
[22] This idea is of course not universally accepted, but in our opinion, Sen and Williams (1982) (and the references therein) make a persuasive argument: “More specific to utilitarianism and closely related to its consequentialist structure, is the neglect of a person’s autonomy.” (p. 5).
[23] Some pioneers of the cooperative movement were Owenite socialists and promoters of factory reform. Also, in some developing countries, cooperatives were promoted as an alternative to capitalism (Birchell 2003).

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