

MICROFINANCE AND AMARTYA SEN'S CAPABILITY  
APPROACH

by

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A thesis submitted to the University of Birmingham for the degree of  
DOCTOR OF PHILOSOPHY

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September 2011

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## Abstract

There are two main motivations for undertaking this thesis on Sen's capability approach and microfinance. One is to evaluate Sen's capability approach by considering moral philosophy (utilitarianism and John Rawls' theory of justice) and developmental ethics contexts. The other is to analyse the impact of microfinance on poverty reduction in accordance with Sen's approach. This thesis argues that Although Sen's capability approach has drawbacks, both as a general moral theory and as a theory of justice, it does bring up important aspects of development and poverty reduction. When the empirical evidence is combined with criteria from the capability approach, microfinance is a relative failure as a poverty-reducing approach. The evidence that micro-loans reduce poverty is weak, and there are moral arguments against the group lending approach that is used to assure repayments. Other services sometimes associated with microfinance – savings and insurance — do help the poor, however. However, we should notice that the conclusion I propose here does not exclude the possibility that perhaps microfinance does help promote some other freedoms that are of significance locally.

## Acknowledgements

First and foremost, I am heartily thankful to my supervisor Tom Sorell, whose encouragement, guidance and support from the initial to the final stage enabled me to finish this thesis. Tom's exceptionally extensive comments on each of the sentences of my draft helped me improve each part of the thesis.

I would like to show my gratitude to several dear friends. Ip has always been a great inspiration for me. Ip encouraged me to study abroad, giving me helpful and practical advice on my thesis. In fact, without Ip's recommendation, I would never have a chance to study at University of Birmingham. I cannot thank him enough for this. Joakim Sandberg and John Guelke gave me extensive and extremely helpful ideas during the writing process. Joakim's and John's vivid and rigorous thinking helped me refine philosophical arguments. I have learned a lot about both philosophy and life through our conversations. Merrilyn Onisko has made my thesis clear and readable. As my housemates, Lasse Kyllonen and Johanna Herttuainen have always encouraged me when I was daunted by philosophical problems.

Being a member of a Research Network in Microfinance and Global Justice issues funded by one of the UK research councils and based in the Centre for the Study of Global Ethics (University of Birmingham) was a unique and invaluable experience in that I have benefited a lot from the scholars and practitioners specialised in philosophy, social development, and microfinance. In particular, I would like to thank Jonathan Morduch and Marek Hudon for giving me helpful advices on my thesis. I would also like to thank participants in the seminar in philosophy at University of Birmingham.

Finally, my deepest appreciation goes to my family for their deepest love and unconditional support. I would like to dedicate this thesis to my brothers Victor, Alain, my mom Jenny, my wife, Monica, and my sons Ike and Spike.

Chuan Chia Tseng  
Birmingham, September 2011

# Contents

|  |     |
|--|-----|
| Chapter One: Introduction  | 1   |
| Chapter Two: Sen's capability approach   | 12  |
| Chapter Three: Possible theories of well-being and poverty – Rawls' theory of<br>justice and utilitarianism                | 41  |
| Chapter Four: The foundation of Sen's capability approach  | 87  |
| Chapter Five: Objections to Sen's capability approach as a comprehensive<br>evaluation framework of well-being and poverty | 106 |
| Chapter Six: An introduction of microfinance – the concept and recent trends<br>in microfinance business                   | 148 |
| Chapter Seven: The assessment of microfinance through the lens of Sen's capability<br>approach                             | 237 |
| Conclusion   | 299 |
| References   | 302 |

## **Chapter One**

### **Introduction**

Most of us live in societies that are comfortable and secure. However, as of 2008, over one-fifth of the world's population (1.4 billion) lives on less than \$1.25 a day. According to the World Bank (2008), as of 2005, over three billion people, almost half of the world's population, live on less than \$2.50 a day<sup>1</sup>. Although people's opinions on the issue of how income and wealth should be distributed are still divided, there is a growing consensus that no one should live in extreme poverty. Despite countless NGO's and international aid agencies having initiated various poverty reduction programs, poverty continues to grow, and billions of people, in particular, women and children, lack the necessary money, food, healthcare, education, and resources to fulfill basic human needs. This not only leads to them suffering chronically but very often to death.

According to a survey by the United Nations (UN), over 840 million people around the world suffer from hunger every day, over 100 million people have no housing, and about one-sixth of the world's population is illiterate<sup>2</sup>. Moreover, approximately 1.1 billion people in developing countries do not have adequate access to water. According to the United Nations Children's Fund (UNICEFA),

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<sup>1</sup> World Bank Development Indicators 2008. Available at [data.worldbank.org/indicator](http://data.worldbank.org/indicator).

<sup>2</sup> United Nations Poverty Curriculum, <http://www.un.org/cyberschoolbus/poverty2000/food.asp>

approximately 148 million children under the age of 5 in developing countries are underweight; 22 million infants are not protected from vaccine-preventable diseases; 8 million children died before the age of 5 in 2009; 2 million children under 15 years are infected with HIV; nearly half a million women die each year from causes relating to pregnancy and childbirth<sup>3</sup>. Also, approximately 22,000 children die due to poverty<sup>4</sup> and nearly a billion children were unable to read or sign their names when entering the 21st century<sup>5</sup>. Indeed, these reports only show a fraction of the reality of how people suffer from living in impoverished conditions. However, they are enough to make me feel that it is a privilege to sit down and discuss poverty.

While many experts in development and poverty reduction have been frustrated by not being able to find an effective approach to eliminate poverty and a great number of people are still living in miserable conditions, a new approach to poverty reduction – microfinance, a practice involving the provision of small loans to people without conventional collateral and other financial services such as microsavings and microinsurance – has reignited their hope of eradicating poverty. Academics, social activist entrepreneurs, and economists throughout the world have become fascinated by this innovative approach. Moreover, the United Nations pronounced 2005 as the Year of Microcredit, with Muhammad Yunus, founder of Grameen Bank, receiving the

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<sup>3</sup>State of the World's Children, 2010. Available at [www.unicef.org/rightsite/sowc/pdfs/SOWC\\_Spec%20Ed\\_CRC\\_Main%20Report\\_EN\\_090409.pdf](http://www.unicef.org/rightsite/sowc/pdfs/SOWC_Spec%20Ed_CRC_Main%20Report_EN_090409.pdf)

<sup>4</sup>Ibid.

<sup>5</sup> The State of the World's Children, 1999. Available at [www.unicef.org/sowc99/index.html](http://www.unicef.org/sowc99/index.html)

Noble Peace Prize the following year.

Indeed, the hope that poverty can be eliminated by introducing poor people to microfinance has been boosted by hundreds of inspiring stories about how poor people use tiny loans to start or expand their small businesses and how they have experienced remarkable gains not only in income and consumption but also in health, education and social empowerment. Moreover, microfinance practitioners use these successful stories as evidence to obtain support from international donors and investors. Muhammad Yunus' claims that microfinance plays a significant role in poverty reduction and enhancing peace are often heard (Yunus 1999, 2009). Such a claim is not only used by Grameen style (village banking) microfinance institutions but also by commercially driven microfinance institutions. However, do these anecdotal cases allow us to claim that microfinance does actually reduce poverty? To investigate how microfinance contributes to poverty reduction, we inevitably have to answer some other equally important questions, such as how is the term 'poverty' defined? Should poverty be defined by the status of lacking money or something else? Certainly, when someone is poor, their well-being or quality of life is low. However, how should we assess an individual's well-being? Moreover, if microfinance does not increase poor people's income, can we claim that microfinance does not contribute to poverty reduction at all? These intriguing issues suggest that there is a need for a



theory of poverty and well-being that is able to adequately define and explain the relation between the notions of poverty, well-being and development.

There are two main motivations for undertaking this thesis on Sen's capability approach and microfinance. One is to evaluate Sen's capability approach by considering moral philosophy and developmental ethics contexts. The other is to analyse the impact of microfinance on poverty reduction in accordance with Sen's approach.

The methodology used to assess Sen's capability approach is: (1) to compare it with other possible competing theories, in particular, Rawls' theory of justice and utilitarianism, and (2) to reply to objections to Sen's work. It is clearly impossible to go deeply into these potentially competing theories in a work of this length. However, it is hoped that the discussion will be in enough detail to show the strengths and weaknesses of Sen's theory as a theory of well-being and poverty. While Sen's capability approach has generated significant support from academics, international agencies, NGOs, public officials and those who engage in civil society, it has also been scrutinised and criticised by many scholars and experts who specialise in the poverty reduction and development field. Given the time and space available, this research will be unable to go into every critique from every direction. Instead, the reply to objections towards Sen's capability approach will focus on objections from

philosophical and economic perspectives.

Economists and development experts agree that Sen's capability approach provides an insight into the notions of well-being, poverty and development. However, they have found that it is difficult, if not impossible, to apply Sen's capability approach empirically. Empirical impracticability involves the problems of identifying basic capabilities, setting proper threshold levels and developing an overall evaluation of well-being. Philosophers have also raised fundamental questions regarding the character and justification of Sen's capability approach. One set of objections argues that the sufficient threshold feature embedded in Sen's capability approach will (i) lead to a situation in which too many social resources are devoted to vulnerable groups; (ii) arbitrarily set the proper threshold level; and (iii) pay no attention to inequality above the threshold. Moreover, philosophers question the validation of people's decisions about basic capabilities and the threshold of each basic capability. They argue that there is tension or conflict between a person's direct participation in selecting a list of basic capabilities and having a morally justifiable list of basic capabilities. In other words, capabilities are considered basic because they are thought to be by citizens and may not belong to a morally justifiable list of capabilities promoted by development. For example, Martha Nussbaum, one of the most influential capabilities theorists, insists on having a list of basic capabilities that is

based on adequate moral justification because such a list provides us with the *lowest common denominator* for various lists of basic capabilities made by people from different nations. How is Sen's capability approach able to address the objections raised by economists and philosophers? This thesis will argue that although Sen's approach is sometimes seen as a competitor to Rawls' theory of justice and rule utilitarianism, and as containing a good critique of both, with many supporters, it is better seen as helping to develop our understanding of the kind of poverty that development programs try to eradicate, rather than a general answer to the question 'What is Justice?' or 'What is the difference between Right and Wrong?'.

How should microfinance be assessed when using Sen's capability approach? Since well-being should be evaluated in terms of capability and functioning, poverty should be seen as absolute deprivation in terms of the basic failure of capabilities, with development understood as the process of realising basic capabilities and the assessment of the impact of microfinance on poverty reduction being measured not only by income but by basic capabilities. In other words, the question is, *does microfinance increase or decrease poor people's freedom?* More specifically, *does microfinance increase or decrease poor people's substantial freedoms (basic capabilities)?* However, before investigating how microfinance contributes to basic capabilities, an essential question we have to answer is 'what are the basic capabilities?'

While Sen often emphasises the importance of letting people choose basic capabilities, he is fully aware that no developing country has yet allowed their citizens to choose the basic capabilities, even though basic capabilities are common to all, such as the capabilities of being adequately nourished and educated, avoiding preventable morbidity, taking part in the life of a community and being able to appear in public with dignity. Thus, the assessment of microfinance in accordance with the context of Sen's capability theory will particularly focus on its impact on education, health and the empowerment of women. It should also be emphasised that the evaluation of microfinance is not based on personal field study but rather on a review of existing literature relating to microfinance. Does microfinance have a positive impact on poverty reduction in terms of increasing people's substantial freedoms? This thesis will suggest that the evidence that microfinance reduces poverty is weak: microfinance does not substantially expand people's real freedom – capabilities – to pursue things they have reasons to value.

Bearing in mind the purposes of this thesis spelled out thus far, the overall outline of this thesis is as follows:

Chapter Two will present a general introduction to Sen's capability approach, discussing how Sen refines and transforms his early thoughts about the approach. More specifically, it will debate various poverty definitions, the concept of capability

and functioning, the notion of well-being and agency freedom, the constitutive and instrumental roles of freedom, and the concept of development. In addition, it will argue that while well-being should be evaluated in terms of capability and functioning, poverty should be seen as an absolute deprivation in terms of basic capability failures, with development needing to be understood as the process of realising basic capabilities. Which capability should be weighed as the basic capability depends on people's choices because each person is a free agent whose actions are freely self-determined and entitled to decide the list of basic capabilities and the threshold of each of these capabilities through public discourse and democratic deliberation, which require a society where substantial freedoms are protected by an effective democracy.

Chapter Three will discuss utilitarianism and Rawls' theory of justice. The primary focus of this chapter will be on whether there is a better approach to evaluate well-being and poverty than Sen's capability approach. Several versions of utilitarianism will be discussed in this chapter, including classical utilitarianism (one outcome or act is better than another if it contains a greater total sum of pleasure and satisfaction), modern utilitarianism (one outcome is better than another if, and only if, it contains a greater total sum of desire-fulfilment) and rule-utilitarianism. It should also be noted that while there are a number of different versions of rule-utilitarianism, the kind of rule-utilitarianism discussed in this thesis will be Hooker's version of

rule-utilitarianism.

Chapter Four will then focus on how Sen's capability approach is able to overcome those objections to utilitarianism and Rawls' theory of justice. Finally, the philosophical foundations of Sen's capability approach and his understanding of rationality, public discussion, and democracy will be elaborated.

Chapter Five will discuss objections to Sen's capability approach, particularly addressing critiques raised by economists and philosophers. It will then discuss how Sen's capability approach is able to address critiques from economists and development experts, critiques concerned with the selection of a list of basic capabilities, a set of indicators and an adequate threshold to measure them, in order to reach an overall evaluation of well-being. I will also discuss how Sen's capability approach is able to address critiques from philosophers. In particular, will the feature of sufficient threshold embedded in Sen's capability approach (i) lead to a situation in which too many social resources are devoted to vulnerable groups, (ii) arbitrarily set the proper threshold level, or (iii) pay no attention to inequality above the threshold? I will also consider how Sen's capability approach is able to address the tension between people's participation in choosing a list of basic capabilities and the list being morally justifiable.

Chapter Six will provide a general introduction to the concept of microfinance and recent trends in microfinance business. In particular, the aspects discussed in this chapter include the roots of microfinance, the mechanism to tackle asymmetric information and high administrative costs, the paradigm shifts of microfinance, microfinance products, major types of microfinance institutions and the objectives of microfinance institutions. Further, it will discuss two practical issues within the microfinance industry. It will firstly discuss whether the combination of microloans and commercialisation can lead to mission drift – that is, microfinance institutions attempting to reach out to wealthier clients, whilst at the same time crowding out poor clients. Secondly, it will discuss how we can possibly set a morally acceptable interest rate in the context of letting microfinance institutions be financially sustainable.

Chapter Seven will examine how microfinance contributes to poverty reduction from the point of view of Sen's capability approach. Although Sen says little about how microfinance can contribute to poverty reduction, he does mention that microfinance, particularly microcredit, can have two positive impacts on the empowerment of women. The first impact is that microfinance can increase women's incomes and their social status within society, leading to greater gender equality. The second impact is that microfinance can empower women by increasing their decision-making power over fertility and family planning. Thus, this chapter will

investigate the relations between microfinance and women's income, decision making power and rights. Moreover, it will examine whether microfinance in general decreases or increases people's substantial freedoms in terms of increasing their income, education and health.

In the last part of this thesis, it will summarise the main points suggested in the previous discussion and draw conclusions.



## **Chapter Two**

### **Sen's Capability Approach: Basic Concepts**

Sen's capability approach is widely thought to offer insights about welfare economics, social policy and political philosophy (Alexander 2008; Crocker 2003, 2008; Cohen 1993; Nussbaum 2000, 2003; Rawls). However, Sen has not developed his theory of capability approach overnight. Rather, he has gradually developed the theoretical foundations of the capability approach through his analysis of poverty and famine on one hand and the limitations of evaluating human development and well-being in terms of economic growth and utility on the other. The aim of this chapter is to offer an introduction to Sen's capability approach. More specifically, this chapter discusses the various definitions of poverty, the concept of capability and functioning, the notion of well-being and agency freedom, constitutive and instrumental roles of freedom, and the concept of development.

#### **2.1 Entitlement and poverty and famines**

In his investigation of poverty and famine, Sen is not only questioning the conventional view that famines are caused by the decline of food availability but also building the crucial insight into the concept of poverty which later becomes his capability approach. Traditionally, it was believed that famines occur because of the

sudden collapse of the level of food production and supply in the region. Sen's case analysis of famines, however, challenges this conventional wisdom, showing that there exists the strong possibility that the most devastating effects of famine do not result from the significant shortage of food production, but the sudden collapse of the direct and/or trade entitlement to food. In a private ownership market economy, entitlement typically includes (Sen 1981: 2):

- “(1) trade-based entitlement: one is entitled to own what one obtains by trading something one owns with a willing party (or, multilaterally, with a willing set of parties);
- (2) production-based entitlement: one is entitled to own what one gets by arranging production using one's owned resources, or resources hired from willing parties meeting the agreed conditions of trade;
- (3) own-labour entitlement: one is entitled to one's own labour power, and thus to the trade-based and production-based entitlements related to one's labour power;
- (4) Inheritance and transfer entitlement: one is entitled to own what is willingly given to one by another who legitimately owns it, possibly to take effect after the latter's death (if so specified by him/her)”.

In an exchange market, several factors determine a person's exchange entitlement (Sen 1981:4):

- whether he/she can find an employment, and if so for how long and at what wage rate;
- (2) what he can earn by selling his non-labour assets, and how much it costs him to buy whatever he may wish to buy;
- (3) what he can produce with his own labour power and resources (or resource services) he can buy and manage;
- (4) the cost of purchasing resources (or resource services) and the value of the products he can sell;

(5) the social security benefits he is entitled to and the taxes, etc., he must pay”.

In his four case studies (1981), Sen tells us that even without any shortage of food, people could still become poor if they either do not have any entitlement, or their entitlement cannot be properly fitted into an exchange market of entitlement. For example, from 1972 to 1974, Ethiopia was badly hit by famine, particularly in the province of Wollo, where most people were agriculturists and pastoralists. Since the famine was triggered by a drought, and since drought causes crop failures, it is easy to accept an explanation of the famine in terms of food availability declining. But Sen found that while there was no striking food availability decline for Ethiopia as a whole in the famine year of 1973, there was clearly a shortage of food in the province of Wollo. The shortage resulted from a direct entitlement failure on the part of farmers and a trade entitlement failure for other classes such as labourers and providers of services. People were not only directly entitled to less food from their own production, but there was also a collapse of income and purchasing power and of the ability of attracting food from elsewhere in Ethiopia.

Almost at the same time, on the other side of the earth, Bangladesh also experienced an acute and devastating famine in which around 80 to 100 thousand people died in 2-3 months. During 1973, there was no significant decline in food production, but the relative prices of food shot up, with the implication that only

people in the cities and those with higher wages could afford to buy food. Although rural people had their own entitlement (through labour) to rice that they grow for themselves, the price of rice was rising so high (from June to October 1974) that many were not able to purchase rice to eat. In particular, the percentages of decline of the exchange rate of wage labour with rice in rural Bangladesh in the three most badly hit areas were about 69.5%, 58.0%, and 57.6% respectively. With this kind of decline in the entitlement to rice, labourers ran a significant risk of starvation and death.

Since famines occur mainly because of entitlement failures, Sen argues that the best way to prevent them is to focus on social safety nets for entitlement protection such as unemployment insurance and antipoverty programs. He also insists on viewing the interconnections between people's entitlement and a society's background institutions, which include its legal, economic, political and social features.

Although Sen (1981) did not refine and transform the concept of entitlement into capability in his analysis of poverty and famine, he had already shown that entitlement failures can affect people's command over food and that the fundamental way to protect people's entitlement is to build up their capacities to meet basic necessities for bare survival. This message has sometimes been obscured by the association between Sen on poverty and Sen's support for democracy. While it is true that in *Development as Freedom* Sen states that 'no famine has ever taken place in the

history of the world in a functioning democracy' (Sen 1999: 16), democracy by itself is not supposed to be the answer to poverty. A country with regular elections, opposition parties, transparent and critical media and press, and a culture of public debate has better prospects of avoiding famine. But Sen also reminds us that while democracy and public debate have been more sensitive to extreme disasters, other social failures such as endemic hunger, malnutrition, infant mortality, severe health crises for the poor and systematic social exclusion of women and minorities continue to co-exist with democracy and public debate. Progress on these issues requires strengthening and improvement rather than the denial or bypassing of democracy and public discussion. But it also requires building up capacities that secure entitlements.

## **2.2 Concepts of poverty**

If the causation of famine could be better understood in terms of entitlement failure, could poverty also be properly analysed in this way? According to Sen, the analysis of poverty involves two procedures. One is to identify a group of people as poor (identification); the other is to aggregate the characteristics of the set of poor people into an overall image of poverty (aggregation). These two steps are distinct but related. In fact, any reasonable and acceptable concept of poverty should not only be able to categorize the poor properly but also to display the differences among the poor. Hence,

identification and aggregation become the two principles for Sen to evaluate any approach to the concept of poverty. In the following sections, we will see how Sen uses them to assess those alternative approaches as well as their respective critiques.

### **2.2.1 The biological approach: the maintenance of physical efficiency**

One of the alternative approaches to understanding poverty is the biological approach, which defines poverty as ‘total earnings insufficient to obtain the minimum necessities for the maintenance of merely physical efficiency as being in primary poverty’ (Townsend 1974:16). By using the work of Atwater, an American nutritionist who studied what minimum requirements of protein and calorie intakes were associated with the maintenance of prisoners’ body weight, Rowntree (1901) calculated the average nutritional needs of adults and children, translating them into quantities of different foods as well as the cash equivalent of these foods.

Similar to the work of Rowntree was that of Orshansky, which provided the basis for much of research on poverty in the United States. In 1963 she developed the official US government measure of poverty, which is based on judgements regarding an acceptable trade-off between nutritional standards and consumption patterns. It is not surprising that the biology related to the requirements of survival or work efficiency has often been used in defining the poverty line. Although it gave an insight

to the study of poverty, it also raised several conceptual difficulties (Sen 1981, 1984, 1987; Townsend 1974; Rein 1970). First, there are significant differences related to physical features of people, climatic conditions and work habits. For example, if the incomes of two persons A and B are both below the income poverty line and person A is disabled. In this case, although person A has better income than B, it does not follow that A is richer than B, because A needs far more resources to have an ordinary life. Indeed, A may have a far worse life than B. In fact, even for a specific group in a specific region, nutritional requirements are difficult to define precisely (Sen 1981, 1999). People have been known to adapt to harsh living conditions, and there seems to be a significant improvement of life span as the dietary limits are raised. What is more, physical affluence seems to keep increasing widely. Second, normally, the translation of minimum nutritional requirements into minimum food requirements correlates minimum nutrition with cheapest commodities. However, the minimum cost diet turns out to be unvaried and people do not always eat what is cheapest. Third, the problem of specifying minimum requirements of non-food items is usually solved by assuming that a specified amount of money will be spent on food. With this assumption, the minimum food costs can be used to derive minimum income requirements. But the proportion spent on food varies not only with individual habits and culture, but also with relative prices and availability of goods and services. It is not surprising that the

assumption often ends up contradicting actual experiences. During the Great Depression in the 1930s or even in the recent credit crunch crisis, people spend a much lower proportion of their income on food than was assumed (Townsend, 1974).

Because of its arbitrariness in identifying a group of people as poor and specifying minimum requirements of non-food items together with the diversity of people's consumption habits, the biological approach is not able properly to aggregate the characteristics of the set of poor people into an overall picture of poverty.

### **2.2.2 The inequality approach**

The idea that the concept of poverty is essentially one of inequality has some plausibility. After all, transfers from the rich to the poor can make a substantial change in poverty in some societies. The American sociologists Miller and Roby have put their position thus (1971:143):

Casting the issue of poverty in terms of stratification leads to regarding poverty as an issue of inequality. In this approach, we move away from efforts to measure poverty lines with pseudo-scientific accuracy. Instead, we look at the nature and size of the differences between the bottom 20 or 10 per cent and the rest of the society.

Although there is a clearly quite a lot to be said in favour of this approach, Sen argues



that it is based on some confusion. A sharp fall in general prosperity from a low starting point causing widespread starvation and hardship must be seen by any acceptable criterion of poverty as an intensification of poverty. But if poverty is seen as an issue of inequality, then someone can claim that there is no poverty since the original social distributional framework – the size of the differences between the bottom 20 or 10 per cent and the rest of the society remains the same.

Inequality is fundamentally a different issue from poverty (Sen 1981). To try to analyse poverty as an issue of inequality or the other way around, would do little justice to either. Inequality and poverty are not unrelated, but neither concept subordinates the other. For example, a transfer of income from a person in the top income group to one in the middle income range must reduce inequality; but it may leave poverty quite unaffected. Similarly, a general decline in income that keeps the chosen measure of inequality unchanged may, in fact, lead to a sharp increase in starvation, malnutrition and obvious hardship; it will then be implausible to claim that poverty is unchanged. Hence, it is not proper to define poverty as inequality in terms of aggregation.

### **2.2.3 Relative deprivation**

The concept of relative deprivation has been seen as one of the influential tools in the analysis of poverty (Runciman 1966, Townsend 1971 presenting two different approaches to the concept). Of course, being poor has much to do with being deprived, and it is natural to accept the idea that poverty should be defined as a relative concept, because every society has different standards of living, which depend on the 'total contribution of not one but several systems distributing resources to individual, families, work-groups and communities' (Townsend 1974: 31-32). As Townsend notes (Townsend 1979: 17-18),

Any rigorous conceptualisation of the social determination of need dissolves the idea of 'absolute'. And a thorough-going relativity applies to time as well as place. The necessities of life are not fixed. They are continuously being adapted and augmented as changes take place in a society and in its products. Increasing stratification and a developing division of labour, as well as the growth of powerful new organisations, create, as well as the reconstitute, 'need'. Certainly no standard of sufficiency could be revised only to take account of changes in prices, for that would ignore changes in the goods and services consumed as well as new obligations and expectations placed on members of the community. Lacking an alternate criterion, the best assumption would be to relate sufficiency to the average rise (or fall) in real incomes.

Following this line of thinking, poverty appears to be almost impossible to eliminate, if the poverty line is fixed entirely relatively to the average income. As Atkinson (1983: 228) notes, "[I]t is sometimes suggested that if, for example, we define the poverty line as half the average income, moving up with the general standard of living,

then poverty cannot be abolished” . Indeed, the concept of relative deprivation has been particularly used by industrialized countries to describe the process of marginalization and deprivation that can arise even in rich countries with comprehensive welfare provision. Yet, Sen (1981) argues that the approach of relative deprivation cannot be the only basis for the concept of poverty. First, absoluteness of needs is not the same thing as their fixity over time. The relativist approach sees deprivation in terms of a person or a household being able to achieve less than others in that society do, and this relativity is not to be confused with variation over time. So the fact that ‘the necessities of life are not fixed’ is neither here nor there, and there is no a priori reason why these variables might not change over time.

The second problem is that “there is a difference between achieving relatively less than others, and achieving absolutely less because of falling behind others” (Sen 1984: 328). This general distinction can be illustrated with a different type of interdependence of ‘positional goods’:

Your ability to enjoy an uncrowded beach may depend on your knowing about that beach when others do not, so that the absolute advantage you will enjoy – being on uncrowded beach – will depend on your relative position – knowing something that others do not. You want to have that information, but this is not because you particularly want to do relatively better than or as well as others, but you want to do absolutely well, and that in this case requires that you must have some differential advantage in information. So your absolute achievement – not merely your relative success – may depend on your relative position in some other space (Sen 1983:155-156).

Third, a famine, for example, will be accepted as a case of acute poverty no matter what the relative poverty line within the society happens to be. 'There is an irreducible core of absolute deprivation in our idea of poverty, which translates reports of starvation, malnutrition and visible hardship in to a diagnosis of poverty without having to ascertain first the relative picture' (Sen 1981:17). Thus the approach of relative deprivation cannot give us an overall picture of poverty, and it should supplement rather than replace the analysis of poverty in terms of absolute deprivation.

#### **2.2.4 The basic needs approach**

The most common way to identify who is poor is through specifying a set of basic needs, and saying that someone is poor if those needs are unmet. This approach attempts to define the absolute minimum resources necessary for long-term physical well-being, usually in terms of consumption goods (commodities) such as food, housing, schools, health care etc.

In order to see who is living below the threshold of poverty, it is possible to use at least two alternative methods. One is to check the set of people whose actual consumption baskets happen to leave some basic needs unsatisfied. This does not involve the use of any income notion, so called poverty-line income. In contrast, in

what may be called the income method, the first step is to calculate the minimum income at which all the basic needs are satisfied, usually in terms of consumption goods such as food, water, clothing, and housing (Pardhan and Ravallion 2000). The next step is to identify those whose actual incomes fall below that poverty line. The poverty line can be further set in relative or absolute terms. 'Relative income poverty line' refers to the position of an individual or household compared with the average income in the country, such as a poverty line set at one-half of the mean income, or at the 40<sup>th</sup> percentile of the distribution. Relative poverty lines will vary with the level of average income. 'Absolute income poverty line' usually refers to the people who consume less than two dollar per day.

Theoretically, the direct method is better than the income method, since it is not based on particular assumptions about behaviour which displays great variety and ambiguity. However, the income method does cover one aspect that direct method does not. It captures a person's ability to meet his minimum needs whether or not he, in fact, chooses to use that ability. As matter of fact, if poverty line income can be derived from typical behavioural norms of society, a person with a higher income who is choosing to fast on a bed of nails can be declared to be non-poor. So the fundamental difference between the direct method and the income method is that the former "identifies those whose actual consumption fails to meet the accepted conventions of minimum needs, while the [latter] tries to identify those who do not have the ability to meet these needs within the behavioural constraints typical in that community" (Sen 1981: 28). In fact, these two alternative methods relate closely to Seebohm Rowntree's (1901) contrast between 'primary' and 'secondary' poverty. As we have seen Rowntree defines families which are not able to meet their minimum necessity for continuing physical efficiency, as being in 'primary poverty, But he also defines as secondary poverty the possession of income adequate for buying products that would keep them well nourished and healthy, but where the money is spent on other things. In other words, secondary poverty is a condition in which "earning would be sufficient for the maintenance of merely physical sufficiency were it not that some portion of it is absorbed by other expenditure, either useful or wasteful" (Streeten 1984:1) such as smoking, gambling, and inefficient housekeeping. So for the basic needs approach, the direct method is similar to primary poverty since it

checks the set of people whose actual consumption baskets happen to leave some basic needs unsatisfied. The Income method corresponds to secondary poverty because it can capture the situation in which people have enough money to be well-nourished, but would like to spend their money on non-minimum necessary physical efficient items or to choose to fast otherwise.

Can poverty be defined as inability to satisfy basic needs? Although the basic needs literature sheds much light on the concept of poverty and the strategies for eliminating poverty, the concept of basic needs has its own problems. One of the problems is that since basic needs are defined as needs for commodities; this may distract us from the fact that these commodities are no more than the means to ends. Furthermore, the relationship between commodities and capabilities may be different among individuals and societies. For example, the relation between food intake and nutritional achievements varies greatly with metabolic rates, body size, gender, and other factors. As Streeten (1984) notes, that there is a difference between having a specific commodity  $A$  and meeting a basic need by using commodity  $A$ . The purpose of meeting basic needs is not because it helps us to possess commodities, but for helping people succeed in doing and being.

Can poverty be defined as low income? Generally, the objections to defining poverty as income poverty can be summarised as follows. First, it does not give us detail as to the allocation of income within the family (Laderchi, Saith, and Stewart 2003). For example, in many Chinese families, parents often allocate far more family resources to their sons than their daughters. This, however, would not be shown in the

income poverty line approach. Second, as Sen notes, the relationship between income and capability is varied in different communities, families, and individuals. For instance, if a poor woman happens to be disabled, needing more resource than any other normal citizens, then being able to have income that is beyond income poverty line does not necessarily mean that she is able to convert income into her well-being. In fact, a person's ability to convert her income into well-being will not only be affected by mental and physical conditions, but other factors (such as geography, political institutions, social roles, basic infrastructures, etc). This indicates that merely focusing on income will blind us to some influences on the ability to convert income into capability and to ignore other factors that play significant roles of promoting individuals' well-being. To take another example, suppose there are two countries, A and B: the government in A is corrupt and lacks democracy, and the government in B is transparent and democratic. In such a case, we would generally agree that people's well-being will be more easily realised in B than in A if people living in A and B have the same level of income. Taken together, these two objections indicate that there is a danger in defining poverty as income poverty.

If the concept of poverty is inadequately understood in the context of biological approach, inequality, relative deprivation, and basic needs, then what is the proper approach to the concept of poverty? Sen argues that at its core, poverty is absolute

deprivation, which is understood in the context (space) of capabilities. Before seeing how Sen connects absolute deprivation with capability failure, let us briefly go through the concept of capability as such and related concepts.

### **2.3 Capability and functioning**

Sen (1987, 1992, 1993) refines and transforms the concept of entitlements into the capabilities approach. In his *Tanner Lecture* (Sen 1987), Sen argues that the right focus for assessing people's well-being and standard of living in society is neither commodities, nor characteristics, nor utility, but their 'capacity to achieve valuable functionings' (Sen 1993: 31). Sen defines functionings as a number of 'doings' and 'beings' that a person manages to achieve at a time or accumulates over time:

A functioning is an achievement of a person: what he or she manages to do or to be. It reflects, as it were, a part of the 'state' of that person. It has to be distinguished from the commodities which are used to achieve those functionings... It has to be distinguished also from the happiness generated by functioning... A functioning is thus different both from (1) having goods (and the corresponding characteristics), to which it is posterior and (2) having utility ( in the form of happiness resulting from that functioning), to which it is, in an important way, prior (Sen 1987:7).

Living may be seen as consisting of a set of interrelated 'functionings', consisting of beings and doings (Sen 1992:39).

By way of example, Sen mentions not only basic functionings like nutrition, life expectancy, health and education, but also complex functionings like self-respect,



social recognition and political participation which are relevant to the assessment of well-being (Sen 1992). In order to achieve these simple and complex functionings, we would certainly require resources such as money, private goods and public goods. We would also derive certain psychological sensations (happiness, fulfilment, etc) from achievement of these functionings. Sen, nonetheless, insists that functionings should be the basis of assessment of a person's well-being.

Sen defines capabilities as the freedom that a person is actually able to do and to be or as a wide range of capacities and opportunities required for *human well-being* as a whole. As he puts it (Sen 1992:40) :

Closely related to the notion of functionings is that of the capability to function. It represents the various combinations of functionings (beings and doings) that the person can achieve. Capability is, thus, a set of vectors of functionings, reflecting the person's freedom to lead one type of life or another.

If a functioning achievement (in the form of an *n-tuple* of functionings) is a point in that space, capability is a set of such points (representing the alternative functioning n-tuples from which an n-tuple can be chosen) (Sen 1993:38). And hence, a person's set of achievements (capability set) in this aspect can be understood as the vector of his or her functionings, which displays the overall freedom a person enjoys to pursue his/her well-being. For example, if a person claims that he is fasting, then we should

examine whether he has, at least, an alternative choice such as a choice of being able to have food to eat. If the person in question did not have any choice, then he certainly could not claim that he has the capability of fasting. Thus to judge a person's well-being, we are not only examining the actual functionings he/she has, but for his/her vector of functionings (capability set).

There has been a considerable debate and discussion among philosophers and capability theorists as to what exactly Sen means when he uses the term 'capability'. Does it refer to various skills and abilities or various options and opportunities? Crocker (1995:163) states that in Sen's writings the notion of capability mainly refers to people's opportunities of doing things they have reasons to value. Cohen (1993:20-25), by contrast, suggests Sen's notion of 'capability is to do with various skills and abilities and hardly has any reference to opportunities and conditions that are required to develop capabilities<sup>6</sup>. Sen has, however, clarified this as follows (Sen 1993:33):

The freedom to lead different types of life is reflected in the person's capability set. The capability of the person depends on a variety of factors, including personal characteristics and social arrangements. A full accounting of individual freedom must, of course, go beyond the capabilities of personal living and pay attention to the person's other objectives (e.g. social goals not directly related to one's own life), but human capabilities constitute an important part of individual freedom.

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<sup>6</sup> Indeed, Cohen holds that Sen's capability approach espouses an inappropriate 'athletic' image of the person in that his emphasis on ability to achieve valuable functionings indicates that life is valuable only if people actively choose most facets of their existence (1993:25-26).

This suggests that in Sen's understanding, the meaning of capability is two-fold. First it involves "capacities or powers of people as human beings: these can range from the most basic ones required to fulfill nutritional and health needs to more complex ones such as the exercise of practical reason and living with self-respect in a community" (Alexander 2008:57) . Second it refers to the extent of freedom that "people have to nurture and to exercise their capacities" (Alexander 2008:57). Although the meaning of capability is two-fold, Sen emphasizes that the main function of capability is rather to reflect a person's freedom – the substantial freedom – to achieve valuable functionings than to reflect a person's capacity or powers as a human being, and the importance of evaluating a person's freedom by referring to the outcomes and processes that he has reasons to value and seek (Sen 1992: 49):

Capability is primarily a reflection of the freedom to achieve valuable functionings. It concentrates directly on freedom as such rather than on the means to achieve freedom, and it identifies the real alternatives we have...it can be read as a reflection of substantive freedom.

Sen emphasizes that people can freely either choose to realize basic functionings or not when basic capabilities are available to them. What is more, this can help us to differentiate an individual's responsibility in a context of social justice. For example, a person with capability of being nourished might choose to fast for the religion or

some other purposes. As Sen puts it (1992:148):

With reference to responsible adults it is more appropriate to see the claims of individuals on the society (or the demands of equality or justice) in terms of freedom to achieve rather than actual achievement. If the social arrangements are such that a responsible adult is given no less freedom (in terms of set comparisons) than others, but he still wastes the opportunities and ends up worse off than others, it is possible to argue that no unjust inequality is necessarily involved. If that view is taken, then the direct relevance of capability (as opposed to achieved functionings) will be easy to assert.

If capability is mainly a reflection of the freedom to achieve people's beings and doings, then what does freedom mean? Freedom can be understood in terms of a person's well-being and agency freedom on one hand, and its role of development on the other.

#### **2.4 Well-being and agency freedom**

Capability is mainly a reflection of a person's freedom to achieve various beings and doings that he/she has reasons to value. However, a person's freedom to do and to be is not confined to his/her own well-beings. A person's freedom of doing and being can also be understood in terms of his/her agency aspect, which refers to a person's broader freedom to bring about the achievements he/she values and which are associated with the well-being of others. In other words, the goals or the reasons that motivate a person to act are not always derived from his own self-interests. A person

can also be motivated by altruistic goals for the sake of which he may sacrifice his fortune, friends, and even life itself. For example, in western society we see many doctors give up their jobs and voluntarily fly to Afghanistan to give the locals medical treatment and some even got killed.

An achievement realized in one's agency aspect is called an agency achievement, whereas an achievement realized in one's well-being aspect is called a well-being achievement. Agency achievement can further be broken down into two categories: direct agency achievement (instrumental agency success) and indirect agency achievement (realized agency success). While direct agency achievement requires goals to be brought about by one's own efforts, indirect agency achievement does not (Sen 1992: 57-58). For example, let us consider the following situations.

Situation A: I want my house to be clean and I cleaned it myself.

Situation B: I want my house to be clean but I cannot clean it, for I am disabled.

My neighbor helps me to clean my house.

In Situation A, having a clean house is called the direct agency achievement, whereas having a clean house in situation B is called the indirect agency achievement. The distinction between direct agency achievement and indirect agency achievement signals that not only can institutions and other people bring about the realization of our own goals, but they can bring about an effective realization of our own goals.

Moreover, it reflects the extent of a person's participation in various actions. For instance, if I feel ill I could have two choices:  $x$ : go to the pharmacy and choose medicine myself and  $y$ : go to see a doctor and let him choose which pill I should take. In choice  $x$ , my direct agency achievement has been realized, but it does not necessarily bring me an effective result in terms of curing my disease if I do not have enough relevant knowledge. Indeed, I could end up killing myself if I take the wrong pill that triggers a fatal allergy. In choice  $y$ , although my direct agency achievement is not realized, my indirect agency achievement is realized and brings me an effective result. The choice  $y$  particularly reflects the fact that we live in a society in which complicated political bureaucracies and economic activities have been established that are, in some cases, beyond one's ability to cope with oneself. Thus, we allow different professionals such as lawyers, accountants, and insurance brokers etc., to take decisions for us to bring about the result that we would actually choose (Sen 2009:301-303).

Sen's attempt to make a differentiation between a person's agency aspect and well-being aspect emphasizes that human behaviors are not always motivated by their own well-being (Crocker 2006). A person's own well-being does not use up his/her achievements and objectives. People can also pursue goals that could reduce their well-being and even end their lives. Although well-being freedom plays a significant

role in public policy making, such as poverty reduction “in the form of eradicating major deprivation in well-being freedom”, it is also important not to ignore that a person can also have his/her agency freedom (Sen 2009: 289). The real freedoms that people enjoy are not necessarily associated with people’s own well-being, but they must have the freedom to choose between their agency freedom and well-being freedom.

## **2.5 Constitutive and instrumental roles of freedom**

Freedom can also be understood in the context of development. Freedom has constitutive and instrumental roles. While the former refers to substantive freedoms that uplift human life, which includes basic capabilities like “being able to avoid such deprivation as starvation, undernourishment, escapable morbidity and premature mortality, as well as the freedoms that are associated with being literate and numerate, enjoying political participation and uncensored speech and so on” , the latter refers to political freedom, economic freedom, social opportunities, transparency guarantees and protective security, which provides effectiveness of freedom of different kinds to promote human freedom, (Sen 1999:36). In fact, the distinction between constitutive and instrumental freedoms is derived from Sen’s earlier distinction between control and effective freedom (Sen 1985). Control freedom refers to opportunities that are the

outcome of a person's own exercise of choice. The role of other agents might in such cases be minimal. Effective freedom, by contrast, refers to opportunities that are the outcome of other agents such as the family, community or the state. The person is either a mere beneficiary or his exercise of control is very minimal (Sen 1985:210):

The contrast between effective power [effective freedom] and procedural control [control freedom] is important in practice. It is often not possible to organize society in such a way that people can directly exercise the levers that control all the important aspects of their personal lives. To try to see freedom exclusively in terms of control is to miss the demands of freedom when control cannot feasibly be exercised by the persons themselves.

Sen's motivation for retaining the distinction between the constitutive (control) and instrumental (effective) roles of freedom in development is to recognize the importance of economic, social and political structures that can either facilitate or hamper individual capabilities. Persons acquire, exercise and enhance their capabilities depending on their social conditions. Sen (1992) gives us an example of a doctor who wants to help other people, lives in a society where there is a lack of efficient economic and political structures or basic civil infrastructures (no roads for cars, military obstructions, making travel to her destinations hard). In this case, how is she to achieve her goal? Obviously, she might be forced to delay her plan until the circumstances get better. Instead of advocating the view that freedom is an exclusive result of the individual's privilege and achievement, Sen reminds us of its other



important dimensions (Sen 1992:69):

[Freedom] is one of the most powerful social ideas, and its relevance to the analysis of equality and justice is far-reaching and strong. When we assess inequalities across the world in being able to avoid preventable morbidity, or escapable hunger, or premature mortality, we are not merely examining differences in well-being, but also in the basic freedoms [substantial freedom] that we value and cherish.

Freedoms and opportunities generated by public goods are results of effective freedom, which consists of responsible governments and communities.

Although Sen has elaborately amplified the different aspects of freedom that could be important in assessing people's benefits and standing in society, he is well aware that there is a certain unavoidable 'ambiguity' between 'capability' and 'functionings', since the latter stands for a person's 'achievements', whereas the former stands for the person's freedom to achieve. Yet he points out that this should not deter us from focusing on a person's choice and freedom: 'In so far as there are genuine ambiguities in the concept of freedom that should be reflected in corresponding ambiguities in the characterization of capability' (Sen 1993:33).

## **2.6 Poverty as absolutist deprivation of basic capabilities**

If the right course for evaluating a person's well-being is to focus on a person's capabilities and functionings, then poverty should be seen in terms of deprivation of

basic capabilities. That is, without some basic capabilities – ‘the substantive freedoms’ (Sen 1999:87) – people *can barely initiate any move toward the life they have reason to value*. As I have discussed, in order to be able to use an uncrowded beach, a person might need the capability of using the internet; having driving skills and so on. These are instrumental capabilities, and among instrumental capabilities some might be more necessary than others. In this sense, a person can never initiate movement toward the life he has reason to value, unless he is able to meet basic capabilities. Seeing poverty as deprivation of basic capabilities brings more fundamental elements such as rights and other social arrangements into the frame of poverty, providing us a better understanding of what is involved in the challenge of poverty. In other words, poverty is not seen as a state of lacking enough income, but as a state of lacking basic capabilities to live in a valuable life. The absolute-relative dispute in the conceptualization of poverty is superseded in this framework. While poverty is seen as an absolute notion in the space of capabilities, poverty as such will take a relative form in the space of commodities or characteristics. Sen uses Adam Smith’s discussion of the concept of necessities to clarify the distinction between absolute and relative poverty (Smith 1776: 351-2, cited in Sen 1984: 333):

By necessities I understand not only the commodities which are indispensably necessary for the support of life, but what ever the custom of the country renders it indecent for creditable people,

even the lowest order, to be without...Custom...has rendered leather shoes a necessary of life in England. The poorest creditable person of either sex would be ashamed to appear in public without them.

In this view, to be able to avoid shame in 18<sup>th</sup> century, an Englishman had to have leather shoes. As we consider more and more expensive commodities, the commodity requirement of the same capability – avoiding this type of shame – increases. In the commodity space, therefore, escape from poverty in the form of avoiding shame requires a varying collection of commodities. There is no conflict between irreducible absolutist elements in the notion of poverty and relative poverty in terms of incomes. When Townsend estimates the resources required for being able to participate in a community or society, he is literally measuring the varying resources requirements of fulfilling the same basic capabilities. In a developing country, in order to meet the requirements of fulfilling nutritional needs, i.e. being clothed and sheltered, a person A may need £10 per month, but if a person B lives in a developed country, even though he can earn twice as much as person A, it does not necessarily follow that person B could be able to meet the requirements of fulfilling nutritional needs, and being clothed and sheltered, since in the country where he lives he may need far more money to maintain basic physical functionings. Being relatively poor in a rich country can be a great capability handicap, even when one's absolute income is high in terms of world standard.

What is more, instead of setting the poverty line in terms of income shortage, the poverty line could be defined as a level below which a person is not able to meet nutritional requirements, achieve adequate participation in communal activities and appear in the public without feeling shame. While some capabilities, such as being well nourished, may have more or less similar demands on commodities irrespective of the average living standard in which a person lives, other capabilities, such as to be free from public shame, or to be able to visit friends, may require more real income and wealth in a developed country than in a developing country.

## **2.7 Development as the expansion of people's capabilities**

Since the proper way of evaluating people's well-being, according to Sen, is in terms of their actual opportunities and capacities of doing things they have reason to value, development should be seen as expanding the substantive freedom that people enjoy. But why should we see development in this way? Sen argues that the previously dominant conception of development' as increase in GNP per capita exacerbated distributional inequality, failing to disaggregate and separately consider other important dimensions of development, such as health and education. Again, and more importantly, the GNP conception ignores other dimensions of development such as political participation and dissent.

Why not take the increase of utility rather than capability as the goal of development<sup>7</sup>? Sen argues (1992, 1999a) that utility cannot adequately capture the concept of development, which has heterogeneous and incommensurable characteristics. First, it fails to take people's adaptive preferences into account. People's ability to adapt themselves to harsh circumstances is phenomenal. A totally deprived person, who lives a very limited life, might not appear to be badly off in terms of the mental metric of desire and its fulfillment. As a result, he may even lack the confidence to demand any radical change, adjusting his desires and expectations to what he sees as feasible. Second, development as increased utility ignores inequalities in the distribution of utilities (happiness or pleasure). Third, it attaches no intrinsic importance to certain valuable elements such as liberal and democratic rights. For example, a dictator can justify his policy of prohibiting the right of speech and vote by saying that 'people are happy and satisfied'. If development is seen as enrichment of freedom, the liberal and democratic rights will have their own important place in the development. They are 'part and parcel of enriching the process of development' (Sen 1999a:37). The importance of having liberal and democratic rights does not have to be built on their contributions to utility; they have their own important intrinsic value.

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<sup>7</sup> A thorough comparison between Sen's capability approach and utilitarianism will be displayed in chapter 3.

## Chapter Three

### **Possible theories of well-being and poverty: Rawls' theory of justice and utilitarianism**

As we have just seen, Sen has developed his own approach – the capability approach – to the evaluation of well-being, poverty, and development. According to Sen, while well-being should be evaluated in terms of capability and functioning, poverty should be seen as the absence of basic capabilities and development should be understood as the process of expanding basic capabilities. Basic capabilities serve as the foundation for people to pursue the kind of lives they have reason to value. Indeed, well-being and poverty can be seen as two distinct but highly correlated concepts. We can even say that poverty is one of worst forms of *destitution of well-being*. This entails that a person is farther away from being poor if her well-being has been improved. When well-being and poverty are connected in this way, two political philosophies that have immense influence on morality and social arrangements—utilitarianism and Rawls' theory of justice – are highly relevant. Although utilitarianism and Rawls' theory of justice disagree on the importance to be given to well-being, how individuals' well-being should be promoted and how social arrangements should be settled, they would all agree that poverty can in part be seen

as *an unacceptable degree of inequality*<sup>8</sup> because both of them share the same ideas: persons are equal by nature and each person's interests matter and matter equally. In this chapter, these two competing theories will be examined from the viewpoint of Sen's capability approach. Moreover, I argue that while Sen's critique of Rawls' theory of justice is reasonable, his critique of utilitarianism does not refute utilitarianism. One form of utilitarianism – rule-utilitarianism – that has not been discussed by Sen, may resist his criticisms of utilitarianism and, more importantly, can be adapted to the ethics of poverty alleviation.

### **3.1 Rawls' theory of justice as the theory of well-being and poverty**

Sen's approach commends itself to philosophers not just as a framework appropriate to the ethics of development. It also contains a critique of a dominant moral theory, namely Rawls'. In the present section, the discussion will focus on whether Rawls' theory of justice can serve as an adequate theory of well-being and poverty. In his book *A Theory of Justice [TJ]*<sup>9</sup>, Rawls begins by expressing his dissatisfaction with

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<sup>8</sup> I say generally, because Rawls also considers the causes of inequality. If someone has won a million dollars on the lottery and gambles it all away, ending up poor, the resulting poverty is not necessarily unacceptable.

<sup>9</sup> Henceforth, Rawls' Theory of justice (1999) and Political Liberalism (1993) will be referred as *TJ* and *PL* respectively.

utilitarianism<sup>10</sup> and intuitionism<sup>11</sup> as the foundation of social justice and the measure of well-being, arguing that an adequate theory of social justice cannot be derived from either. A proper theory of social justice is the theory that provides a society with guidelines that help its major social institutions (the basic structures of society) – political constitution, principal economic and social arrangements – fairly distribute basic rights and duties and equally determine the division of advantages from social cooperation. Although people may have various conceptions of justice, Rawls argues that through the device of the veil of ignorance<sup>12</sup> and the prerequisite of a well-ordered society<sup>13</sup>, a free, equal and disinterested person will autonomously accept and uphold the two principles of justice that he has proposed (*PL*: 5-6):

1. Each person has an equal claim to a fully adequate scheme of equal basic rights and liberties, which is compatible with the same scheme for all; and in this scheme the equal political liberties, and only those liberties, are to be guaranteed their fair value.
2. Social and economic inequalities are to be arranged so that they are both:

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<sup>10</sup> While there are many forms of utilitarianism, Rawls particularly compares his theory of justice with Sidgwick's formation of utilitarianism, which is defined as follows: '[a] society is rightly ordered, and therefore just, when its major institutions are arranged so as to achieve the greatest net balance of satisfaction summed over all the individuals belonging to it' (TJ,20).

<sup>11</sup> According to Rawls, Intuitionism is defined as the doctrine that there is an irreducible family of first principles which have to be weighed against one another by asking ourselves which balance, in our considered judgement, is the most just' (TJ,30).

<sup>12</sup> The veil of ignorance refers to the initial situation in which 'no one knows his place in society, his class position or social status, nor does any one know his fortune in the distribution of natural assets and abilities, his intelligence, strength, and the like...the parties do not know their conceptions of the good or their special psychological propensities'. The main purpose is to ensure that 'no one is advantaged or disadvantaged in the choice of principles by the outcome of natural chance or the contingency of social circumstances'. Further, a person is defined as a 'free', 'rational', and 'mutually disinterested' being who 'can apply principles of give and take in relation to others and principles of rational prudence in furthering his own goals' (Sorell 1991:31).

<sup>13</sup> A well-ordered society is a society in which '(1) everyone accepts and knows that the others accept the same principles of justice, and (2) the basic social institutions generally satisfy and are generally known to satisfy these principles' (TJ,4). In short, in a well-ordered society, each citizen is effectively regulated by a shared conception of justice and understands what is just and unjust publicly.



- (a) attached to offices and positions open to all under conditions of fair equality of opportunity, and
- (b) to the greatest benefit of the least advantaged, consistent with the just savings principle.

There is a strict lexical order among the principles of justice. That is, while 2a is prior to 2b, the first principle (equal basic liberty principle) is prior to the second principle: no arrangement which satisfies the second principle can justly violate the first. Moreover, according to the first principle, the basic liberties can be infringed only when the restriction of certain basic liberties can 'strengthen the total system of liberties shared by all' and is accepted by 'those with the lesser liberty' (TJ, 266). In short, a basic liberty cannot be violated for the purpose of increasing wealth or income, or having a better distribution of economic resources. Although Rawls gives a short list of basic liberties, he reminds us that they are only 'roughly speaking' (TJ,540). The list of basic liberties refers to 'political liberty (the right to vote and to hold public office) and freedom of speech and of assembly; liberty of conscience and freedom of thought, which includes freedom from psychological oppression and physical assault and dismemberment (integrity of the person); the right to hold personal property<sup>14</sup>; and freedom from arbitrary arrest and seizure' (TJ, 53).

Regarding the second principle, social and economic inequalities are permitted only

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<sup>14</sup> According to Rawls, the right to hold personal property does not include 'the right to own certain means of production and freedom contract as understood by the doctrine of laissez-faire' (TJ, 54).

when inequality of opportunity enhances ‘the opportunity of those with less opportunity’ (TJ, 266). In other words, social and economic inequalities are allowed if they benefit the least well off without violating the first principle. Further, the second principle is lexically prior to the principle of efficiency and that of maximising the sum of advantage.

Rawls’ two principles of justice not only indicate what social goods should be equally shared, but, more importantly, they tell us in what situation inequality in the distribution of primary goods is allowed. Rawls argues that what should be fairly shared among citizens are the “primary goods’ including ‘liberty, opportunity, income and wealth, and self respect” (TJ,380). Although Rawls recognises that some other goods such as health, intelligence, vigour, imagination, and natural talents are also of great importance in shaping every citizen’s life, he argues that they should be seen as natural primary goods, which are affected by social basic institutions, but are not directly distributed by them. Thus the primary goods that matter to Rawls’ theory are the social primary goods (TJ,303):

All primary goods – liberty and opportunity, income and wealth, and the bases of self-respect – are to be distributed equally unless an unequal distribution of any or all of these goods is to the advantage of the least favoured.

In the present section, two questions will be examined, namely, the relation between

primary goods and well-being; and the relation between primary goods and poverty.

### **3.1.2 Primary goods and the measurement of well-being**

Rawls defines primary goods as the goods “which it is supposed a rational man wants whatever else he wants” or which are “generally necessary for the framing and the execution of a rational plan of life” or (TJ, 79, 380). According to Rawls, a rational man is the person who has the ability to take effective means to achieve his ends (TJ, 352). Further, ‘a good thing’ is a thing that is able to ‘effectively’ achieve one’s ends.

Putting them together, a thing considered as a good thing is one that has the properties which it is rational for a rational person to want in a specific situation or a state of affairs in view of his interests and aims. For example, if I want to know what time it is now, then a watch that can tell time exactly will be considered as a good watch by me.

If a good thing is defined as a means that can effectively achieve one’s end, then what can be counted as an effective means to achieve a person’s rational plan of life? To answer this question, one needs to define the meaning of a rational plan for life.

According to Rawls, the first criterion for a rational plan for life is that it has to be consistent with the principles of rational choice. The principles of rational choice particularly refer to the principles of effectiveness, inclusiveness, and the greater possibility (Rawls 2000). The principle of effectiveness holds that we choose the

means that can realise the end in the best way (either the one with least expenditure or the one having the fullest possible extent). The principle of inclusiveness holds that one plan is better than another ‘if its execution would achieve all of the desired aims of the other plan and one or more further aims in addition’ (TJ, 632). The principle of the greater possibility holds that if an objective can be achieved by two plans, one would prefer the plan having greater chance of achieving that objective. Although the principles of rational choice can serve as guidelines for reflection, Rawls argues that they tell us little as to the relative intensity of a person’s wants or desires and how to prioritise them<sup>15</sup>. As Rawls notes, a choice is not only a reflection of what we want, but also of how much we want it. For example, a person may prefer a plan A to B, even when plan B is more effective and inclusive, for his desire for A is stronger than for B. Thus, a rational plan of life is not only in line with the rational principles of choice, but also in line with the hierarchy of a person’s desires. To have such a rational plan of life, Rawls introduces the notion of ‘deliberative rationality’, which refers to a person’s ability to know “what he would now desire and seek if the consequences of all the various courses of conduct open to him were, at the present point of time, accurately foreseen by him and adequately realized in imagination” (TJ, 366). That is to say, a rational plan would be the result of a person’s deliberative

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<sup>15</sup> Rawls refers the principles of rational choice as ‘counting principles’, for they do not ‘require a further analysis or alteration of our desires, nor a judgment concerning the relative intensity of our wants’ (TJ, 364).

reasoning, in which he believes that a specific course of action would be the best way to realize his more fundamental desires.

However, the claim that a rational plan for a person is the one coordinated with that persons' deliberative rationalities could lead to a concern that a rational plan for life is not necessarily objectively rational, for a person may have false beliefs or insufficient information or knowledge. Indeed, it is very difficult to have such an objective rational plan for life, since our knowledge could be limited by various factors (physical, mental, and social conditions). Although Rawls argues that it is possible for a person to have an objective rational plan for life if 'our information is accurate and our understanding of the consequences complete in relevant respects', he never holds the view that a person's rational plan for life must be an objective one. For Rawls, the difference between deliberative rationality and those rational or irrational choices is not the objectivity, but the absence of 'self-reproach'. As Rawls puts it, "a rational person may regret his pursuing a subjectively rational plan, but not because he regret his choice, at least not in the sense that he later believes that at the time it would have been more rational to have done otherwise" (TJ, 371).

If the concept of goodness is understood as what can rationally be chosen and a rational plan for life is understood in terms of meeting a person's deliberative rationality, then the reason for choosing social liberty and opportunity, income and

wealth, and the bases of self-respect as primary goods must be that they serve as the foundation for its initiation and the execution of any rational plan of life. In other words, the primary goods are the most important things that each person should have in terms of promoting their well-being.

But how can we be sure that the principle of equal liberties and the difference principle for distributing the primary goods are acceptable principles of justice. Rawls' answer is that they would be chosen in a deliberative process that corrects for bias. The veil of ignorance serves in his theory as a device that prevents every citizen from exploiting their arbitrary advantages in the selection of principles of justice. In particular, when people are behind the veil of ignorance (TJ, 118):

[N]o one knows his place in society, his class position or social status; nor does he know his fortune in the distribution of natural assets and abilities, his intelligence and strength, and the like. Nor, again, does anyone know his conception of the good, the particulars of his rational plan of life, or even the special features of his psychology such as his aversion to risk or liability to optimism or pessimism. More than this, I assume that the parties do not know the particular circumstances of their own society. That is, they do not know its economic or political situation, or the level of civilisation and culture it has been able to achieve. The persons in the original position have no information as to which generation they belong to.

### **3.1.3 Objections**

Can Rawls' theory of justice be seen as an adequate theory of well-being from the view point of Sen's capability approach? In the present section, two objections raised

by Sen will be discussed. The first objection is that Rawls' theory of justice overlooks people's real opportunity to convert their resources or primary goods into their well-being. The second issue is that Rawls' emphasis on primary goods could lead to fetishism.

As has been seen, Rawls takes the primary goods as the fundamental constituent elements of well-being, arguing that social justice would be achieved when the primary goods are equally distributed among citizens. Thus, Rawls, claims that while a person's well-being should be measured in terms of the primary goods, liberty has the absolute priority. Indeed, at the risk of oversimplifying, Rawls' explanation of the connection between well-being and freedom on the one hand and primary goods on the other can be summarised in this way:

1. Each person has a moral personality reflected in being able to be a self-directing pursuer of a life-plan.
2. Primary goods give people means to pursue their respective life-plans, and are properly used to measure well-being.
3. Each person has equal moral personality which cannot be traded off for wellbeing
4. Thus, while a person's well-being is important. It cannot be pursued at the expense of any basic liberties: these liberties are prior

Sen argues against (2) that primary goods do not necessarily equip people to pursue their life-plans, on the ground that focusing on primary goods alone would neglect individuals' ability to convert their primary goods into their well-being. For example, a pregnant woman or a disabled person may need more income or other primary goods to achieve functioning than a normal person would have. The critique raised by Sen is that people may not have opportunities (real freedom) to pursue their rational plan of life even if the primary goods have been equally distributed, or unequally distributed in accordance with the difference principle, because people have different capacities to convert primary goods into their relevant doings and beings. The reason why Rawls believes that the primary goods can give people the ability to pursue their respective objectives is that Rawls presuppose that "each person has physical and psychological capacities within the normal range": thus, while each citizen should have equal basic liberties (the right to vote, to run for office, due process, free speech, mobility, etc.), the least advantaged people judged in terms of social and economic inequalities should have greatest compensation defined in terms of income and wealth (Alexander 2008:40) . As Rawls puts it (2000: 83-84),

To fix ideas, let us single out the least advantaged as those who are least favored by each of the three main kinds of contingencies. Thus this group includes persons whose family and class origins are more disadvantaged than others, whose natural endowments (as realized) permit them to fare less well, and whose fortune and luck in the course of life turn out to be less happy, all within the normal



range and with the relevant measures based on primary goods...I shall assume that everyone has physical needs and psychological capacities within the normal range so that the question of health care and mental capacity do not arise.

Although Sen admits that the issue of physical and mental disabilities can be avoided by presupposing that people have physical and psychological capacities within the normal range, he insists that a better theory of well-being is one taking into account people's variation in personal characteristics from the very beginning because the problem of disability is not trivial but rather gigantic. Sen reminds us that "more than 600 million people –about one in ten of all human beings – live with some form of significant disability. More than 400 million of them live in developing countries". The disabled people living in developing countries are often the core poor for they not only suffer from an "earning handicap", but from "the conversion handicap" (Sen 2009: 258). Thus, Rawls underestimates the number of people whose physical and psychological capacities are below the average level.

Turning to the second half of (2), Sen raises the following concerns. First, Rawls' emphasis on treating primary goods as the measure to well-being could lead to fetishism – that is, we could end up only focusing on primary goods to the exclusion of freedom itself. As noted earlier, a person's freedom or ability to pursue a life she has reason to value would not only be affected by how many resources (primary goods) she has, but also be influenced by her personal characteristics. Some people

would remain disadvantaged, even when the primary goods have been equally distributed to all. Thus, a better approach is not one measuring well-being in terms of the holding of primary goods, but one measuring well-being in terms of the substantial freedoms and the basic capabilities.

Another concern is that the priority Rawls gives to basic liberties is too extreme (Hart 1973; Sen 2009). Put differently, why can basic liberties be restricted only for the sake of a greater “system of liberty as a whole” (Rawls 1999:203)? As Hart has pointed out, Rawls’ insistence that basic liberties can only be restricted for the sake of liberty contradicts a common sense belief that, in juridical matters, an individual’s basic liberties can be interfered with not only when it can bring greater liberty, but when they can protect people from harms and losing “other elements of real utility” (Hart 1973:548). For example, suppose only Charlie, living in a remote village, has a van. Suppose two villagers have been bitten by a snake and would not be able to survive without being treated in hospital within 2 hours. Suppose that the only way to reach the hospital in time is to commandeer Charlie’s vehicle. In this case, can Charlie’s basic liberty – to use the vehicle as he likes – be restricted? Apparently, it would be counter-intuitive if we insist that Charlie’s private ownership of the van should not be restricted. This case shows that sometimes *the reason for limiting basic liberties is not for the sake of liberty*. A person’s basic liberty can be infringed not

only when it interferes with “another individuals’ basic liberties”, but when it causes “various forms of harm, pain and suffering” (Hart 1973: 550). In line with Hart’s critique, Sen argues that basic liberties should have some kind of priority, but “total unrestrained priority is almost certainly an overkill” (Sen 2009: 65). Moreover, the use of primary goods should take account of basic capabilities for basic capabilities are no less important than basic liberties. That is to say, in some cases (such as hunger, starvation, and medical neglect) the trade-off of liberty for food or medical care is accepted if having food to eat and access to medical care are seen as essential to basic capabilities. In fact, in his later works, Rawls has made the priority of basic liberties less absolute, admitting that Sen’s “basic capabilities are of first importance and that the use of primary goods is always to be assessed in the light of assumptions about those capabilities” (1993:183). Although Rawls notices that there would be a challenge in terms of extending his theory of justice to the realm of capabilities without slipping into a form of comprehensive conception of the good<sup>16</sup>, he expresses his acceptance of Sen’s idea of basic capabilities with a more affirmative tone in his last publication *Justice As Fairness: A Restatement*. As Rawls puts it (2001: 176),

The more extreme cases I have not considered, but this is not to deny their importance. I take it as obvious, and accepted by common sense, that we have a duty toward all human beings, however severely handicapped. The question concerns the weight of these duties when they conflict with other basic claims. At some point, then, we must see whether justice as fairness can be extended to

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<sup>16</sup> Norman Daniels (1993; 2003) has made a convincing argument as to how Rawls’ priority of basic liberties can be less extreme in such a way that Sen’s critique related to basic capabilities can be addressed in the issue of health care.

provide guidelines for these cases; and if not, whether it must be rejected rather than supplemented by some other conception...If Sen can work out a plausible view for these, it would be an important question whether, with certain adjustments, it could be included in justice as fairness when suitably extended, or else adopted to it as an essential complementary part.

Although Rawls' theory of justice may be good at evaluating well-being and protecting certain individual rights from being sacrificed for the sake of the common good, it appears to be an inadequate measure for well-being from the viewpoint of Sen's capability approach. In the next section, I consider whether primary goods can be seen as an adequate measurement of poverty in the view of Sen's capability approach.

#### **3.1.4 Primary goods as the measurement of poverty**

As has already been seen, since people do not know what position they will occupy in society or what goals they will have or what physical and mental condition they will possess when they are behind the veil of ignorance, Rawls argues that the things that will initiate and promote people's rational plans of lives are the primary goods (social liberty and opportunity, income and wealth, and the bases of self-respect).

If the primary goods serve as the fundamental means of achieving one's rational plan of life, the connection between primary goods and poverty, then, becomes clear.

That is, we can argue that a person could be seen as *poor if she does not have or does not have enough primary goods*<sup>17</sup>. Compared with the definition of income poverty, the main advantage of *defining poverty as the lack of primary goods* is that it extends poverty measurement from income to a broader range of things that are important in promoting individuals' social opportunities, making countries, particularly developing countries, pay more attention to their fundamental political institutions rather than their economic policies only. Many developing countries, for example, often claim poverty has been alleviated by showing that there is an increase in people's incomes or national GDP (Gross Domestic Product). But if we look more closely, the increase of income or GDP is often the result of working in harsh circumstances and poor political institutions. In those circumstances, people would probably not turn their money into well-being unless their political liberties and civil rights are guaranteed. For example, in the past ten years, China has been one of the fastest GDP growing countries in the world<sup>18</sup>. However, a report issued by Asia Monitor Resource Center (2001) shows that workers in China still work in abysmal conditions<sup>19</sup>. According to that report, workers are often required to put in 16 hours days for six, sometimes seven, days a week and are being paid about \$50 per month. In addition, workers live

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<sup>17</sup> Vero (2006) makes an interesting comparison between defining poverty as the lack of primary goods and the lack of functionings and capability.

<sup>18</sup> <http://www.uschina.org/statistics/economy.html>.

<sup>19</sup> <http://www.wnd.com/?pageId=11906>

in unhealthy and overcrowded dormitories where they only have tiny beds to sleep in and insufficient space to store their things. Further, workers do not have right to join union and other rights that are significantly relevant to workers' well-being.

### **3.1.5 Critiques**

Can poverty be defined as the lack of primary goods? The definition appears to be inadequate from the viewpoint of Sen's capability approach. Consider the following case. Suppose there is a billionaire living in a repressive country. Suppose that this billionaire is also disabled and despised and excluded from many important offices of state and from professions by special edict. We are unlikely to regard this billionaire, lacking in some important primary goods, as poor, because we do not think he is living under an unacceptable degree of deprivation. His urgent needs such as food, shelter, and medical care would likely be met by his wealth. In short, what the case shows is that defining poverty as the lack of primary goods fails to capture one of the essential feature of poverty, namely, that poverty involves the lack of means for buying basic necessities.

The second critique inspired by Sen's approach is that defining poverty as deprivation of primary goods overlooks a person's real ability to convert her resources into her well-being. As has been discussed earlier, primary goods give individuals

opportunities to pursue their respective objectives, which are formed by each one's own "conceptions of good". If a person has the same amount of primary goods as others and he ends up being less happy, then Rawls argues that there is no injustice and that the person in question should take responsibility for his own decisions. Sen, however, argues that the Rawlsian approach to poverty fails properly to capture the relation between income and resources, on the one hand, and well-being and freedom, on the other. Whether a person can be pulled out of poverty not only depends on how much income and resources she has, but depends on her ability to make use of them. The divergence among people's ability to make use of income resources can be "very great" in terms of "gender, location, and class, and also to general variations in inherited characteristics" (Sen 1992: 8-9).

While the Rawlsian definition of poverty is better than defining poverty as income poverty, it is too weak in its informational basis to address the issue of poverty, for it fails to reckon poverty as an unacceptable degree of deprivation, overlooking a person's real ability to convert resources into her well-being. However, it would be a mistake to think that Sen's capability approach can be a replacement of Rawls' theory of justice. Sen points out that while his capability approach can provide a supplement to Rawls' *difference principle*, it should not be deemed as a replacement of Rawls' theory of justice, for the capability approach falls short of "telling us enough about the

fairness or equity of the process involved, or about the freedom of citizens to invoke and utilize procedures that are equitable” (Sen 2004: 336; also see Sen 2002a: 583–658). Sen envisages the possibility of having a social policy or arrangement which is procedurally unfair but has a positive impact on people’s capabilities and freedoms. For example, if we are concerned only with equality of the capability to live for a long time, then we might come up with a social policy that women should have less medical care than men if women tend to live longer than men. Such a social policy is questionable because it does not examine whether the process (requiring women to have less medical care) is a fair process or not. Policies, social arrangements, and institutions need also to be procedurally fair, apart from the outcomes they achieve (Robeyns 2005). Thus, Sen concludes that his capability approach helps Rawls’ theory of justice better address the issue of people’s ability to convert their resources into their well-being. As Sen puts it (2005: 336-338),

[Capability] comes into its own in dealing with the remainder of the second principle, viz. “the difference Principle” (with its concentration on “primary goods”). The territory that Rawls reserved for primary goods, as used in his Difference Principle, would indeed, I argue, be better served by the capability perspective. That does not, however, obliterate in any way the relevance of the rest of the territory of justice (related to the first principle and the first part of the second principle), in which process considerations, including liberty and procedural equity, figure.



## 3.2 Sen's critique of utilitarianism

### 3.2.1 Sen's characterisation of utilitarianism

I now turn from Sen's critique of Rawls to his anti-utilitarianism. Sen argues that utilitarianism can generally be characterised by three features (1987: 39):

- 1) '*welfarism*', requiring that the goodness of a state of affairs be a function only of the utility information regarding that state
- 2) '*sum-ranking*', requiring that utility information regarding any state be assessed by looking only at the sum-total of all utilities in that state;
- 3) '*consequentialism*', requiring that every choice, whether of actions, institutions, motivations, rules, etc., be ultimately determined by the goodness of the consequences

These three features together yield a moral principle that an act, regardless of what kind of action it is and of what intention it is performed with, is morally right if and only if its consequences contain a greater total sum of well-being (utility)<sup>20</sup> than any alternative open to the agent.

### 3.1.2 Sen's notion of utility

If utilitarianism evaluates acts in terms of their utility, then what does utility consist in?

As Emmanuelle notes, there exists a widely held opinion according to which there are two versions of utilitarianism: "one would have retained 'happiness' as the criterion of

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<sup>20</sup> From Sen's point of view, well-being and utility are interchangeable for utility is considered as a theoretical measure of well-being.

right and wrong and the other ‘desire-fulfilment’” (2008: 2). In many ways, Sen seems to follow such a distinction, arguing that well-being varies according to the kind or version of utilitarianism under consideration. For example, in *Commodities and Capabilities* Sen says that (1985: 2):

The term utility does, of course, have meanings of its own, defined by utilitarians...This took the form of seeing utility as *satisfaction or happiness* (in line with classical utilitarianism), or as *desire fulfilment* (in line with much more modern utilitarianism).

In *Inequality Reexamined*, Sen asserts a similar idea that ‘there are various ways of defining utility (such as happiness, pleasure or desire-fulfilment) in distinct versions of utilitarianism’ (1992: 43). And again, in *Development as Freedom*, Sen expresses the same idea that (1999: 56-57):

In utilitarianism’s classical form, as developed particularly by Jeremy Bentham, utility is defined as pleasure, or happiness, or satisfaction, and everything thus turns on these mental achievements...In modern forms of utilitarianism, the content of ‘utility’ is often seen differently: not as pleasure, satisfaction or happiness, but as the fulfilment of desire, or as some kind of representation of a person’s choice behaviour.

Thus, in Sen’s understanding, the meaning of ‘well-being’ varies with different forms of utilitarianism. In ‘classical utilitarianism’, well-being is understood as happiness, pleasure or satisfaction, whereas in “modern utilitarianism” utility is understood as

desire-fulfilment. In Sen's opinion then, classical utilitarianism would say that one outcome is better than another if it contains a greater total sum of pleasure and satisfaction; modern utilitarianism would say that one outcome is better than another if and only if it contains a greater total sum of desire-fulfilment with relatively few restrictions on what desires they are.

Note that one of the crucial differences between pleasure-taking and desire fulfilment is that whereas the former refers to any enjoyable mental state, the latter has real-world effects that can fulfil or thwart other desires. A desire to smoke cigarettes, for example is a desire to realize a state of affairs in which "I am smoking a cigarette" is true. However, making this true can bring about a future state of affairs such as cancer that thwarts other desires. This would make the desire to smoke a bad desire – a desire that tends to thwart other desires<sup>21</sup>. A desire on the part of someone to help others, on the other hand, tends to fulfil other desires, the helper's and other people's.

Note also that 'sum ranking' implies an impartial thinking. The identity of the person feeling pleasure or having desire-fulfilled does not matter. As Bentham puts it, "everyone is to count for one, no one for more than one" (1823:311).

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<sup>21</sup> This, however, does not mean a desire that tend to thwart other desires is always a bad one. For example, suppose I develop a desire that, when satisfied, makes me have an aversion to cigarettes. Here thwarting another desire can be good.

### 3.2 Sen's critique of utilitarianism

Sen's critique of utilitarianism is mainly developed in *Commodities and Capabilities* (1985) and is expressed more succinctly in *Development as Freedom*. According to Sen, utilitarianism in general suffers from a number of drawbacks (1999:62)<sup>22</sup>:

- “1. Distributional indifference: The utilitarian calculus tends to ignore inequalities in the distribution of happiness (only the sum total matters – no matter how unequally distributed). We may be interested in general happiness, and yet want to pay attention to “aggregate” magnitudes, but also to extents of inequalities in happiness.
2. Neglect of rights, freedoms and other non-utility concerns: The utilitarian approach attaches no intrinsic importance to claims of rights and freedoms (they are valued only indirectly and only to the extent they influence utilities).
3. Adaptation and mental conditioning: Even individual well-being (pleasure or desire fulfilment) is not very robust as a basis for distribution, since, as utilitarianism understands it, individual well-being can be easily swayed by mental conditioning and adaptive attitudes”.

Sen's first objection is rather straightforward. It is that utilitarianism evaluates acts only in terms of how much *aggregate* well-being they produce. For instance, suppose that we have a choice between distribution A and distribution B. Suppose that they have the same total amount of well-being. In this case, utilitarianism will treat them as equal even where there is great inequality in A and perfect equality in B (see the following Table 3.1).

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<sup>22</sup> The first time Sen shows his dis-satisfaction with utilitarianism is in *Collective Choice and Social Welfare* (1970).

Table 3.1

|                  | Distribution A | Distribution B |
|------------------|----------------|----------------|
| Group A          | 9              | 5              |
| Group B          | 1              | 5              |
|                  | 10             | 10             |
| Total well-being |                |                |

As for the second objection Sen insists, contrary to utilitarianism, that rights, freedoms, and other concerns not usually recognized by utilitarians – such as equity, class position, and family influence – affect well-being in some places and cultures (Sen 1992, 2002). For Sen, well-being is not measured in terms of GNP growth or industrialization or accumulation of pleasure or satisfied desires, but in terms of expanding real freedoms that people enjoy. When well-being is understood as a process of expanding the real freedom that individuals enjoy, rights, freedoms, and non-utility are not merely seen as means to well-being, but sometimes as constitutive parts of well-being. Thus, Sen argues that utilitarianism cannot be deemed an adequate normative structure for recovering the value of rights and freedoms. Utilitarianism overlooks an important aspect of rights and freedoms – that is, their constitutive relation to well-being and human development.

Sen's second criticism is that the idea of reducing well-being to pleasure or desire-fulfilment makes utilitarianism too permissive, for 'any loss (including individuals' freedom, right, or even life), no matter how great, to some people can be justified by making sufficiently many other people only slightly better off' (Bykvist 2010: 61). Sen writes: "the fulfilment or violation of recognized rights" is not adequately mirrored "in the statistics of pleasure, cannot directly swing a normative evaluation in this utilitarian structure" (1999:56-57). That is to say, under utilitarianism, relatively trivial payoffs can mount up to outweigh things that are intuitively important. Thus, one is required to violate rights and freedoms or rules such as 'keep your promise', 'do not lie' and even 'do not kill' when doing so could maximise total well-being. For example, a doctor has five patients who will all die if they do not have an immediate transplant. One patient needs a new heart, two need a new lung, and two need a new kidney. By sheer coincidence, the doctor finds out that a healthy person, who is in hospital for a routine check-up, happens to be the perfect donor for all five patients. According to some versions of utilitarianism, the doctor is obligated to cup up the healthy person (sacrificing his right to survive, autonomy, and so on) and distribute the organs to the five patients, since that would maximize total well-being<sup>23</sup>.

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<sup>23</sup> Discussed in Judith Jarvis Thomson, 'Killing, letting die, and the Trolley problem', *The Monist*, Vol. 59, 1976, pp.204-217.

Sen has a third line of criticism. He reminds us that even if well-being could be reduced to pleasure and desire, utilitarianism does not sufficiently take into account the phenomenon of adaptive pleasure and desire in which a person's pleasures and desires will be distorted if he lives in deprived conditions. Sen explicitly raises his concern at people who live in deprived circumstances (1999: 62-63):

The utility calculus can be deeply unfair to those who are persistently deprived: for example, the usual underdogs in stratified societies, perennially oppressed minorities in intolerant communities, traditionally precarious sharecroppers living in a world of uncertainty, routinely overworked sweatshop employees in exploitative economic arrangements, hopelessly subdued housewives in severely sexist cultures. The deprived people tend to come to terms with their deprivation because of the sheer necessity of survival, and they may, as a result, lack the courage to demand any radical change, and may even adjust their desires and expectations to what they unambitiously see as feasible.

In other words, a person living in an extreme condition of deprivation can still be very happy if he/she has learned to adapt to this situation.

### **3.3 Is utilitarianism refuted by Sen?**

I think Sen's critiques do show that classic and modern utilitarianism in some forms run counter to many of our moral intuitions (common-sense moral views). They are "ultimately insensitive to the distribution of well-being" (Hooker 2000: 44). They neglect the intrinsic importance of freedoms and rights as the preeminent objective of

development. They also do not pay enough attention to the phenomenon of adaptive preferences. A person's pleasures and desires will be influenced not only by his physical and mental conditions, but by all possible economic and social conditions in which he is living.

But do Sen's critiques go so far as to refute utilitarianism? One form of utilitarianism – rule-utilitarianism – seems to survive his critique of utilitarianism, as the next section will show.

### **3.4 Rule-utilitarianism**

Although there are a number of different versions of rule-utilitarianism, the kind of rule-utilitarianism I would like to discuss is Hooker's version of rule-utilitarianism. Here I can only propose a brief introduction to Hooker's version of rule-utilitarianism due to its complexity.

#### **3.4.1 Hooker's version of rule-utilitarianism**

Hooker's form of rule-utilitarianism holds that (Hooker 2000:59):

An act is wrong if it is forbidden by the code of rules whose internalization by the overwhelming majority of everyone everywhere in each new generation has maximum expected value in terms of well-being. The calculation of a code's expected value includes all costs of getting the code



internalized. If in terms of expected value two or more codes are better than the rest but equal to one another, the one closest to conventional morality determines what acts are wrong.

To understand Hooker's formation of rule-utilitarianism, a further explanation is needed: first, the consequence of rules should be judged in terms of their expected consequences rather than their actual consequences, for the actual results are literally impossible to know; thus no one would be blamed if he is wrong about the expected consequences where they are too complex to calculate. Second, the expected result of following rules is assessed in terms of aggregate well-being. Well-being is the primary thing that is of intrinsic value. Put differently, the code of rules upheld by rule-utilitarianism is a set of rules that could maximally promote people's well-being. Third, since Hooker's rule-utilitarianism is applied to real world in which not only do we have to interact with immoral agents who are not interested in doing right, but also with moral agents who will often fail to live up to their moral standards, Hooker argues that we should leave some room for dealing with people failing to follow rules and that any selected rule should be internalized by 90% of each new generation. To internalise a particular code of rules is to 'accept' a particular code of rules, which in turn involves the corresponding conscience. He says (2000: 91):

Rule-consequentialism takes the acceptance of rules to involve more than certain associated motivations. It also involves having sensitivities, emotions, and beliefs – indeed a particular cast of

character and conscience. If you accept a rule against stealing, you will be motivated not to steal simply because it is stealing (not merely because you will get into trouble). You will also be disposed to feel guilty if you steal, disposed to resent stealing by other people, and disposed to blame them for it... We might sum all this up by saying that to accept a code of rules is just to have a moral conscience of a certain shape. In other words, when rule-consequentialists consider alternative codes of rules, they are considering alternative possible contours for people's consciences.

Fourth, the selected rules are public and applied equally to everyone everywhere.

Fifth, any selected rules should be impartial in its justification of moral requirements.

In next section, I will examine whether Hooker's version of utilitarianism is vulnerable to Sen's critiques.

### **3.4.2 Rule-utilitarianism versus distributional inequality of well-being**

Is rule-utilitarianism blind to distributional inequality of well-being? The short answer is no. According to some utilitarians (Hooker 2000; Mulgan 2005), it is less likely that any chosen rule containing maximum expected value would cause distributional inequality of well-being. The reason is simple: any chosen rule cannot be sustainable if it is an unfair rule. As Hooker has pointed out, "if rules benefit some far more than others without any obvious rationale, sooner or later the results will be alienation, resentment, and unrest" (2000: 63). However, one might argue that Hooker's rule-utilitarianism cannot explain a situation in which the majority may obtain a greater overall utility by upholding a rule that is oppressing the minority. Influenced

by Kymlicka (1990), Hooker argues that we can avoid such a situation by adding a restriction that ‘external preferences’, which concern the goods, resources, and opportunities one wants available to others, should be excluded in the assessment of utility. Thus, the reason why Hooker asserts that utilitarianism is ultimately insensitive to the distribution of well-being is not that utilitarianism does not care about the distribution of well-being between people, but that any rule that could cause enormous inequality of well-being would be ruled out. In other words, in real world, utility will most likely be maximized by the rules benefiting people more or less equally.

Hooker, however, notices that although any rule that could cause enormous inequality of well-being would be excluded from his form of rule-utilitarianism, certain distributional inequality of well-being caused by disparity of incomes will still remain. The phenomenon of disparity of incomes seems unavoidable if we see economic incentive as an essential feature of bringing market productivity, innovation, variety, and growth<sup>24</sup>. However, if we only emphasize economic incentives, then those who are ill and handicapped could easily be left behind because “their skills and abilities are not sought by the capitalist market system” (Brandt 1996: 219). But, on the other hand, if rule-utilitarians consider giving priority to the well-being of the

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<sup>24</sup> Such a phenomenon has been described vividly by Nagel, who writes: “Going by contemporary evidence, the advantages of a significant private sector in the economy...are enormous, as measured by productivity, innovation, variety and growth. The productivity advantages of competitive market economies are due to the familiar acquisitive motives of individual” (1991:91).

worst-off, it seems to violate the *maximization rule*, namely, we should choose a code of rules that has maximum expected utilities. Consider the following example. Suppose that we have two groups of people that are classified between worst off and better off. Suppose that we have two codes of rules A and B (see tables 3.2, 3.3). In this case, according to the maximization rule we should choose code A since it produces more well-being than code B.

Table 3.2 Code A

|                                      | Units of well-being |           | Total well-being |
|--------------------------------------|---------------------|-----------|------------------|
|                                      | per person          | per group |                  |
| 10,000 people in worst off group     | 2                   | 10,000    |                  |
| 1,000,000 people in better off group | 12                  | 1,200,000 |                  |
|                                      |                     |           | 1,220,000        |

Table 3.3 Code B

|                                      | Units of well-being |           | Total well-being |
|--------------------------------------|---------------------|-----------|------------------|
|                                      | per person          | per group |                  |
| 10,000 people in worst off group     | 6                   | 60,000    |                  |
| 1,000,000 people in better off group | 11                  | 1,100,000 |                  |
|                                      |                     |           | 1,160,000        |

To resolve such a conflict, Hooker suggests that we can use the *law of diminishing marginal utility of material resources*— that is, the first unit of consumption of a good or service yields more utility than the second and subsequent units. For example, suppose that both of us can derive the same level of benefit from the same sets of material resources. If you like to eat burgers, the more burgers you eat, the less satisfaction you would have from eating an additional one. This suggests that if you have three burgers and I have none, then the total well-being will increase if you give one of your burgers to me instead of eating all of them yourself. In the same manner, the poorer you are, the more an extra dollar matters to your well-being, and the richer you are, the less a lost dollar matters to your well-being. If total well-being is

calculated with the consideration of the law of diminishing marginal utility, then in the previous example choosing code B will no longer be seen as a violation of the maximization rule, for code B will produce more well-being than code A. Thus, as Brandt suggests, “it is necessary to reduce disparity of income in order to obtain maximal utility” (1996: 221). The beauty of the law of diminishing marginal utility is that it allows rule-utilitarians to take egalitarian distributions of material goods into account without contradicting the maximization rule, i.e. we should choose a code of rules whose internalization would have greatest expected utility.

### **3.4.2 Rule-utilitarianism versus valuation neglect**

Does rule-utilitarianism attach no intrinsic importance to claims of rights, freedom, and other non-utility concerns? Again, the short answer is ‘No’. Hooker is fully aware of this issue, suggesting that things other than the utilitarian staples of pleasure and satisfied desire such as “important knowledge, friendship, autonomy, achievement are also desirable for their own sake” (2002:23). The reason why utilitarians should move away from a version of utilitarianism that focuses only on pleasure is clear: friendship, achievement, knowledge, and autonomy contribute to well-being even though they sometimes do not directly or indirectly bring us pleasure. For example, knowledge about the nature of universe may not bring you pleasure, but that does not imply that

knowledge is less important to our well-being than pleasure. The same rule also applies to our friendship, achievement, and autonomy. If utilitarianism is able to see other things are desirable in terms of their intrinsic role in constituting our well-being, then the intrinsic value of rights and freedoms can also be accommodated in the same way. That is, rights and freedoms can be beneficial to us, can increase our well-being, over and beyond whatever pleasure they directly or indirectly bring us.

Now I would like to address the question whether rule-utilitarianism is too permissive. Recalling the hospital case, would rule-utilitarianism ask the doctor to kill the innocent person who happens to have a routine check-up? Well, I think it would not, for the rule-utilitarians would assert that the best code of rules will include important constraints. As Hooker has pointed out, “one motivation that rule-consequentialism would endorse is a motivation to prevent disaster” (2000:98). Thus, rule-utilitarianism will not allow doctors to cut up the healthy persons who happen show up in hospital, distributing their organs to save others’ lives, for the distrust and fear that could develop if healthy people were primarily medical resources for transplants. Similarly, rule-utilitarianism upholds such rules as ‘keep your promise’, ‘do not lie’ and so on. But it will require agents to break these rules when obeying them will lead to disasters. Rule-utilitarianism, for instance, will ask you to not tell your colleague the truth about where his girl-friend is if you know that

he is planning to kill her. Of course, one might argue that utilitarians do not properly spell out what counts as disaster. To this point, Hooker admits that it is unlikely that one could clearly define what counts as disaster due to its complexities. However, he insists that at least rule-utilitarians would not be labelled as ‘rule-worshippers’ – that is, “people who will stick to the rules even when doing so will obviously be disastrous”<sup>25</sup> and therefore can avoid the charge of being too permissive.

### **3.4.3 Rule-utilitarianism versus the adaptive Adaptation and mental conditioning**

The final issue I would like to discuss is whether rule-utilitarianism is vulnerable to Sen’s critique of adaptive pleasures and desires. I think Sen’s concern with adaptive pleasures and desires reflects a more general problem with certain formulations of utilitarianism, in particular, with its subjective account of well-being. If individuals’ well-being is measured only in terms of their feelings about their lives, then our guide to deprivation and disadvantage could be very arbitrary in that it causes deeply unfair situations to those who are persistently deprived. I think the only way for utilitarians to address this issue is to abandon the subjective account of well-being and go for an objectivist account by which what makes something good or bad for a person need not be a subjective feature of him. In next section I will examine why Hooker argues that rule-utilitarianism can be seen as a form of objective theory of well-being.

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<sup>25</sup> <http://plato.stanford.edu/entries/consequentialism-rule/>



According to Hooker, the theory of well-being can usually be divided into subjective and objective list theories. While the subjective theorists argue that a person's well-being should be measured in terms of his pleasure and desire-fulfilment, the objective list theorists argue that there is an objective list of things that are important in forming a person's well-being. Moreover these things are not selected "by the extent to which they bring people pleasure or fulfil their desires" (Hooker 2001:41). Although the subjective theorists have been criticised for its inadequacy in distinguishing between rational and irrational preferences and for its wrongness of referring goodness to rightness (Rawls 1999, Ch 7; Scanlon 1998, Ch 3), they insist that their approach is better than that of objective theorists. Subjective theorists assert that the objective camp is a form of paternalism or perfectionism, imposing certain kinds of lives on others. The objective list camp, as Hooker notes (2001), can avoid this critique by adding autonomy to the objective list; therefore it is able to rule out illegitimate and adaptive preferences without moving itself to the realm of paternalism or perfectionism. Thus, Hooker suggests that the most plausible form of rule-utilitarianism is the one including "some modest form of objective list account of well-being" (2001:43). It is in this context that rule-utilitarianism can be seen as a form of objective theory of well-being.

### **3.4.4 The constituent elements of well-being: a hybrid account**

If the most plausible form of rule-utilitarianism is the one including some modest form of an objective list account of well-being, then what does a person's well-being consist in, and what is well-being on the modest form of objective list account of? As I have shown in the last section, Hooker suggests that while pleasure, knowledge, friendship, achievement, and autonomy are elements of a person's well-being, autonomy should be included in any modest form of objective list account of well-being. He says that (2001:43):

A life could be maximally pleasurable, or have maximum desire-fulfilment, and still be shallow. This would be the case if the life were devoid of friendship, achievement, knowledge, and autonomy. While pleasure and success in one's aims are certainly important parts of well-being, these other things are important in their own right. So, to come clean, I think the most plausible form of rule-consequentialism will involve some modest form of objective list account of well-being. Such an account will recognize the central role of autonomy. Equally, it will recognize the importance of difference in people's aptitudes, capacities, and inclinations.

I think Hooker's account of well-being has several implications: first, it is against perfectionism or paternalism. It does not claim that people should pursue a particular way of good life, but that the items chosen in its objective lists can be used to promote many different ways of life; second, since people are different in terms of aptitudes, capacities, and inclinations, they should have autonomy to form, revise, and decide their own plans of good life; thus any plausible objective account of well-being should,

at least, put autonomy in its list. Third, any selected code of rules consistent with the modest form of objective list account of well-being is one whose consequences have the greatest expected value in terms of securing or promoting individuals' autonomy to form, revise, and decide their own plans of good life. Can Hooker's version of rule-utilitarianism with an objective list account of well-being address adaptive pleasures and desires? Let us apply it to an example. One of the typical cases of adaptive pleasures can be found in the Philippines. According to the survey provided by *Time* (2005)<sup>26</sup>, although the Philippines has all kinds of natural disasters (earthquake, typhoon, volcano eruption) and corrupt political and economic institutions, Filipinos are the happiest people in the world because they are content with their life and they do not reckon money is very important. However, Filipinos' success in 'happily' adapting themselves to such harsh conditions does not entail that they have a high level of well-being. To measure one's well-being we not only have to take note of people's subjective well-being (pleasure or desire), but to take into consideration – other general aspects of well-being. But it would be inappropriate if someone thinks that we can directly use Hooker's objective list account of well-being to measure Filipinos' well-being, for some items might be too general and abstract in a way that seems to be irrelevant to the measurement of Filipino's well-being. For

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<sup>26</sup> <http://www.time.com/time/magazine/article/0,9171,1015832,00.html>

example, it is clear that Filipinos can still make friends and have certain knowledge in difficult circumstances. Thus, in order to adequately measure Filipinos' well-being, some alterations in Hooker's objective list account of well-being are needed. When Hooker proposes such an objective list, he insists that it is a 'modest' form of objective list. In other words, he does not deny the possibility of having certain alterations (supplementation or deletion) in his objective list account of well-being. If my understanding is correct, then Hooker will certainly agree that other considerations such as food, shelter, education, medical care, and an efficient democratic system can also be added to his objective list account of well-being, for they would generally contribute greater utilities in terms of total well-being; therefore, we can make a cost-benefit comparison between an expected value resulting from a country where people do not have enough food, proper shelters, certain level of education and medical care, and protection from efficient democratic system on the one hand and an expected value resulting from a country where people have food, proper shelters, certain level of education and medical care, and protection from efficient democratic system on the other. Clearly, when an individual's well-being is measured in this way, we certainly will not claim that Filipinos have a high level of well-being even though they happily adapt themselves to such difficult circumstances. Thus, the problem of adaptive pleasures and desires will most likely be

defused in Hooker's version of rule-utilitarianism with a modest objective list account of well-being.

When rule-utilitarianism adopts a modest objective list account of well-being, it is making a clear break from classical utilitarianism. However, it should not be seen as a complete departure from utilitarianism or a pure form of objective theory of well-being, for moral rightness is still evaluated by its outcome which in turn is measured by subjective and objective well-being. That is to say, people's well-being is assessed by examining whether social arrangements, policies, and institutions meet the code of rules that could maximally promote people's pleasure, knowledge, friendship, achievement, and autonomy.

In the light of the preceding, I am not sure whether Sen's critiques can be applied to rule-utilitarianism, for Hooker's account of rule-utilitarianism seems to be able to address those objections. Moreover, I have shown earlier, Hooker's version of rule-utilitarianism shows that utility can be adapted for poverty, for it also allows a further alternation in its objective list account of well-being, so that individuals' well-being can be properly measured. In addition, to give poor people food, shelter, and the opportunity of being educated would be generally deemed as acceptable approaches to poverty if they would promote the total well-being in a society. Further, it provides us a plausible moral ground to claim that each relatively well-off

individual has an obligation to help the poor by giving up certain percentage of his/her resources if doing so would maximize total well-being and would not cause him/her ‘a significant aggregative personal cost’ in a sense that he/she is not required to “forgo any other personal projects or deep personal relationships” (Hooker 2000:166-167).

Does uncertainty over Sen’s critique of utilitarianism lead one to the conclusion that rule-utilitarianism is better than Sen’s capability approach in the context of development theory? Of course, one might argue that Hooker’s endorsement of pleasure, knowledge, friendship, achievement, and autonomy could also promote people’s substantial freedom to pursue things they have reasons to value. Certainly, I do not deny that Hooker’s rule-utilitarianism could potentially be further developed as a theory of development. But I think Hooker’s rule-utilitarianism does not particularly focus on the concepts of freedom, development and poverty. Instead, it focuses on how a moral act or choice or rule should be evaluated.

I think Sen’s capability approach is a solid normative theory of development for many reasons which attract many philosophers, economists, and experts in development. It gives experts and practitioners of development the insight that development or poverty reduction occurs not when people have more money, but when people have greater capabilities (freedoms). While poverty should be seen as deprivation of basic capabilities, social arrangements should be evaluated in the light

of their contribution to people's capabilities (freedoms) in general and basic capabilities (substantial freedoms) in particular. Sen's idea of linking basic capabilities with poverty has shed much light on the issue of measuring poverty. Basic capabilities do not refer to wide-ranging freedoms, but refer to individuals' real freedoms to do things considered necessary for survival or to avoid serious deprivations or to go beyond a threshold of well-being. Thus, in the context of developing countries, basic capabilities are often to do with the ability to be well nourished, healthy, and educated.

It might be thought that Sen's shift from all valuable capabilities to these capabilities (being well nourished, healthy, and educated) is not fundamentally different from the basic need approach because this approach also considers these capabilities as basic needs. Although Sen's capability approach appears to be identical with the basic needs approach when applied to developing countries, it is better than the basic needs approach for at least two reasons (Streeten 1984:973-978; Stewart and Deneulin 2002:64). First, it does not entail paternalism<sup>27</sup>. Sen's capability approach allows people to choose basic capabilities for themselves, putting a strong emphasis on freedom of personal choice and the right to be self-determining in the major

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<sup>27</sup> While the term 'paternalism' can be defined in various ways, the one I would to use is Dworkin's definition: "By paternalism I shall understand roughly the interference with a person's liberty of action justified by reasons referring exclusively to the welfare, good, happiness, needs, interests or values of the person being coerced" (Dworkin 1996: 278).

decisions of life. Second, unlike the basic needs approach, Sen's capability approach can be applied not only to poor countries, but also to affluent countries for it can focus on capabilities which are more sophisticated and considered to be necessary in every day life (even though they appear to be less necessary for survival such as being able to use a computer and access the Internet or drive a car).

For the economists who are against the previous dominant thinking according to which the goal of development is increase in GNP per capita, Sen's capability approach offers not only a powerful critique of GNP as the main goal of development (exacerbating distributional inequality, failing to disaggregate and separately consider other important dimension of development, such as health, education, political participation and so on), but a better understanding of human diversity and a better measure of well-being. Sen's capability approach points out that people (especially disabled and poor people) may not have opportunities (real freedom) to pursue their rational plan of life, even if social resources have been equally distributed, because people have different capacities to convert primary goods into their relevant doings and beings. Sen reiterates that individuals' abilities to convert resources into their well-being are affected not only by their physical and mental conditions, but by social contingencies and geographical differences. Thus, when development and well-being are assessed in this way, we are able to pay attention not only to the income and



various physical and mental conditions of individuals, but to the basic political institutions, social norms and arrangements that have significant impacts (positive or negative) on our daily activities and life plans. In short, Sen's capability theory shows that the evaluation of well-being has to go beyond income, utility, and resources to the "substantial freedoms (the capabilities) to choose a life one has reason to value" (Sen 1999a:74), providing a persuasive approach to the understanding of the ends of development, the assessment of well-being and poverty, and the formulation of development policy.

### **3.5 Conclusions**

In the preceding sections, I have discussed Sen's objections to considering Rawls' primary goods and utilitarianism as a sufficient measure to a person's well-being in general and poverty reduction in particular. Neither is attuned to the difference in the condition of human beings globally. Although Rawls' theory of justice is better than utilitarianism in terms of measuring well-being and poverty, primary goods are still not proper measures of well-being and poverty, for they do not go deep enough to address personal heterogeneities, environmental diversities, distribution within the family and they underestimate the number of people whose capabilities are below the average level. That is to say, a person would not have actual opportunities to

determine her fate unless both her social and personal conditions could be properly addressed. A person's actual opportunity to do the different things she has reasons to value should be seen as a person's 'freedom' to do the things she values doing. However, it would be wrong to see Sen's capability approach as a replacement of John Rawls' theory of justice because it cannot adequately address the aspect of process fairness. Institutions and structures are acceptable not only because they promote capabilities, but because they are procedurally just.

I have also shown my uncertainty over Sen's critique of utilitarianism, for not only could Hooker's version of rule-utilitarianism resist Sen's critiques of utilitarianism, but it also shows that utilitarianism can be applied to poverty. Sen's objections to utilitarianism can be applied to certain forms of utilitarianism, but they certainly do not defeat utilitarianism as such. More interestingly, Hooker's version of rule-utilitarianism appears to be in line with Sen's capability approach in the sense that Hooker's endorsement of pleasure, knowledge, friendship, achievement, and autonomy can expand people's substantial freedom. However, as noted earlier, my uncertainty over Sen's critique of utilitarianism is not strong enough to lead me to the conclusion that rule-utilitarianism is better than Sen's capability approach. While I would like to leave open the question whether Hooker's version of rule-utilitarianism is better than Sen's capability approach, I think both of theories are unique in their

own ways. Hooker's rule-utilitarianism is a better general moral theory for its focus on general moral questions (justice, right and wrong, and so on) and how a moral act or choice or rule should be evaluated. However, in saying that I certainly do not deny that Hooker's rule-utilitarianism could potentially be further developed as a theory of development and that Sen's capability approach could potentially be further developed as a theory of morality. Sen's capability approach is a better theory of development than Hooker's rule utilitarianism for several reasons. First, it gives us a better account of what constitutes an individual's well-being and how a person's well-being should be assessed, directing our attention from the means to the ends of development. A real development is not merely because people are happier or have more money and commodities, but because they have freedoms – capabilities – to do things that they have reason to value. Second, compared with other development approaches, it is based on a more elegant and sophisticated philosophical foundation.

## **Chapter Four**

### **The Philosophical Foundation of Sen's Capability Approach**

Why is Sen's capability approach attractive to philosophers even though it is not a general moral theory (it does not address general moral questions such as 'What is justice?' or 'What is the difference between Right and Wrong?') Many (Crocker 1992: 590-607; Nussbaum 1990: 203-52, 200:34-35) argue that compared with other development approaches, Sen's capability approach has a much stronger philosophical foundation, which is deeply connected with Aristotelianism. Is Sen's capability approach much to do with Aristotelianism? The aim of this chapter is to answer this question and to dig out the important philosophical features embedded in Sen's capability approach.

#### **4.1 Aristotelian essentialism**

One might argue that Sen's theory entails the essentialist position that "human life has certain central defining features" (Nussbaum 1992:205). Moreover, it might be thought that Sen's essentialism is reminiscent of an Aristotelian conception of human functioning: not only does Sen argue that certain functionings and capabilities (the real opportunity to be able to have combinations of functionings) constitute human well-being, but he also asserts that the philosophical basis of his version of the

capability approach “can be traced to Aristotle’s writings, which include a penetrating investigation of ‘the good of man’ in terms of ‘life in the sense of activity’ (Sen 1992: 29). Although Sen from time to time mentions the Aristotelian idea of a truly human functioning, he does not go further to give an account of how his version of the capability approach is philosophically connected with it. Instead, Sen endorses Martha Nussbaum’s elaboration of Aristotelian essentialism and its connection with the capability approach<sup>28</sup>.

By essentialism, Nussbaum refers to the view that “human life has certain central defining features” (Nussbaum 1992:205). These defining features can be found through Aristotle’s general method of inquiry, which is “to preserve the greatest number and the most basic of the ‘appearances’— human perceptions and beliefs – on the subject” (Nussbaum 1995: 102). Such a general inquiry strategy consists of two parts: the preservation of the greatest number of appearances –including agreement with “intuitions”-- and the search for the most fundamental appearances. With respect to the preservation of the greatest number of appearances, Nussbaum argues that Aristotle considers appearances as “what people say, perceive, believe” and the people

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<sup>28</sup> Though at the time of proposing the approach, I did not seize its Aristotelian connections...[t]he Aristotelian perspective and its connections with the recent attempts at constructing a capability approach have been illuminatingly discussed by Martha Nussbaum (Sen 1993:30, n.2; cited from Alexander 2008: 61).

The connection of this approach [capability approach] with Aristotelian ideas was pointed out to me by Martha Nussbaum, who has gone on to make pioneering contributions to this growing field of investigation and has strongly influenced the way the approach has developed (Sen 2009: 231).

in question are not limited to any particular community but come from different countries with different cultures (Nussbaum 1994:57). However, the exercise of gathering appearances is only the first step; the second step is to ‘winnow’ the appearances and to preserve ‘the greatest and deepest part’ of them, which requires our internal evaluative inquiry (Nussbaum 1992: 208):

We must ask which things are so important that we will not count a life as a human life without them? Such an evaluative inquiry into what is deepest and most essential in our lives need not presuppose an external metaphysical foundation, clearly; it can be a way of looking at ourselves, asking what we really think about ourselves and what holds our history together.

In addition, Nussbaum reminds us that the outcome of the winnowing process based on our internal inquiry ought to be open-ended. That is, it is open for revisions if “another one emerges that does the job better” (Nussbaum 1994:58). Further, such an outcome must be a “reflective equilibrium”. That is, it is consistent, not merely internally, but also with our ethical beliefs and desires about what fundamentally constitute our well-being: "What the individual comes to see more clearly is a conception of the good that he receives from society and according to which he intends to live in a society; the communal agreement is arrived at as a result of the reciprocal scrutiny and clarification of different individual proposals" (Nussbaum 1986:61; cited from Crocker 1992:589).

Thus, Nussbaum's Aristotelian essentialism is understood as the view that human life has certain central defining features, which can be found by our examination of the cultural and historical variety in human understanding and through our internal evaluative inquiry as to how should one live, what should count as intrinsically valuable in our lives, and what should count as a flourishing life (i.e., eudaemonia). In other words, Nussbaum's Aristotelian essentialism is "a historically sensitive account of the most basic human needs and human functions" (Nussbaum 1992:205). But why does Nussbaum favour such a form of essentialism? One of the reasons is that it is not a metaphysical-realist essentialism, which claims that "there is some determinate way that the world is apart from the interpretive workings of the cognitive faculties of living beings" (Nussbaum 1992:206). Thus, it is not subject to the objection that a metaphysical truth does not exist, or, if it does, human beings can know nothing of it. The other reason for Nussbaum to uphold the historically sensitive internalist essentialism is that it does not neglect historical and cultural differences and ignore the voices of women and minorities. By taking the cultural and historical variety in human understanding seriously and engaging in an Aristotelian internal evaluative inquiry as to how should one live, what should count as intrinsically valuable in our lives, and what should count as a flourishing life (i.e., eudaemonia), Nussbaum argues that we can have a cross-cultural consensus on the idea of essential humanness.

In many places, Sen seems to be taking Nussbaum's Aristotelian essentialist position in that, as has been discussed above, not only does he endorse Nussbaum's interpretation of Aristotle, but he also seems to suggest that some capabilities are fundamentally important. For example, in *Resources, Values and Development* (1984), Sen argues that any moral theory (including his capability theory) "has to dig for foundation" even though "there is a substantial issue involved in deciding where to stop digging" (Sen 1984:310). Sen's enthusiastic endorsement of UNDP's Human Development Index (a long and healthy life, access to knowledge, and a decent standard of living) also suggests that he is upholding the possibility of having a common set of valuable function is a substantial issue involved in deciding where to stop digging and basic capabilities through our examination of human history and human cognition.

#### **4.2 Relativism**

On the other hand, one may argue that Sen is taking a relativist position that standards and values are relative to cultures, because his distinction between the self-evaluation approach, (an approach that is "concerned with each person's assessment of his or her own living standard vis-à-vis that of others") and the standard-evaluation approach (an approach that rejects relativity). That is, a person's choice can be based on her



own evaluative perspective resulting from her observations, beliefs, knowledge, locations, and relationship placing individuals' living conditions in a general ranking in terms of some social standards) indicates that he allows relativisation to the individual to play a significant role (Sen 1987:30-31). By a self-evaluation approach, Sen refers to a person's positional diversities and special concern for her own actions (Sen 1982: 18-38). When a person's positional characteristics are take into consideration, Sen argues that there is no paradox when someone regards "his standard of living to be higher than his neighbours's, even though in terms of general 'contemporary standards', his living standard would be judged to be lower" (Sen 1987:31).

Thus far we have two seemingly contradictory interpretations of Sen's position in his version of the capability approach. What position does Sen take? Many suggest that Sen is taking the 'middle ground position' or 'broad consequentialist position' (Chakraborty 1998:3241-3242; Alexander 2008, Ch 4). That is, Sen is seeking a combination of "a purely objective account of human well-being and the subjectivism of welfarism" (Chakraborty 2003:11). In particular, while Sen believes that we can reach an agreement on "the nature of the space of value-objects [functionings and capabilities]", he lets people themselves choose what valuable functionings and basic capabilities are and accepts the possibility of having more than one list of basic

capabilities across societies (Sen 1993:48). However, the relativist position (one can have her own evaluative perspective based on her observations, knowledge, beliefs, and reasons for action) that Sen takes is rather a modest one because he does not uphold the idea that the evaluation of capabilities is so different among individuals that we may end up having an empty set of basic capabilities. Rather, he argues that people in a society will be able to have a common set of basic capabilities, which will yield a dominance partial order that is reflexive, transitive, but not complete. For example, we can reach a consensus on capabilities  $x, y, z$ , as basic capabilities, although we are currently not be able to rank all kinds of capabilities ( $x, y, z, w, u, \dots$ ) and to reach a consensus about who has the highest priority between  $x, y, z$ . Such a dominant partial ordering list of basic capabilities, Sen argues, is useful in terms of assessing individuals' well-being and social justice, because it has already implied that the identified capabilities ( $x, y, z$ ) have positive weights. Consequently, we can examine social arrangements and political institutions in terms of evaluating their impact on the identified capabilities in question. Moreover, Sen does not exclude the possibility that such a dominant partial ordering list of basic capabilities could be "widely shared after adequate reflection" (Sen 1985: 42). However, one might ask 'If a choice of basic capabilities should be the outcome of a democratic process, then why does Sen at the same time endorse the Human Development Index, with its

assumptions about what counts as development? Further, how can people, who may have different conceptions of goods, have a common list that is chosen and accepted by them? Could such a list be a morally acceptable list? Sen argues that the answers to these questions are to do with individuals' rationality, public discussion, and democracy.

Sen defines rationality as reasoned and informed scrutiny of one's values and preferences, not just in the narrow sense of maximizing some composite index of well-being or as mere internal consistency of choice. He says that (Sen 2002:4):

Rationality is interpreted here, broadly, as the discipline of subjecting one's choices – of actions as well as objectives, values and priorities – to reasoned scrutiny. Rather than defining rationality in terms of some formulated conditions that have been proposed in the literature (such as satisfying some pre-specified axioms of internal consistency of choice, or being in conformity with "intelligent pursuit of self-interest," or being some variant of maximizing behavior), rationality is seen here in much more general term as the need to subject one's choice to the demands of reason.

Thus, Sen's conception of rationality can be seen as a person's ability critically to self-reflect, compare, evaluate, and rank alleged human goods and ends (Hamilton 2003:99). In other words, in using people's values as the basis of the selection of basic capabilities, only those that have been subjected to reasoned scrutiny should be counted (Osmani 2009:32). However, Sen also notices that even a person's rational choice could be a false one because his beliefs could have resulted from a lack of

exposure to adequate information. For example, Sen argues that a person or a group of people could wrongly believe that the moon is as big as the sun when they lack certain relevant information (Sen 1981). This entails that people could choose an inadequate list of basic capabilities if they have wrong beliefs about what functionings and capabilities are essential to their well-being. Sen rejects a paternalistic approach as a means of avoiding having such a list, as paternalism involves interference with a person's decision on the selection of basic capabilities for the purpose of advancing that person's good. Instead, he suggests that the problem of inadequate lists can be addressed by allowing people to have a public dialogue, which is upheld by an effective democracy in which various views of what functionings and capabilities constitute one's living well can be freely debated and discussed. This is where the Human Development Index comes into Sen's capability approach. It has two roles: one is to serve as a constraint on the democratic debate on the selection of basic capabilities; the other is to serve as one of the options available within the debate. Such an index can motivate and inspire people to ask questions such as 'Why are those opinions held and these values cherished?' or 'Why do some people or some countries deem capability x, y, and z as basic capabilities?' (Sen 1987:32). When the public dialogue is initiated in such a way, Sen is confident that people will eventually agree on a list of basic capabilities which is not only accepted by them, but is also

morally acceptable. This is the reason why Sen enthusiastically endorses UNDP's Human Development Index (HDI). Sen is convinced that a person's self-evaluation does not occur in a vacuum, but takes place within the framework of contemporary standards and beliefs. Thus, UNDP's Human Development Index is a non-prescriptive set of the basic capabilities that can give governments and policy makers an idea of what kind of list of basic capabilities will be, which in turn motivates and inspires them to shift their attention from concentration on economic development to the development of human functionings and capabilities.

Now, it appears that Sen's capability approach does not have much in common with Nussbaum's Aristotelian essentialism, since he does not think that development is for realising human nature, but only individual capabilities. If this is the case, then why does Sen very often mention Nussbaum's contribution to the connection between Aristotle and the capability approach as if he endorses Nussbaum's Aristotelian essentialism? The reason for Sen to acknowledge Nussbaum's effort to connect the capability approach with Aristotle is not that he thinks the search for basic capabilities should be built on Aristotle's account of human nature, but that he accepts other parts of Nussbaum's interpretation of Aristotle. Ricardo Crespo (2008) explicitly lays out how Sen connects his capability approach with Aristotle through Nussbaum's interpretation of Aristotle (Crespo 2008: 13- 19): First, Sen agrees with Aristotle's

conception of the relation between economics, ethics, and politics (Sen 1987a:3-4). That is, the end of economics and politics is the common promotion of a good quality life. Second, Sen is in line with Aristotle as to the role of wealth (income) and properties in a good life, criticising commodity fetishism. Income or commodities are only instrumentally important. Their importance lies on their contribution to the good quality of life (Sen 1987a:3; 1993:47; 1999b:14). Third, Sen agrees with Aristotle's conception of eudaimonia as an activity according to reason (flourishing living), insisting that people should pursue goals they have reason to value (Sen 1992:39; 1993:48). Fourth, Sen agrees with Aristotle's assertion about the need to examine the process of choosing the activities that constitute or contribute to eudaimonia. Individuals are not only able to choose, but the choices they make result from a free and autonomous circumstance (Sen 1993:48). Fifth, Sen agrees with Aristotle's account that the human good is explicitly linked with human functionings. One can have a good living only when he is quipped with functionings that are relevant to the good living in question (1986:29; 1987a: 64; 1987b: 23). Thus, to this degree Sen is Aristotelian, but he is not essentialist. Sen's version of the capability approach is not that close Nussbaum's Aristotelian essentialism.

### 4.3 Agency

In the last section, I mentioned that Sen's respect for the complexity of human capabilities has forced him to leave his version of the capability approach deliberately incomplete, allowing people to choose valuable functionings and basic capabilities by themselves. However, there is another important reason for Sen to do so – that is, his endorsement of an individual's agency. Before discussing why Sen upholds the value of agency, let me briefly discussing how Sen understands agency.

Sen's notion of agency has little to do with the principal-agent distinction used by institutional economists, accountants, and lawyers. Rather, it is associated with a person's ability to act on his own behalf, and with assessing a person's achievements by his own objectives. As he puts it (Sen 1999a: 18-19),

The use of the term "agency" calls for a little clarification. The expression "agent" is sometimes employed in the literature of economics and game theory to denote a person who is acting on someone else's behalf (perhaps being led on by a "principal"), and whose achievements are to be assessed in the light of someone else's (the principals) goals. I am using the term "agent" not in this sense, but in its older – and "grandier" – sense as someone who acts and brings about change, and whose achievement can be judged in terms of her own values and objectives, whether or not we assess them in terms of some external criteria as well.

Although Sen has not yet proposed a further analysis of his notion of agency, Crocker and Robeyns (2009: 83), suggest that to be an agent described by Sen one should display the following:

- I. self-determination: decides for herself rather than someone or something else making the

decision to do X;

- II. reason orientation and deliberation: bases her decisions on reasons, such as the pursuit of goals;
- III. action: she performs or has a role in performing X; and
- IV. impact on the world: thereby brings about (or contributes to bringing about) change in the world.

Thus, if a person is deemed an agent, he has to be able to act and exert power (his own authority over his own actions); and the action or power has to have an impact (a positive impact) on the world and his decision on taking the action is made by himself and is based on his critical self-scrutiny of reasons and values. Certainly, Sen's understanding of agency implies that an agent cannot only act, but engage freely and be self-determined. Sen reiterates that to investigate whether a person is an autonomous agent, we have to pay attention not only to whether she gets what she wants (she initiates an action), but to whether she herself decides to perform the act in question. For example, in scenario A, a person called Ike wants to stay at home and he manages to do exactly what he wants. In scenario B, while Ike is thinking about staying at home, a group of gangsters breaks into his house and forces him to stay at home. Although in both scenarios Ike can get what he wants (to stay at home), he has not been given a free choice in Scenario B because he stays at home under duress. Thus, Ike is not considered as an autonomous agent in scenario B, for "there is clearly



a violation of freedom” when Ike “is being forced to do exactly what [he] would have chosen” (Sen 2004:331).

Why does Sen value agency? The first reason is that agency is intrinsically valuable. The exercise of agency allows people to have a life that is governed, determined, and realised by themselves. As Crocker (2009: 86) notes, it is better to “act than be acted upon either as someone else’s tool or a pawn of circumstance”. Thus, Sen says that “[the] achievement of development is thoroughly dependent on the free agency of people” (Sen 1999:4), committing himself not only to negative freedoms, which concentrate on the “absence of a class of restraints that one person may exercise over another, or indeed the state may exercise over individuals”, but, more importantly, to positive freedom, which focuses on “what a person can choose to do or achieve” (Sen 1988b:272). In other words, only by being agents having the ability (freedom) to help ourselves and to participate in economic, social and political actions individually or jointly can we achieve real development<sup>29</sup>. The second reason for Sen’s emphasis on agency is that it helps to address the issue of individual responsibility. When people are allowed freely to make their own decisions and to plan and chart their own courses

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<sup>29</sup> In fact, Sen even considers his capability approach as a human agency approach. In his book *In India: Development and Participation* (2002), co-authored with Dreze, Sen explicitly expresses that his theory of capability approach is “essentially a ‘people-centered’ approach, which puts human agency (rather than organizations such as market or governments) at the centre of the stage” (Dreze and Sen, 2002:6).

through lives, we are in a better position to ask them to take responsibility for the consequences of their choices. As Sen (1999a:288) has pointed out, “responsible adults must be in charge of their own well-being; it is for them to decide how to use their capabilities”. While a government should try to ensure that each citizen is equipped with certain valuable capabilities (e.g. opportunities for education and health), it is up to them to decide whether or not to exercise these capabilities.

The third reason for Sen to value agency is that it makes possible social and political shifts that are necessary for human development, such as the recognition of gender equality or environmental protection. Sen rightly points out that some goals can only be achieved when the majority of people in a society are aware of their importance and willing and able to take action. People are not merely beneficiaries of economic and social progress in societies, but are active agents of change – a change for a better world. What has recently happened in Egypt shows that the power of collective agency can be enormous. The whole process of throwing the then Egyptian president Hosni Mubarak out of power shows that when people are aware of their ability to make a difference and willing to exert power jointly (such as street demonstrations, marches, rallies, acts of civil disobedience, riots, labour strikes) that they can create a better society which is governed by fair and democratic institutions.

Finally, agency plays a significant role in shaping our understanding of human

rights. As we know, although the notion of human rights has gained a great deal of support in recent years, many countries still take them as ‘window dressing’. However, when human rights are seen as rights to certain specific capabilities (freedoms), we pay attention not only to the question whether human rights exist in societies, but, more importantly, to the question whether people in societies are in a position to exercise them. As Nussbaum notes (2003), a people in a country do not have an effective right to political participation simply because it exists on paper. Instead, governments have to apply themselves to build up an environment which is suitable for people to realise human rights. Indeed, Sen’s emphasis on the agency aspects of individuals in the context of development has made governments pay more attention to gender inequality. Consequently, in 1995, the Gender-Related Development Index (GDI) and the Gender Empowerment Measure (GEM) were developed. They were designed to measure gender inequality in achievement of basic capabilities and in opportunities in economic and political areas. In 1997, a composite measure of multi-dimensional poverty – the Human Poverty Index (HPI) was introduced to measure derivational and distributional aspects of human development.

#### **4.4 Conclusion**

To summarise, the combination of elements reminiscent of Aristotle (not the fullblown Nussbaum position), relativism, and agency lays the philosophical foundation of Sen's capability approach. As far as the issue of identification (which space is the proper space for assessing individuals' well-being) is concerned, Sen takes Nussbaum's interpretation of Aristotle (particularly its emphasis on the method of self-inquiry and considering the cultural and historical diversity in human understanding seriously), arguing that every one will agree that the most appropriate measure of well-being is one that focuses on individuals' capabilities – that is, the substantive freedoms to achieve alternative functioning combinations their freedom to do things they have reason to value. The ultimate goal or value of development is the freedom – the freedom (capability) to do things people have reasons to value. When the issue of evaluation (the selection of which freedoms – capabilities – are substantial freedoms) is considered, Sen favours a non-essentialist conceptualisation of well-being, for his recognition of the complexity of human capabilities and the endorsement of each individual's agency aspect have convinced him to take a modest relativist position, which accepts the possibility that people may have different ideas of what freedoms (capabilities) are considered as fundamental ones, and to allow people to choose basic capabilities through public reasoning which is upheld by an

effective democracy. In his short essay “Human rights and capabilities” Sen clearly expresses such a view (2005:157):

My own reluctance to join the search for such a canonical list arises partly from my difficulty in seeing how the exact lists and weights would be chosen without appropriate specification of the context of their use (which could vary), but also from a disinclination to accept any substantive diminution of the domain of public reasoning... Indeed, I would submit that one of the uses of the capability perspective is to bring out the need for transparent valuational scrutiny of individual advantages and adversities, since the different functionings have to be assessed and weighted in relation to each other, and the opportunities of having different combinations of functionings also have to be evaluated. The richness of the capability perspective broadly interpreted, thus, includes its insistence on the need for open valuational scrutiny for making social judgements, and in this sense it fits in well with the importance of public reasoning.

Sen’s recognition of human diversity and emphasis on a person’s agency aspect – ability to decided things by himself, to bring about positive changes to the world – have forced him to admit that the idea of what are deemed basic capabilities is inescapably pluralist. Moreover, a common set of basic capabilities is morally acceptable if it is chosen by people through public reasoning, which is protected by an effective democracy. Thus, Sen considers democracy not only necessary but sufficient for enlarging basic capabilities.

However, Sen’s endorsement of leaving the selection of capabilities to a process of democratic deliberation has raised sharp criticism. In the next chapter, the objections to Sen’s capability approach will be discussed. In particular, I shall

examine – the problem of identification of basic capabilities, the problem of measuring capabilities, and the problem of differentiating among core poor, upper poor, and non-poor.

## Chapter Five

### **Objections to Sen's capability approach as a comprehensive evaluation framework of well-being and poverty.**

In the previous chapter, I discussed Sen's objections to considering utilitarianism as a theory of measuring well-being and poverty. I also reviewed Sen's misgivings about treating Rawls' primary goods as a sufficient measure of persons' well-being in general and poverty reduction in particular. Moreover, I spelled out the philosophical foundation of Sen's capability approach. In this chapter, I would like to discuss recent objections to Sen in the philosophical and economic literature.

From the point of view of some economists and development experts, defining poverty as income poverty is still attractive, notwithstanding its arbitrariness and oversimplifications. Advocates of income poverty measurement stress the empirical impracticability of Sen's capability approach. The empirical impracticability particularly involves the problem of identifying basic capabilities and the problem of setting the proper thresholds of basic capabilities.

Philosophers have also raised fundamental questions regarding the character and justification of Sen's capability approach. One set of objections argues that the feature of sufficient threshold – no-one should fall below the critical threshold of basic capabilities – embedded in Sen's capability approach would (i) lead to a situation in

which too many social resources are devoted to vulnerable groups;(ii) set the proper level of threshold arbitrarily; and (iii) pay no attention to inequality above the threshold (Arneson 2000, 2006). A second objection focuses on Sen's ambition of allowing people to choose basic capabilities for themselves. Philosophers are not against Sen's idea that people are able to select basic capabilities and the threshold of each basic capability, but they question the validity of people's decisions about basic capabilities and the threshold of each basic capability. Some argue that a list of basic capabilities chosen by people may not amount to a morally justifiable list. (Arneson 2006; Nussbaum 2006). A list of basic capabilities is not acceptable merely because it is chosen: the moral reasons for choosing it have to be good ones. But who is to judge whether the reasons are good ones? Does the judgement require expertise in moral theory or in some other kind of theory? In other words, should a list of basic capabilities be made e.g. by philosophers, or should it be made by people through democratic public deliberation, as Sen proposes? In this chapter I address these objections to Sen, and argue that Sen's capability approach is able to address the issues raised by economists, development experts, and philosophers.



## **5.1 Critiques from economists and development experts**

The areas of empirical difficulty for Sen's capability approach (Sugden 1993; Yasander 1993; Srinivasan 1994; Roemer 1996; Alkire 1998; Robeyns 2000; Laderchi, Saith, & Stewart 2003) can be summarised as follows:

1. Selecting a list of basic capabilities.
2. Selecting a set of indicators related to the selected list of basic capabilities and relevant thresholds for requiring them.

With reference to the issue of choosing a list of basic capabilities, many have suggested that it is difficult, if not impossible, to achieve a consensus as to which capabilities should be chosen as basic capabilities. For example, Sugden argues that "Given the rich array of functionings that Sen takes to be relevant, given the extent of disagreement among reasonable people about the nature of the good life, and given the unresolved problem of how to value [capability] sets, it is natural to ask how far Sen's framework is operational" (1993:1953). Similarly, Yasander (1993:84) points out that "in an overwhelming number of cases, the investigators failed to observe and measure anything which could, with the best will in the world, be called a capability".

Is Sen's capability approach able to address the issue of selecting basic capabilities? First of all Sen never plays down the need for making the capability

approach practicable. For instance, Sen stresses that “the approach must nevertheless be practical in the sense of being usable for actual assessments of the living standard” when discussing adequate criteria for evaluating the standard of living (1987: 20).

Second, as has been discussed earlier (chapter 3), Sen asserts that basic capabilities are chosen by people through public reasoning, which requires a society protected by an effective democracy. When public reasoning is followed in an effective democracy, Sen envisages that two unique social practices embedded in public reasoning will be fully realised, namely, “the tolerance of different points of view (along with acceptability of agreeing to disagree) and the encouragement of public discussion (along with endorsing the value of learning from others)” (2003:31). Once these two social practices are activated among citizens who are able to self-reflect, compare, evaluate, and rank alleged human goods and ends, Sen suggests that not only would public reasoning have a role in playing down the influence of citizen’s ‘private, non-public reasons and beliefs’ on the selection of basic capabilities, but, more importantly, it would eventually lead citizens to a kind of ‘rational agreement’ about the list of basic capabilities (Alexander 2008:159). Such a process of identifying and ranking different valuable functionings and capabilities does not need to be comprehensive or complete, given the multidimensional character of values and human diversity. Instead, it will yield a dominance partial order – the basic

capabilities are chosen without requiring any agreement on relative weights among them (chapter 3).

However, one can raise a concern that Sen's vision – a list of basic capabilities is chosen through democratic public reasoning and discussion – is far-fetched since the majority of developing countries do not have effective democratic systems. Is the absence of an effective democratic system a decisive obstacle to implementing Sen's capability approach? Probably not. By using questionnaires, several followers of Sen's capability approach have shown that it is possible to help local communities lacking effective democratic mechanisms to arrive at their own list of basic capabilities and use the list in question as a measure of poverty. For example, Klasen (2000: 40) uses questionnaires to help people to have their say on what capability should be included in the list of basic capabilities and the priorities of basic capabilities (See Table 3.1). Similarly, Clark and Qizilbash (2006:27) use questionnaires to obtain people's views of basic capabilities in three impoverished areas in South Africa (See Table 3.2). Although the scale of the experimental questionnaires is relative small, they have already shown that it is possible to obtain ordinary people's view on basic capabilities if the questionnaires are properly designed and the interviewers are well-trained. Moreover, even if people living in developing countries are not able to make their decision on basic capabilities through

public discussion due to the absence of democratic systems, that will not damage the foundation of Sen’s capability approach as an effective measure to poverty, well-being, and social justice. We can still evaluate whether a social phenomenon, arrangement, or policy is just, based on its influence on individuals’ ability to be an autonomous agent and on democracy (chapter 3). For example, without a list of basic capabilities, we can still criticise a social policy of denying women’s right to vote or a social plan of denying all citizens have equal access to basic medical care because the absence of any guarantee of medical care and the right to vote curtails our substantive opportunities of helping ourselves and participating in economic, social and political activities.

Table 3.1

| Ranking | Component | Ranking | Component          | Ranking | Component            |
|---------|-----------|---------|--------------------|---------|----------------------|
| 1       | Education | 6       | Sanitation         | 11      | Nutrition            |
| 2       | Income    | 7       | Energy             | 12      | Health Care          |
| 3       | Wealth    | 8       | Employment         | 13      | Safety               |
| 4       | Housing   | 9       | Transport          | 14      | Perceived Well-being |
| 5       | Water     | 10      | Financial Services |         |                      |

Table 3.2 Core Capabilities and needs essential for life selected by South Africans

Living in Three Areas

|                               |                                |
|-------------------------------|--------------------------------|
| 1 Housing/ Shelter            | 16 Land and Livestock          |
| 2 Food                        | 16 Own business/Enterprise     |
| 3 Water                       | 16 Religion and Churches       |
| 4 Work/Jobs                   | 19 Furniture                   |
| 5 Money/Income                | 20 Happiness and Peace of mind |
| 6 Clothes                     | 21 Community Development       |
| 7 Education/Schools           | 22 Love                        |
| 8 Health/Health Care          | 23 Freedom/Independence        |
| 9 Electricity/Energy          | 24 Better life                 |
| 10 Safety and Security        | 24.Oxygen                      |
| 11 Transport/Car              | 24 Respect                     |
| 12 Family and Friends         | 27 Blankets                    |
| 13 Sanitation                 | 27 Heat/Temperature            |
| 14 Infrastructure             | 29 Sexuality                   |
| 15 Leisure/Leisure Facilities | 29 Sunlight                    |

As for the issues of selecting a set of indicators related to the selected list of basic capabilities and choosing a minimum level for each indicator, again, Sen is confident that a consensus can be reached on indicators that are relevant to the basic capabilities and the threshold for each indicator among people. Sen often approaches the issue with a quotation from Adam Smith about social necessities (1776, Book 5, chapter 2, part 2 article 4):

By necessities I understand, not only the commodities which are indispensably necessary for the support of life, but whatever the custom of the country renders it indecent for creditable people, even of the lowest order, to be without. A linen shirt, for example, is, strictly speaking, not a necessary of life. The Greeks and Romans lived, I suppose, very comfortably though they had no linen. But in the present times, through the greater part of Europe, a creditable day-labourer would be ashamed to appear in public without a linen shirt, the want of which would be supposed to denote that disgraceful degree of poverty which, it is presumed, nobody can well fall into without extreme bad conduct. Custom, in the same manner, has rendered leather shoes a necessary of life in England. The poorest creditable person of either sex would be ashamed to appear in public without them...Under necessities, therefore, I comprehend, not only those things which nature, but those things which the established rules of decency have rendered necessary to the lowest rank of people.

Sen argues that Smith here identifies the capability of avoiding public shame as a basic capability i.e. a social necessity (or a minimum living condition). Moreover, people are able to choose indicators that are relevant to basic capabilities and minimum level for each indicator. While ‘leather shoes’ refers to the relevant indicator, ‘a pair’ of leather shoes refers to the minimum level as to how many leather shoes one

at least should possess. Thus, Sen maintains that a person is seen as absolutely poor if he does not have basic capabilities at all or his basic capabilities are below the minimum threshold democratically selected by people (chapter 1). However, many argue there is an ambiguity embedded in Sen's definition of absolute poverty: should one be seen as absolutely poor if one is doing badly in any one of basic capabilities or in all basic capabilities (Brandolini & D'Alessio 2001; Bradshaw & Finch 2003)? To address this ambiguity, supporters of Sen have proposed two kinds of approach. The first approach suggests that a person is seen as belonging to the absolutely poor if she is doing badly in one basic capability (Brandolini & D'Alessio 2001; Bourguignon & Chakravarty 2003; Dutta, Pattanaik, and Xu 2003; Atkinson 2003). The second approach suggests that a person is classified as an absolutely poor if she is doing badly in all basic capabilities (Bradshaw & Finch 2003). Which approach is more convincing? Suppose that we have selected two capabilities as basic capabilities: having food to eat and health care. Suppose that a person is doing sufficiently badly in one of these two basic capabilities (she does not have any food to eat or any medical care). In such a case, should we treat this person as an absolutely poor person or as one of the better off poor? I think it is more convincing to see the person in question as an absolutely poor person, for it would be implausible to claim a person is not absolutely poor if she does not have any opportunity of getting food to eat. Moreover,

in a real situation it is unlikely that one would be quite well-off in terms of having medical care while being denied access to food.

To summarize, while it is true that Sen's capability approach will be more practically useful to a society if the society in question is equipped with a democratic system and able to have a list of basic capabilities that is democratically chosen by majorities, that does not entail that Sen's capability approach is useless for assessing social policies and arrangements of a society lacking a democratic environment where people are not used to arriving at consensuses (including a consensus about basic capabilities). Even in the absence of democracy it is possible to ask how social policies or arrangements would affect people's ability to be free agents, and identify specific capabilities (e.g. the Human Development Index, Gender-Related Development Index, and the Gender Empowerment Measure that have been reckoned by many countries).

## **5.2 Critiques from philosophers**

Recent criticism in the philosophical literature has raised fundamental questions regarding the problem of identification of basic capabilities. One set of objections argues that the feature of sufficient threshold embedded in Sen's capability approach would (i) lead to a situation in which too many social resources are devoted to



vulnerable groups;(ii) set the proper level of threshold arbitrarily; and (iii) pay no attention to inequality above the threshold (Arneson 2000, 2006). A second objection focuses on Sen's ambition of allowing people to choose basic capabilities on their own. Critics who propose such objections emphasize that a list of basic capabilities is not only acceptable because it is chosen, but because of the moral reasons for it. A list that is chosen by individuals democratically could for all that be morally unacceptable due to a lack of relevant information or in the absence of adequate basic political institutions or because it does not combine general principles and empirical information in a satisfactory way. Should people be left to make a list of basic capabilities through democratic public deliberation, or should they leave it to experts, e.g. philosophers?

### **5.2.1 Sen's capability approach: a sufficientarian approach?**

The concept of sufficiency is generally understood in the context of social justice. The principle of sufficiency mandates that everyone is entitled to enough 'X' where X enables people to live and reach a threshold level of sufficiency (Crisp 2003, Frankfurt 1987). In other words, no-one should fall below the critical threshold of X. In order to justify this argument, one needs to answer the following questions (Arneson 2006: 23-24): (i) what is X? Could the X be public goods or something else?

(ii) When and for how long must sufficiency obtain? Should a certain sufficient level be maintained throughout one's life or should it refer to the idea of a "canonical moment" (the moment a person turns into adulthood), which requires that "each person should be able to choose and pursue a reasonable plan of life that will gain for him or her a sufficient level of well-being throughout the person's life"? (iii) How much is enough? How do we set the threshold?

Arneson (2006) argues that the capability approach does have the features of a sufficientarian account because not only does Sen suggest that equality should be understood in terms of basic capability, but he also argues that certain elementary capabilities should be brought up to 'certain levels', which will enable each person to choose a reasonable plan of life. However, if the goal of social policy is to bring each person to the minimum standard of living in terms of basic capabilities, Arneson claims that Sen's capability approach would (i) lead to a situation in which so many social resources are spent on vulnerable groups that other people, who are above threshold level of capabilities, might be drawn below the threshold; (ii) pay no attention to inequality above the threshold; and (iii) set the proper level of threshold arbitrarily. In this section, these three criticisms will be examined.

### 5.2.2 Severe disability: a social black hole?

Taking Arneson's first criticism first, let us consider two situations. In situation A, an individual could be extremely disabled but somehow be brought up to a minimum standard of living threshold if they can get huge resources. In situation B, an individual is so disabled that no matter how many resources they get, they will never reach the minimum standard of living threshold. In both situations, severely disabled people become a social black hole, swallowing enormous resources, and pulling other people below the threshold. Is Sen's capability approach vulnerable to this critique? The short answer is no. Sen argues that there is a subtle difference between 'attainment equality' and 'shortfall equality'. Attainment equality is 'concerned with equal absolute levels of achievement' *regardless of a number of contingent personal and social circumstances*<sup>30</sup>. For example, a society may ask all citizens to be able to identify 700 hundred different vocabulary words regardless of whether a person is blind or finds difficulty in reading or remembering things. Shortfall equality, on the other hand, considers particular 'circumstances' (include social, demographical, geographical, and biological conditions) that could limit people's potentiality to achieve certain things at the same levels (Sen 1992:89-90). Indeed, Sen's concept of shortfall equality indicates that in some cases it is impossible to see equality in terms

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<sup>30</sup> According to Sen (1999:70-71), personal and social contingent circumstances include personal heterogeneities (such as disability, illness, age or gender), environmental diversities, (such as climatic circumstances), variations in social climate, differences in relational perspectives, and distribution within the family.

of the absolute level of achievement, since people's potentiality to make something of a given bundle of resources (commodities or income) depends crucially on certain contingent personal and social circumstances. A sufficient absolute level of achievement is nearly impossible for a seriously disabled person to attain no matter how many resources he/she gets. Sen points out that, "[i]n the case of serious disabilities, attainment equality may be hard to achieve, and it may be particularly tempting to opt for shortfall equality" (1992:91). Moreover, Sen argues that when shortfall equality is applied, we should try to maximize those disabled people's below-par functioning ability. He says that (1992:91)

There might well be a good argument in that direction, but I would like to argue that it is not the case that the choice is made clear-cut simply by the non-feasibility of attainment equality. It can be argued that even when a disabled person cannot, in any way, be given the freedom to enjoy the same level of the functioning in question (e.g. the same ability to move about freely as others), there is nevertheless a good case – based on fairness – for trying to maximize his below-par functioning ability, rather than settling for the same shortfall (absolute or proportionate) as others have from their – much higher – maximal functionings.

In other words, to say every one should have a basic capability of movement does not necessarily entail that every one should be able to achieve the same level of movement. It is unreasonable to expect a severely disabled person to have the same ability to move about as other non-disabled people. Thus, Sen's differentiation between attainment equality and shortfall equality helps to explain why a society in

which some people cannot reach certain minimally acceptable levels of basic capabilities should not necessarily be considered an unfair society.

It should also be emphasised that although, in most cases, we should help disabled people to reach certain minimally acceptable levels of basic capabilities (attainment equality), it does not follow that they have priority in being helped even at the cost of lowering other people's maximum achievement. Sen suggests that while equality is better seen in terms of shortfall equality, efficiency should also be taken into account (1992: 143-144):

Efficiency in the capability space, if defined analogously to the usual definitions of 'economic efficiency' (characterized in terms of the utility space), would require that one's capability can be further enhanced while maintaining the capability of everyone else at least at the same level.

If equality is understood in terms of shortfall equality and efficiency has been considered, a disabled person will have priority in being helped to get close to his maximum achievement without threatening others' opportunity of realizing their maximum achievement in terms of basic capabilities. In addition, in a normal situation, a very disabled millionaire will not be seen as poor since he has enormous resources to get to his maximum achievement. Thus Sen's capability approach will not require so many social resources to be spent on vulnerable groups that other people, who are above threshold level of capabilities, will be drawn below the

threshold.

Even if the issue of social black holes can be settled, Sen's capability approach has still to address two other important issues. First, how could the threshold of basic capabilities avoid being arbitrary? Sen argues that it is possible for people to choose basic capabilities and functionings, and the thresholds for these capabilities could be set through public discussion and democratic deliberation, which require a society where substantial freedoms are protected by an effective democracy. But does not any chosen threshold of any chosen basic capability suffer from being arbitrary? The short answer is no. As I have argued, when Sen argues that basic capabilities refer to 'the ability to satisfy certain elementary and crucially important functionings up to certain levels' (1992: 45 n. 19), the crucially important functionings up to certain levels are understood in terms of the minimum standards of living. Since each society could have a different threshold, each of them could have different minimum standards of living. For example, if the capability of being educated is seen as a basic capability, to what extent a person should be educated depends on which society he lives in. Thus, while in Mexico schooling is required through lower secondary school, the compulsory education in Canada is set for ages six through sixteen. However in saying that each society could have different thresholds, that does not entail that Sen denies the possibility of having a regional or an international minimum standard of

living. Nor is Sen suggesting that any other minimum standard of living, no matter how different it is, is morally acceptable when it is chosen by people. Far from it, Sen argues that contemporary standards (either regional or international) could be established, since specific capabilities are widely recognised as valuable by people. Moreover, when a society sets up a specific standard of living, which is much lower than international standards, it has to offer reasons resulting from democratic public discussion, which requires not only dialogue between different groups or communities, but good arguments, which have considered various values, interests, and trade-offs of the choice in question. Further, when a democratically chosen minimum standard of living conflicts with existing regional or international standards, that does not necessarily mean that the former must be wrong and therefore has to be discarded in favour of the latter: it can result from the inadequate design of the latter. Thus, the conflict in question can help us critically reflect on current regional or global standards, enabling us to come up with better global standards than the ones we already have.

Does Sen's capability approach pay no attention to inequality above the threshold?

To Sen, this is an inappropriate question, since it confuses equality with adequacy. In a just society, we do not need to bring every one up to same level, but to bring them up to an adequate level. Let us consider the following example. In society A, while

10% population is below the threshold (-20) and suffering starvation, the rest of the population is above the threshold (+30). In society B, all people are above the threshold. While 50% of the population is 100 units higher than the threshold, the other 50% of population is 200 units higher. In Sen's understanding, the reason why we claim society A is an unfair society is because it causes 10% of the population to suffer from *starvation and the threat of death*. What matters morally is not that every one has the same quality of life, but that everyone has an adequate quality of life. In Sen's capability approach each one could have a different achievement, but this difference would not necessarily be a consequence of social inequality in that it could be a result of a person's choice. For instance, consider two people of equal capabilities who share the same social background and have equal shares of resources from the very beginning. Suppose that one does not want to work as hard as the other one and therefore has less income. In this case, the difference between them is nothing to do with social inequality but is to do with their choices.

### **5.3 A list of basic capabilities: who decides and why?**

We noted earlier (chapter 3) that Sen attaches great value to treating people as agents, who are able to act on their own behalf with good intentions (willing to bring positive impacts to the world) and to assess their achievements by public standards, stressing



the necessity of allowing people to choose basic capabilities freely through democratic public deliberation. However, Martha Nussbaum, one of the most influential proponents of the capability approach, is against the idea that basic capabilities are identified by collective choice, asserting that it is a philosophers' job to identify the basic capabilities. Should a list of basic capabilities be made by philosophers or should it be left to a democratic public deliberation? In the following sections, I will discuss the debate between Sen and Nussbaum's positions on the question of making a list of basic capabilities.

### **5.3.1 Nussbaum's capability approach**

Nussbaum's version of the capabilities approach begins with a conception of the dignity of the human being, and of a life that is worthy of that dignity - a life that has available in it "truly human functioning". With that basic idea as a starting point, Nussbaum attempts to justify a list of ten capabilities as central requirements of a life with dignity, by applying Aristotle's general inquiry method (see chapter 3). These ten capabilities are regarded as general goals that can be further specified by the society in question. More specifically, Nussbaum's version of the capability approach can be broken down into three elements.

### **5.3.2. The dignity of human being and the essential features of human beings**

The first element of her theory is an account of the essential features of human beings, that is, an account of what are the necessary features for us to count as a human life. These essential features serve as limits for engaging in various sorts of activities. According to her, certain functions are of great importance in human life, “in the sense that their presence or absence is typically understood to be a mark of the presence or absence of human life” (Nussbaum 2000: 71-72). Without these essential features, we would not see ourselves as human beings. Such an account says: “Take away properties X and Y and Z (a suntan, let us say, or a knowledge of Chinese, or an income of \$40,000 a year) and we will still have a human being on our hands. On the other hand, take away properties A and B and C (the ability to think about the future, say, or the ability to respond to the claims of others, or the ability to choose and act) and we no longer have a human life at all.” (Nussbaum 1992: 207) Moreover, inspired by Marx’s understanding of Aristotle’s idea of the good for man and the Kantian notion of the inviolability and the dignity of the person, Nussbaum argues that a human being is a dignified, free being who shapes his or her own life in cooperation and reciprocity with others, rather than being passively shaped or pushed around by the world in the manner of a flock or held animal. A human being shall be seen as “having worth as an end, a kind of awe-inspiring something that makes it horrible to

see this person beaten down by the currents of chance – and wonderful, at the same time, to witness the way in which chance has not completely eclipsed the humanity of the person” (Nussbaum 2000:73). And thus, these essential features turn out not only to be certain basic capabilities for engaging in various sorts of activities and undergoing various sorts of experiences but for defending Human dignity and objecting to the idea of a person as a mere object for the use of others. Nussbaum describes these essential features as follows (1992:216-220):

**Mortality.** All human beings face death and, after a certain age, know that they face it. This fact shapes more or less every other element of human life.

**The human body.**

1. Hunger and thirst; the need for food, drink. All human beings need food and drink in order to live; all have comparable, though varying, nutritional requirements.
2. Need for shelter. A recurrent theme in myths of humanness is the nakedness of the human being, its relative susceptibility to heat, cold, and the ravages of the elements.
3. Sexual desire. Though less urgent as a need than the needs for food, drink, and shelter (in the sense that one can live without its satisfaction), sexual need and desire are features of more or less every human life.
4. Mobility. Human beings are, as the old definition goes, featherless bipeds – that is, creatures whose form of life is in part constituted by the ability to move from place to place in a certain characteristic way, not only through the aid of tools that we have made but with our very own bodies.

**Capacity for pleasure and pain.** Experiences of pain and pleasure are common to all human life (though once again both their expression and, to some extent, the experience itself may be culturally shaped). Moreover, the aversion to pain as a fundamental evil is a primitive and, it appears, unlearned part of being a human animal. A society whose members altogether lacked that aversion would surely be judged to be beyond the bounds of humanness.

**Cognitive capability:** perceiving, imagining, thinking. All human beings have sense perception, the ability to imagine, and the ability to think, making distinctions and reaching out for understanding, and these abilities are regarded as of central importance.

**Early infant development.** All human beings begin as hungry babies, aware of their own helplessness, experiencing their alternating closeness to and distance from that, and those, on whom they depend.

**Practical reason.** All human beings participate (or try to) in the planning and managing of their own lives, asking and answering questions about what is good and how one should live.

**Affiliation with other human beings.** All human beings recognise and feel some sense of affiliation and concern for other human beings. Moreover, we value the form of life that is constituted by these recognitions and affiliations.

**Relatedness to other species and to nature.** Human beings recognize that they are not the only living things in their world, that they are animals living alongside other animals and also alongside in a universe that, as a complex interlocking order, both supports and limits them.

**Humor and play.** Human life, wherever it is lived, makes room for recreation and laughter. The forms that play takes are enormously varied; yet we recognize other humans, across cultural barriers, as the animals who laugh. Laughter and play are frequently among the deepest and also the first modes of our mutual recognition.

**Separateness.** However much we live with and for others, we are, each of us, one in number, proceeding on a separate path through the world from birth to death. Each person feels only his or her own pain and not anyone else's. Each person dies without entailing logically the death of anyone else...Because of separateness, each human life has, so to speak, its own peculiar context and surroundings – objects, places, a history, particular friendships, locations, sexual ties – that are not exactly the same as those of anyone else, and in terms of which the person to some extent identifies oneself.

### **5.3.3 The justification of essential features of human nature**

But how does Nussbaum justify this choice of essential features? Instead of trying to derive an ethic from some metaphysics of nature or from an externalist account of an extra-historical human essence, or religious tradition, she suggests that the list of essential features of human nature is to be justified by appealing to "the commonness of myths and stories from many times and many places" (Nussbaum 1990: 217) or to "a wide variety of self-understandings of people in many times and places, from the

stories people tell themselves."(1993: S54) That is to say, we can discern values not by trying to get outside all human practices and conceptual frameworks but by exploring our ways of thinking and acting "from within," by "the deepest examination of human history and human cognition" (Nussbaum 1993: S50) . In this sense we reach essential features of human nature by asking: "What are the features of our common humanity, features that lead us to recognize certain others, however distant their location and their forms of life, as humans, and on the other hand, to decide that certain other beings who resemble us superficially could not possibly be human?" (Nussbaum 1990: 219).

#### **5.3.4 A list of basic human functional capabilities**

The second element of Nussbaum's account is a list of "basic human functional capabilities" based on the essential features isolated in the first part of her account. Nussbaum argues that this list provides a minimal conception of the good (1993: S57). More specifically, in connection with each of the basic human functional capabilities we are able to define a threshold level of good functioning, that is, a threshold "beneath which those characteristic functions are available in such a reduced way that, though we may judge the form of life a human one, we will not think it a good human life" (1993: S57). She calls this a "thick, vague conception of the good". The central

capabilities are “not just instrumental to further pursuits: they are held to have value in themselves, in making the life that includes them fully human” (Nussbaum 2000: 75). In particular, these central human functional capabilities are described by Nussbaum as follows (Nussbaum 2006:76-78):

1. Life. Being able to live to the end of a human life of normal length; not dying prematurely, or before one’s life is so reduced as to be not worth living.
2. Bodily health. Being able to have good health, including reproductive health; to be adequately nourished; to have adequate shelter.
3. Bodily integrity. Being able to move freely from place to place; to be secure against violent assault, including sexual assault and domestic violence; having opportunities for sexual satisfaction and for choice in matters of reproduction.
4. Sense, Imagination, and Thought. Being able to use the senses, to imagine, think, and reason – and to do these things in a ‘truly human’ way, a way informed and cultivated by an adequate education, including, but by no means limited to, literacy and basic mathematical and scientific training. Being able to use imagination and thought in connection with experiencing and producing works and events of one’s own choice, religious, literary, musical and so forth. Being able to use one’s mind in ways protected by guarantees of freedom of expression with respect to both political and artistic speech, and freedom of religious exercise. Being able to have pleasurable experiences and to avoid non-beneficial pain.
5. Emotions. Being able to have attachments to things and people outside ourselves; to love those who love and care for us, to grieve at their absence; in general, to love, to grieve, to experience longing, gratitude, and justified anger. Not having one’s emotional development blighted by fear and anxiety.
6. Practical reason. Being able to form a conception of the good and to engage in critical reflection about the planning of one's life.
7. Affiliation.
  - A. Being able to live with and toward others, to recognize and show concerns for other human beings, to engage in various forms of social interaction; to be able to imagine the situation of another.
  - B. Having the social bases of self-respect and non-humiliation; being able to be treated as a dignified being whose worth as equal to that of others. This entails provisions of non-discrimination on the basis of race, sex, sexual orientation, ethnicity, caste, religion,

national origin.

8. Other species. Being able to live with concern for and in relation to animals, plants, and the world of nature.
9. Play. Being able to laugh, to play, to enjoy recreational activities.
10. Control over one's environment.
  - A. Political. Being able to participate effectively in political choices that govern one's life; having the right of political participation, protection of free speech and association.
  - B. Material. Being able to hold property (both land and movable goods), and having property rights on an equal basis with others; having the right to seek employment on an equal basis with others; having the freedom from unwarranted search and seizure. In work, being able to work as a human being, exercising practical reason and entering into meaningful relationships of mutual recognition with other workers.

Nussbaum reminds us that first, “the list is, emphatically, a list of separate components. We cannot satisfy the need for one of them by giving a larger amount of another one” (Nussbaum 2000: 81). Each central human functional capability is of the same importance. Second, the list is “open-ended and subject to ongoing revision and rethinking, in the way that any society's account of its most fundamental entitlements is always subject to supplementation (or deletion)”. Third, the items of the list “ought to be specified in a somewhat abstract and general way, precisely in order to leave room for the activities of specifying and deliberating by citizens and their legislatures and the courts that all democratic nations contain”.

### **5.3.5 A principle of distributive justice**

The third part of Nussbaum's capability approach is a principle of distributive justice – a principle for just distribution of society's goods and resources in light of securing threshold levels of basic capabilities. Ultimately, distributive justice requires “moving all of the citizens across the threshold into capability to choose well, should the available resources at all permit this. The focus is always on getting more to cross the threshold, rather than further enhancing the condition of those who have already crossed it” (1990: 216-217). Furthermore, with respect to each of the basic human functional capabilities “citizens are to receive the institutional, material, and educational support that is required if they are to become capable of functioning in that sphere according to their own practical reason” (1990: 228). Thus the argument for Nussbaum's theory of development as freedom can be stated as follows:

1. people matter, and matter equally;
2. people are separate individuals, each with different personalities, characteristics and with their own life to live;
3. each person's well-being should be given equal weight;
4. although people have very different comprehensive conceptions of the good, there is an overlapping consensus regarding basic capabilities.



5. morally right acts for development will allow the basic capabilities to be pursued for each and every person, treating each as an end and none as a mere tool of the ends of others.

#### **5.4 Nussbaum's objection to Sen's version of the capability approach**

Since both Sen and Nussbaum agree that the best category for moral concern is the ethical space of human functionings and capabilities, why does Nussbaum believe that we should have a core list of basic capabilities as well? The key to an answer lies in the following criticism Nussbaum makes of Sen (Nussbaum 2003:55):

[C]apabilities can help us to construct a normative conception of social justice, with critical potential for gender issues, only if we specify a definite set of capabilities as the most important ones to protect. Sen's perspective of freedom is too vague. Some freedoms limit others; some freedoms are important, some trivial; some good, and some positively bad. Before the approach can offer a valuable normative gender perspective, we must make commitments about substance.

Her objection is that Sen's version of the capability approach lacks a procedure for discerning which capabilities/freedoms are fundamentally important and which are not. For example, a male dominated society may choose a list of basic capabilities that is insensitive to gender-based equality. Put differently, a democratic deliberation without restrictions or guidelines (e.g. Who should be included in the public? How to reason) might have a list that is vulnerable to the selection bias (Alkire 2002; Robeyns

2005; Crocker 2006; Claassen 2010). As Alkire has pointed out (Alkire 2003:13; cited from Crocker 2006:314),

The problem is that, although Sen regularly refers to the need for explicit scrutiny of individual and social goals, for reflectiveness, value judgement, practical reason, and democratic social choice, he chooses not to specify the possible range of procedures by which valuational issues are to be resolved or by which information on valuations is to be obtained.

### **5.5 Sen's reply to Nussbaum's objections**

Sen's reply to Nussbaum's objection that his version of the capability approach is vulnerable to the selection bias uses three concepts: rationality; democracy; and open impartiality. As has been discussed earlier (see chapter 3), in *Rationality and Freedom* (2000), Sen refines his notion of rationality, arguing that rationality is viewed as a person's ability to critically self-reflect, compare, evaluate, and rank alleged human goods and ends. This suggests that when Sen argues that people should have the freedom to do things they have reason to value, the content of freedom is not unrestricted. In considering individuals' values as the foundation of the selection of basic capabilities, only those that have been subjected to reasoned scrutiny should be considered. The second part of his reply to selection bias is connected with his notion of democracy. In his most recent book, *The Idea of Justice* (2009), Sen furthers his notion of democracy, defining it as "government by discussion," which includes

“political participation, dialogue and public interaction (326).” Moreover, he argues that regular elections, opposition parties, basic freedom of speech and a free media are keys to public deliberation (Sen 2009: 342). Sen particularly points out that a well functioning media is especially important to public reasoning and democratic practice (2009: 336-337): First, it is important for our capability to communicate with each other and to understand the world in which we live. Second, it spreads information and subjects it to critical scrutiny; third, it protects the minority by subjecting the majority to the gaze of the public eye; fourth it facilitates the formation of common values by the public; and finally, it contributes to the pursuit of justice. This explicitly shows that when Sen argues that a list of basic capabilities should be the outcome of a democratic process, such a democratic process is not totally unconstrained. Rather it is exercised in a functioning democracy equipped with regular elections, opposition parties, basic freedom of speech and a well functioning media. The third part of his answer to selection bias relates to his distinction between closed and open impartiality.

Sen argues that there are two different ways of invoking impartiality (2009: 123):

There is, however, a basic distinction between two quite different ways of invoking impartiality, and that contrast needs more investigation. I shall call them respectively ‘open’ and ‘closed’ impartiality. With ‘closed impartiality’, the procedure of making impartial judgment invokes only the members of a given society or nation (or what John Rawls calls a given ‘people’) for whom the judgements are being made...In contrast, in the case of ‘open impartiality’, the procedure of making impartial assessments can invoke judgements, among others, from outside the focal group,

to avoid parochial bias.

In other words, Sen argues that everyone not only has the ability to be a closed impartial spectator, who is able to examine local social arrangements through local assumptions, but also has the ability to be an open impartial spectator, whose reasoning can go beyond local conventions of thought. That is to say, a person as an open impartial spectator is not only able to consider things from the view of others who are near (e.g. friends or neighbors) but from the view of others who are far (who may live in different countries and have different cultures and living styles). People's ability to be an open impartial spectator allows them to have open-ended discussion, which in turn brings them an opportunity to revise their views based on their changing positions and information. The moral objectivity of public reasoning cannot depend only on closed impartiality in that citizens as members of a given society could be susceptible to 'procedural parochialism' – that is, the limitations of partiality towards the shared prejudices or biases of the focal group itself' (Sen 2009: 139). Putting these three parts together, we can clearly see how Sen replies to the objection that his versions of the capability approach is vulnerable to the selection bias

But how much force is there in Sen's reply to Nussbaum's objection? Before coming to my answer to this question, let me explain why Sen objects to Nussbaum's version of the capability approach.

## **5.6 Sen's objection to Nussbaum's version of the capability approach**

Sen's objection to Nussbaum's idea of making a definite and complete list of basic capabilities consists of two arguments. The first argument is to do with Sen's praise for agency and democracy (chapter 3). The evaluation of basic capabilities is too important to allow others to choose. Any list of basic capabilities will be illegitimate if it has not been arrived at by public discussion or public reasoning, because bypassing democracy denies people's opportunity to choose basic capabilities, which in turn infringes on their right to be an agent who is entitled to have life that is governed, determined, and realised by himself. That is to say, in any society, if there is an agreement on basic capabilities, this agreement must be a volunteer agreement. People will reasonably agree without being coerced and provoked. Thus, Sen emphasises that (Sen 2005: 158):

The problem is not with listing important capabilities, but with insisting on one pre-determined canonical list of capabilities, chosen by theorists without any general social discussion or public reasoning.

The second argument for Sen's rejection of a predetermined list of basic capabilities is that "to insist on a fixed forever list of capabilities would deny the possibility of progress in social understanding and also go against the productive role of public discussion, social agitation, and open debates" (Sen 2004a:80). Indeed, Sen's second

argument appears to be an epistemological objection to Nussbaum's list of basic capabilities. That is to say, any list (including Nussbaum's) is subject to change. And such a change will not be adequately captured by any predetermined list proposed by any person in that we as individuals "will almost always have a partial perspective and thus partial epistemological access", given the impact of our own situatedness (Robeyns 2005: 198). Thus, Sen and his supporters (Robeyns 2003, 2005; Stewart 2001; Kapur 2001; Menon 2002; Charusheela 2008) insist that what we need is not a predetermined list proposed by any individuals but "a process of genuine listening and deliberation until a list, which will necessarily be collective, can be constructed" (Robeyns 2005:198-199).

### **5.7 Nussbaum's reply to Sen's objections**

Certainly, Nussbaum, too, values public discussion and individuals as agents, but she also expresses her misgiving that a list that is democratically chosen can be an outcome of selection bias, which is insensitive to some fundamentally important capabilities (such as the education for women or adequate health care), leaving vulnerable groups ignored (Nussbaum 2003: 53):

Some human matters [capabilities] are too important to be left to whim and caprice, or even to the dictates of a cultural tradition. To say that education for women, or adequate health care, is not

justified just in case some nation[s] believe that it is not justified seems like a capitulation to subjective preferences.

Thus, she is against the idea of allowing people to democratically choose basic capabilities. However, Nussbaum's refusal to leave list-making to democratic processes does not require that she leave public discussion totally untended. Rather she allows public discussion plays a role at the level of "implementation and more precise specification" (Nussbaum 2003:53).

In relation to Sen's second objection that philosophers (or academic theorists in general) cannot possibly know which capabilities are important to people, Nussbaum argues that by appealing to the commonness of myths and stories from many times and many places based on Aristotle's general method of inquiry – to preserve the greatest number and the most basic of the 'appearances' (human perceptions and beliefs) on the subject, we can have a cross-cultural consensus on the idea of essential humanness (chapter 3; chapter 4, section 4.3.1-4.3.4).

### **5.8 Sen or Nussbaum's position?**

I think Sen's objections to Nussbaum's idea of proposing a substantive list of basic capabilities without any public reasoning is compelling, in that Nussbaum's reply to the epistemological issue of how is it possible for an individual to know

which capabilities are most important to people is weak. It seems difficult to accept as a justification for Nussbaum's list the fact that the things on the list agree with "the commonness of myths and stories from many times and many places, stories explaining to both friends and strangers what it is to be human rather than something else", especially as she only gives us only limited cultural sources. Nussbaum only gives us stories that originally come from Ancient Greece and only stories as she interprets them. What about stories from ancient Egypt, China, or South America? In fact, there exist dramatic differences and even conflict between different cultures' interpretations of human nature. For example, Nussbaum asserts that morality is one of the essential features of human life and characterizes it as follows (Nussbaum 1990:219):

All human beings face death and, after a certain age, know that they face it. This fact shapes more or less every other element of human life. Moreover, all human beings have an aversion to death. Although there are many circumstances (varying among individuals and from culture to culture) in which death will be preferred to the available alternatives, it is still true that in general human beings wish to live and, like Lucretius's "first mortals" (prior to any culture) leave with fear and grief "the sweet light of life." If we did encounter an immortal anthropomorphic being, its way of life would be so different from our own that we could hardly regard it as a part of the same kind with us. The same would be true if we encountered a mortal being that showed no tendency to avoid death or to seek to continue its life.

But surprisingly, in Chinese culture people do believe that humans can be immortal.

In particular, the ancient Chinese, influenced by Taoism, had even built up some



practical procedures of being immortal such as how to practice “Qigong”, how to control human’s emotions and senses and how to integrate oneself in to nature as the One. They believe that every person has a chance to be celestial, as long as they stick to those procedure and train hard. These procedures in question are popular in modern Chinese societies, such as in Hong Kong, China, and Taiwan. Thus far I have shown that Nussbaum’s approach to making a substantive list of basic capabilities is unilluminating and culturally parochial, contrary to its aspirations to be more universal.

If Nussbaum’s approach appears to be inadequate, does it entail that philosophers should not make up lists of basic capabilities? I think there is nothing wrong with philosophers’ attempts to propose such a kind of list if they consider their lists as one of the options available within that democratic debate and do not insist that their lists as definitive and uniquely acceptable<sup>31</sup>. Certainly, if Nussbaum considers her list as a piece of input into the process of public discussion, then Sen will not only accept it, but will welcome it, because he himself is doing the same thing. For example, Sen and

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<sup>31</sup> As Claassen notes,

[P]hilosopher seeks influence on the practical level for his theories by way of a more indirect process. Here he is philosopher-citizen, who offers his theory as input into a democratic process run by others...It [philosopher-citizen view] offers – or at least in its most defensible version it should offer – its philosophical theory as a piece of input into the process of actually existing democracies (Claassen 2010:11).

Dreze (2002) invoke several elementary capabilities (such as basic education, health, and gender equality) to clarify and illuminate Indian people's public reasoning relating to their economic and social achievements and failures. However, it appears to me that Nussbaum would not consider her list as one of the options available within that democratic debate because she lets public discussion play a rather limited role in her list – *she only allows people to further specify her list at the level of implementation not to amend its main elements*. This also seems to suggest that she thinks that her list is right and is not subject to change: There is no need for other philosophers to make other lists of basic capabilities based on other philosophical reflections. However, as I have just suggested, if Nussbaum cannot go beyond the epistemological limits, then how is she able to decide authoritatively what should be included on the list or excluded from it?

If there is nothing wrong with philosophers' attempts to propose lists of basic capabilities serving as available options and constraints on the democratic debate on the selection of basic capabilities, then will the process of public reasoning be vulnerable to selection bias as Nussbaum suggested? Again, the short answer is no. Sen's reply to selection bias is convincing. As has been discussed earlier (Chapter 3), when Sen argues that people should have the freedom to do things that they have reason to value, such argument is not a 'blanket endorsement' as Nussbaum (2003:47)

suggested<sup>32</sup>. Rather, only those freedoms that have been subjected to reasoned scrutiny will be legitimate. Reasoned scrutiny involves not only the ability to critically self-reflect, compare, evaluate, and rank all alleged human goods and ends, but to be an open impartial spectator. Moreover, the public debate about basic capabilities is held in a democratic environment which is furnished with regular elections, opposition parties, basic freedom of speech and a well functioning media. When public reasoning is exercised in a democratic model proposed by Sen, then it will not be vulnerable to selection bias. For example, the dispute about whether the United States should have health care as a right of citizenship has been discussed fiercely for the last decade. According to the statistics from the U.S. Census Bureau, 45.7 million people (15.3% of the population) were without health insurance in 2007<sup>33</sup>. Most of them (80%) were working class. Sadly, their income was not low enough for them to be categorized as poor, which would have given them free health care services from the government, but neither was it high enough to enable them to purchase health care themselves; therefore they became ‘health care orphans’. These health care orphans have trouble getting needed medical care, even for serious conditions. They are also

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<sup>32</sup> Nussbaum argues that “One cannot have a conception of social justice that say, simply, ‘All citizens are entitled to freedom understood as capability.’...[s]uch a blanket endorsement of freedom/capability as goal would be hopelessly vague” (2003:46-47). Indeed, Dworkin (2000) raise a similar concern, criticising Sen in upholding the idea that people’s capabilities/freedoms should be equally treated. He says that, Sen is suggesting that “people should be made as nearly equal as possible in their capability to realize ‘complex’ achievements of happiness, self-respect, and a significant role in the life of the community” (2000:301).

<sup>33</sup> ["Income, Poverty, and Health Insurance Coverage in the United States: 2007."](#) U.S. Census Bureau. Issued August 2008.

forced to delay medical services and receive poor care for chronic diseases. As for the majority's position of opposing health care as a fundamental right of citizenship, the main reason is that it would invite governmental intrusion and encroach on individuals' freedom of choice (the aspect of direct agency achievement). But it is hard to find any adequate moral reason to justify the superiority of the freedom of choice for some over the freedom of being healthy for others and for allowing 45.7 million people live without access to health care, which has been widely seen as a fundamental right of citizenship. In fact, among 29 industrialized nations, the United States is the only industrial country that does not guarantee access to health care as a basic right of citizenship. However, through the process of public debate and reasoning, citizens have been able to flesh out their democratic literacy and correct their misunderstandings or prejudices towards health care. As a result, on March 23, 2010, the American government finally passed the law - the Patient Protection and Affordable Care Act (PPACA), providing basic and affordable health insurance to all its citizens. What this example shows is that democracy as public reasoning can address social injustice because it creates a field in which people can freely express their opinions and concerns and defend their interests, allowing them (including philosophers) to be active agents in the construction of social arrangements and policies. Nonetheless, one might think that Sen's endorsement of democratic

processes overlooks a deep concern of Nussbaum's: there can be a time lag between an adequate moral statement and that statement being accepted by majority (2006:58).

I think the problem of the time lag between a morally acceptable list of basic capabilities and that list being accepted by a majority will not pose a serious threat to Sen's endorsement of democratic processes because Sen can argue that the cases of Gandhi or Martin Luther King, Jr., raised by Nussbaum (2003:47) were the outcomes of immature democracies, which lacked opposition parties, basic freedom of speech, and a well functioning media<sup>34</sup>. A time lag between a morally acceptable list and that list being accepted by majority will be substantially reduced if the selection of basic capabilities is exercised in an effective democratic process.

To summarise, Sen's idea of allowing people to choose basic capabilities on their own is convincing in that his model of public discussion is not defenseless against selection bias. Moreover, while Sen is against Nussbaum's version of the capability approach, it does not follow that he opposes philosophers' attempts to propose lists of basic capabilities if they see their lists as one of the options available within the democratic public discussion.

Before ending the current discussion, I would like to mention that several

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<sup>34</sup> Although the US was a mature democracy even fifty years ago, the US did not have a well functioning media. Moreover, some kind of racist activities were still allowed (such as segregation at lunch counters in school and in city buses

proponents of Sen's version of the capability approach suggest that Sen's notion of democracy should have a more substantive account. For example, Robeyns argues that any lists chosen by people should meet the following criteria (2005:205-206):

1. *Explicit formulation*: The list should be made explicit, discussed, and defended.
2. *Methodological justification*: We should clarify and scrutinise the method that generated the list and be able to defend it.
3. *Different levels of generality*: If a selection aims at empirical application or wants to lead to implementable policy proposals, then the list should be drawn up in at least two stages. Each stage will generate a list at a different level, ranging from the level of ideal theory to more pragmatic lists. This means that only from the second stage forward would constraints and limitations related to measurement design and data collection, or to political or socio-economic feasibility in the case of policy-oriented applications, be taken into account. Distinguishing between the ideal and the second-best level is important, because these second-best constraints might change over time; for example, as knowledge expands, or as empirical research methods become more refined, or as the reality of political or economic feasibility changes.
4. *Exhaustion and non-reduction*: The capabilities on the list should include all elements that are important: no dimensions that are relevant should be left out.

Crocker (2006), taking another example, proposes a version of the theory of deliberative democracy which aims at deepening Sen's conception of democracy in terms of clarifying the aims of public discussion and answering the questions of who should engage in public discussion, what background conditions can help individuals deliberate, what is the process of public discussion, and what personal capacities and virtues does a person as a deliberator have (Crocker, 2006: 316-346). I think these supplements proposed by the capability theorists are useful because they give us a more concrete idea of how a list of basic capabilities will be chosen through an

existing democracy meeting Sen's model of public debate.

## **5.9 Concluding Remarks**

This chapter provides an overview of recent objections to Sen both from economic and philosophical perspectives. On the one hand, economists and development experts argue that Sen's capability approach suffers from being impracticable since it does not spell out the possibility of selecting basic capabilities and setting a threshold of each basic capability. However, recent research has shown that Sen's capability approach is able to address these issues. In short, the basic capabilities and the minimal and sufficient levels of each basic capability can be selected by people themselves.

Philosophers, on the other hand, such as Arneson, argue that the feature of sufficient threshold embedded in Sen's capability approach would (i) lead to a situation in which too many social resources are devoted to vulnerable groups;(ii) set the proper level of threshold arbitrarily; and (iii) pay no attention to inequality above the threshold (Arneson 2000, 2006). To some extent, Sen's capability approach can be understood as a sufficientarian approach, but it is not vulnerable to Arneson's criticism. Philosophers also question Sen's ambition of allowing people to choose basic capabilities on their own, for a list of basic capabilities chosen by people could be an outcome of selection bias. However, I have shown that Sen's reply to selection

bias is convincing.



## Chapter Six

### **An introduction of microfinance: the concept and the recent trends in microfinance business**

Microfinance – a practice involving the provision of small loans to people without conventional collateral and other financial services such as microsavings and microinsurance – has received huge attention over the past 30 years. Having access to financial services may be taken for granted by people who have decent work with decent pay. However, for the 1.4 billion people who live on less than \$1.25 a day<sup>35</sup>, access to financial services is a luxury that they cannot even dream of. According to the Asian Development Bank (ADB), in the Asian and Pacific region alone, over 900 million people have consumption levels below \$1 a day.

Poor households are typically excluded from formal financial services due to the high interest rates, collateral requirements, complicated application procedures, and a great deal of red tape on admissions processing. However, several microfinance institutions operating with different innovative microfinancing models show that to the lending to poor without collateral is feasible and that keeping high repayment rates is possible if microfinance institutions are adequately designed.

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<sup>35</sup>[The World Bank, 2007, Understanding Poverty](#)

Academics, social activist entrepreneurs and economists from the entire world have been fascinated by these innovative models. Some (Eijkel, Hermes, and Lensink 2007; Ghatak 1999; Tassel 1999; Stiglitz 1990; Che 2002; Besley & Coate 1995) focus on the non-traditional contracts used to compensate for risks and to address information problems faced by the microlenders. Other literature (Adams and Von Pischke, 1992; Lipton, 1996; Wiggins and Rogaly, 1989; Hulme and Mosley 1996) considers microfinance as a more efficient mechanism than state-owned enterprises to provide insurance, loans, and electricity in low-income economic markets. Others focus on the social impact of microfinance, examining how microfinance reduces or alleviates poverty, inequality between men and women and between the poor and poorest, and the trade-off between sustainability and outreach to the poor (which will be discussed in chapter 6). Still other literature (Egli 2004; Aleem 1990; Boot 2000; Tedeschi 2006; Bhole & Ogden 2009) concentrates on developing innovative techniques of loan repayment. Though much has been done, interest in this topic continues to grow. Moreover, the United Nations pronounced 2005 as the Year of Microcredit. As of 2009, microfinance has spread to cover five continents and numerous countries. The Grameen Bank model alone has been duplicated in Bolivia, Chile, China, Ethiopia, Honduras, India, Malaysia, Mali, the Philippines, Sri Lanka, Tanzania, Thailand, the United States, and Vietnam. By the end of 2007, about 3,316 microfinance institutions

served some 155 million clients in nearly 100 countries (Daley-Harris 2009).

This chapter aims at dealing with the concept of microfinance and bringing out its important features as well as the recent trends in microfinance business. In particular, the aspects discussed in this chapter include the roots of microfinance, the mechanism to tackle asymmetric information and high administrative costs, the paradigm shifts of microfinance, microfinance products, major types of microfinance institutions, and the objections to microfinance institutions.

### **6.1 The roots of microfinance**

Microfinance has existed for a long time. For example, some suggest that the concept of microfinance can be traced back to the middle of the 18th century when the lawyer and political philosopher Lysander Spooner suggested that giving small loans to entrepreneurs and farmers can be an approach to helping people out of poverty. The concept of microfinance might also have been founded when the author and nationalist Jonathan Swift started to provide a small amount of capital to the poor of Dublin (Hollis and Sweetman 2004). Although microfinance has been in existence for more than 200 years, it did not have a big impact until the end of World War II.

Today 'microfinance' refers to a practice of offering poor people access to basic financial services such as loans, savings, money transfer services and microinsurance,

but it used to mean only microcredit, the extension to poor people of small loans for income-generating activities. It was in this form that it was introduced by Muhammad Yunus, the founder of Grameen Bank and Nobel Laureate, and some other organizations (such as ACCION International, SEWA Bank) in 1970s. Three factors brought the existence of these modern microfinance institutions: failure of agricultural credit, formal financial institutions' reluctance to lend to the poor, and ineffectiveness of informal financial providers. I now enlarge on these in turn.

### **6.1.1 Failure of agricultural credit**

In the 1950s, international donors and governments believed that economic development was the key to reducing poverty, and providing poor people with cheap credit was the right way to boost the economy of developing countries. Agricultural Development Banks (ADB) were made responsible for delivering cheap credit to the rural poor from the 1950s to 1980s. Initially, the approach of delivering cheap credit to the rural poor seemed to be working; however, several factors made this approach fail. First, in order to receive international aid, governments often exaggerated the returns of their creditors. In most cases, the calculations of returns were deliberately based on agricultural yields for good years (Adams and Von Pischke, 1992). Second, poor people are likely to borrow money without properly considering their financial

conditions because their outstanding loans would usually be waived during the election period (Adams and Von Pischke, 1992; Lipton, 1996; Wiggins and Rogaly, 1989). Third, inconsistent ideas between governments and international donors, together with poor investment decisions and low repayment rates, made many development finance institutions unable to sustain their lending programs. Fourth, development finance institutions were insufficiently involved in the process of planning, formulating, and implementing these projects (Waddimba 1979; Wolfe 1981; Rehnema 1992).

### **6.1.2 Reluctance to lend to the poor**

The second factor that led to the founding of modern microfinance institutions was that formal financial institutions were reluctant to lend money to the poor. However, such reluctance seems to be against the principle of diminishing marginal returns to capital<sup>36</sup>. As Armendáriz and Morduch have pointed out, based on the ‘principle of diminishing marginal returns to capital’ (2005:5), enterprises set up by the poor should be more profitable because the marginal return (high interest rate) of poorer enterprises is high; therefore not only should formal financial bodies actively get involved, but, in theory, capital around the world should flow to this informal credit

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<sup>36</sup> Samuelson & Nordhaus define the principle of diminishing marginal returns to capital as follows (2001:110): [I]n all productive processes, adding more of one factor of production, while holding all others constant, will at some point yield lower per-unit returns.

market. Such a movement seldom happens in the real world, for the cost of lending money to poor people is so high that formal financial institutions are not interested in participating in an informal credit market.

Generally there are three kinds of costs that any microfinance institution has to address when granting poor micro-loans: the cost of loan defaults, the cost of searching trustworthy borrowers, and the administrative costs. The cost of loan defaults is high, for poor people usually have low incomes and do not have stable income resources and collateral. If banks want to lend money to the very poor, who put up no collateral, they must be able to find creditworthy poor borrowers. However, the cost of searching for creditworthy poor borrowers is extremely high, for banks do not have information as to who is creditworthy. In other words there is “asymmetric information” in which one party has more or better information than the other. Typical problems associated with asymmetric information are ‘adverse selection’ and ‘moral hazard’ (Hulme and Mosley 1996; Yuwa, Bosee, Asgar 1997; Armendáriz and Morduch 2007). Adverse selection refers to the situation in which only risky clients, who probably will not pay back loans, will choose to access micro loans. ‘Moral hazard’ refers to the result of maximization behavior in which a person calculates the costs and benefits of an action and takes an action if benefits exceed costs<sup>37</sup>. For

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<sup>37</sup> The way economists use the term ‘moral hazard’ has nothing to do with ‘moral’ in the sense of ethics.

example, if a person buys insurance against burglary, he may be less cautious about locking his house. In the case of microfinance, the moral hazard is that poor clients may not try hard enough to realize their business goals and to pay back their loans because the costs of failing to pay back a loan are trivial. Since the cost of acquiring and evaluating information on poor clients is extremely high, the only available solution for formal financial institutions is to ask poor borrowers to offer marketable assets as collateral. However, as we have already learned, extremely poor borrowers are too poor to have marketable assets. As a result, only very few poor people, who luckily have marketable assets, are able to access formal financial services.

Formal financial institutions not only have to deal with the high cost of acquiring and evaluating information on poor clients; they also have to deal with high administrative costs including the costs of appraisal, documentation disbursement, and branch manager supervision since in many developing countries poor people often live in remote areas which are far away from banks. These clients also have difficulties in filling out various forms and applications. Taken together, the lack of stable income and collateral and the informational asymmetry (adverse selection and moral hazard) and high administrative costs result in formal financial institutions withdrawing from informal financial markets.

### **6.1.3 Ineffectiveness of informal financial providers**

The third factor that led to the founding of modern microfinance institutions is that informal financial service providers are of limited help in providing financial services to poor. Traditionally, informal financial services are offered by private moneylenders and various kinds of community-based financial organizations:

#### **a) Moneylenders**

Today, moneylenders are still seen as an important source of money for short-term financial difficulties by borrowers who would be rejected for loans or credits by formal financial institutions. However, moneylenders are often labelled as ‘loan sharks’, for abusive lending and collection practices; therefore people usually see moneylenders as a last resort in solving their temporary financial problems (Rowlingson 1994). Moneylenders often charge high interest rates; over 100 percent annual interest is not unusual even in developed countries. For example, in a country like the United Kingdom, some moneylenders even charge between 8000 and 12,000 percent annual interest rates<sup>38</sup>. However, we should not ignore the advantage of borrowing from moneylenders. That is moneylenders lend clients money without credit approval and loan processing. But after paying back the principal and a large amount of interest, clients may be no better or worse off than before taking out the

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<sup>38</sup><http://www.dailymail.co.uk/femail/article-1094717/They-charge-150-000-turn-violent-fail-pay-But-recession-bites-loan-sharks-making-killing-.html>



loan. Although many countries<sup>39</sup> started to legalize moneylenders and to implement ‘consumer protection laws’ to prohibit various predatory lending and collection practices from the 1970s, interest rates remain extraordinary high<sup>40</sup>. However, most developing countries still do not have consumer protection laws, which means that when poor people borrow money from moneylenders, they are at risk of being exploited by various predatory lending and collection practices.

**b) Community-based groups: Rotating Savings and Credit Associations (ROSCAs)**

Community-based financial organizations are self-help groups and do not have professional management. Some common forms of community-based financial organizations are rotating savings and credit associations (ROSCA) and credit unions. In a ROSCA, people form a group, deciding how often and where they will meet, how much they have to contribute at each meeting, and who will receive the total amount collected. When every group member has received funds from the group on time, the cycle is complete. The group dissolves and may or may not reorganise. For example, a group of 20 persons may contribute \$10 per month for 12 months. The \$120 collected each month is given to one member; therefore, a member will lend money to

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<sup>39</sup> the United States, Canada, the European Union, South Africa, Japan, Korea, Taiwan, Singapore, and Some South American countries (such as Peru, Bolivia, and Colombia).

<sup>40</sup> According to Grameen foundation, while MFIs charge people from 18%~60%, moneylenders charge people from 120%~300%.  
See : [http://www.grameenfoundation.org/what\\_we\\_do/Microfinancemicrofinance\\_in\\_action/faqs/](http://www.grameenfoundation.org/what_we_do/Microfinancemicrofinance_in_action/faqs/)

other members through her regular monthly payments. Once she receives the lump sum amount when it is her turn, she then pays back the amount in regular monthly instalments.

The advantages and disadvantages of setting up a ROSCA can be summarised as follows (Bouman 1979, 1995; Armendáriz and Morduch 2007:67-68). First, it serves as an intermediate means of smoothing temporary financial difficulties and allows people to save their money and in the meantime keeps such savings flowing. Second, it generates a lump sum of money, which allows for higher investment to be made earlier than the accumulation of saving. Third, profits and other returns on accumulated contributions are equally distributed to all members. Fourth, unlike moneylenders, ROSCA does not charge high interest. Finally, the risk of defaults is shared by all members, thus setting up peer pressure to ensure that all members pay their money on time. The drawbacks of ROSCAs are that, first, although members can exert some pressure on each other, it lacks an effective mechanism for enforcing repayment so that members always face a risk of mismanagement, fraud and bankruptcy by the organiser if he absconds with the accumulated contributions. If 10 people organize a ROSCA during a harsh economic period, the member who has the priority to win the pot is likely to refuse to make contributions in the later period. In other words, the mechanism for enforcing repayment is trust: each member of a

ROSCA believes that every member will pay on time. However, when members get more and the social structure becomes more complicated, such trust would easily be compromised in that people have difficulty in knowing each other. Second, the timing of the receipt of funds by a member may not necessarily tally with her need for money. Third, ROSCAs lack flexible savings. The money that a member can save is fixed. A member cannot save if she has extra funds. Fourth, since the process of selecting members of a ROSCA is based on ethnic or geographical considerations, a ROSCA is difficult for outsiders to get funds from, so that it has difficulty in expanding its size and is vulnerable to economic uncertainty if its members encounter great economic hardship.

### **c) Credit Unions**

The term ‘credit union’ refers to a cooperative financial institution that ‘is owned and controlled by its members and operated for the purpose of promoting thrift, providing credit at reasonable rates, and providing other financial services to its members’<sup>41</sup> A credit union often consist of 30 to 100 members. Credit unions may use members’ savings to secure a loan, or may require some form of collateral to guarantee loans. The collateral might be a small household asset, such as a bicycle, a cow or a goat.

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<sup>41</sup> CUNA Model Credit Union Act § 0.20 (2007):  
[http://www.cuna.org/gov\\_affairs/legislative/fli\\_briefing.html](http://www.cuna.org/gov_affairs/legislative/fli_briefing.html).

Credit unions rely mainly on their knowledge of the individual member and local environment to make sound loan approval decisions. The loan committee may advise the lender to revise his or her business idea before a loan is granted. Credit unions can mobilize local financial resources more effectively than ROSCAs, have better flexibility of savings, and, most importantly, have better interest rates than banks. Although the notion of a credit union has been applied worldwide<sup>42</sup>, two serious drawbacks can be found in most credit unions: the lack of a professional management structure and an inability to access external funds. The phenomenon of lacking professional management structure is common to many credit unions, for the people operating credit unions are chosen from members. Because the size of a credit union is small, it allows members to control the credit union themselves which is seen as an efficient way of management, for not only do members have better information as to who is trustworthy, but they voluntarily contribute all or part of their time to run their credit union. However, when the size of a credit union becomes larger, allowing members to control the credit union themselves becomes a problem. Members often do not have enough knowledge to deal with agency issues such as forming contracts in which the interests of the principal are protected nor the setting and monitoring fees, nor collecting and processing information (Adams 1995: 5). Moreover, because of the

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<sup>42</sup> According to the World Council of Credit Unions, there were 46,377 credit unions in 97 countries which served 172 million retail members and oversaw US \$1.1 trillion in assets: [www.woccu.org](http://www.woccu.org)

weak governance of credit unions, they are susceptible to difficult natural and social circumstances. As Adams notes,

They [credit unions] typically have thin capital bases, often lack access to funds to meet liquidity shortfalls, have difficulties diversifying their risks, are easily crippled by inflation, and are quickly damaged when their members have economic reverses. Credit unions also face dilemmas as they grow: they lose their informational advantages, they are forced to rely on paid rather than voluntary managers (Adams 1995:11).

To sum up, development agencies, governments, and even private money lenders have experimented over the past three decades with a variety of methods to provide the poor with money to meet their urgent needs and to help them establish microenterprises, but none of them can serve as an adequate model of microfinance. Fortunately, microfinance and development experts have learned lessons from these traditional financing sources. From government and donors, they have learned that giving poor concessional loans does not work due to poor repayment discipline and the funds often ending up concentrated in the hands of those who are better-off. From moneylenders, microfinance and development experts have learned that easy and quick access to credit is important and that the poor have the ability to pay high interest rates. From ROSCAs and credit unions, microfinance and development experts have learned that the poor can save small amounts of money on a regular basis. Peer pressure works to enforce agreements made by the group and the poor are

capable of self-managing their groups.

To say that traditional financing sources failed to provide poor people with micro-credit does not mean that they no longer play important roles in microfinance. Instead, they have also transformed and adapted themselves into a specific local environment based on a series of innovations. As we will see in the next section, several new types of microfinance institutions built on lessons learned from traditional financing methods have come up with several innovative mechanisms to reduce the transactions costs associated with the cost of identifying and screening the client, and the administrative costs.

## **6.2 The mechanisms to tackle asymmetric information**

### **6.2.1.1 Solidarity group lending with joint liability**

To reduce transaction costs caused by asymmetric information associated with adverse selection and moral hazard, microfinance institutions must secure a high percentage of loan repayment. For this purpose microfinance provides a unique lending method – that is, solidarity group lending. Solidarity group lending is a method by which borrowers form a group (usually of between three and six people who are not relations), in which each member agrees to guarantee the loans of the

other in the group<sup>43</sup>. Under such a lending method, potential borrowers have to form groups themselves (usually 5 members as a group). Moreover, each member is liable for the other's loan. Further, all other members will be punished if one of the members does not repay. The typical punishment is to exclude the entire group from further loans. Although only 16 percent of microfinance institutions have adopted this group lending method, they serve more than two thirds of clients from all microfinance programs (Eijkel, Hermes, and Lensink 2007).

How does the solidarity group lending approach reduce the risks of adverse selection and moral hazard? Many microfinance experts have provided theoretical explanations (Ghatak 1999; Tassel 1999; Stiglitz 1990; Che 2002; Besley & Coate 1995). The answer lies in its features of self grouping and peer pressure. As has been discussed earlier, adverse selection problems occur when lenders do not have enough information to differentiate risky clients from safe clients. By encouraging people to form groups themselves (self grouping), MFIs can reduce adverse selection because borrowers have information about who among the people they know is reliable. Moreover, the peer pressure brought by self grouping reduces moral hazard because joint liability forces members to monitor each other and punish any member who does

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<sup>43</sup> Solidarity group lenders can be further differentiated into Latin American solidarity group lending and Grameen Bank solidarity group lending. The main difference between them is that the Latin American solidarity group model chose to retain loan approval and administration, using the already-existing operational systems developed for individual lending; second, Latin American solidarity groups are much more focused on the provision of credit than the more socially-oriented aspects of the Grameen model. The Latin American methodology is a minimalist approach, that is, institutions that follow this model often offer only credit services.

not pay her loan on time. In short, by forming people into small groups, microfinance institutions can ensure a maximum level of joint responsibility and discourage free riders, preventing the misfortune or incompetence of one person from causing the group to collapse.

### **6.2.1.2 Empirical evidence**

Does the solidarity group lending method work in terms of securing high repayment rates? Empirical studies indicate that the impacts of solidarity group lending with joint liability on repayment have been mixed. As Conning (1996) notes, “...group lending programs have been quite successfully implemented in the Cameroon, Malawi, South Korea, Malaysia and Bangladesh but similar schemes have had problems in India, Egypt, Venezuela, Kenya and Lesotho”<sup>44</sup>. Besley and Coate (1995:1-18) suggest that two factors play important roles in effectively applying solidarity group lending with joint liability schemes: social sanction and monitoring cost. That is to say, the stronger the social sanction and the lower the monitoring cost, the better repayment rates. Moreover, those case studies showing a positive impact of solidarity group lending with joint liability have not been considered as reliable empirical investigations by many researchers, due to their failure to address selection

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<sup>44</sup> Quote from Pitt and Khandker (1996), Household and Intra-Household Impacts of the Grameen Bank and Similar Targeted Credit Programs in Bangladesh



bias and their failure to distinguish between whether a borrower defaults strategically or because of insufficient funds (Tassel 1999; Armendáriz and Morduch 2005). Simply making a comparison between an MFI employing solidarity group lending and an MFI that does not -- without taking note of the differences associated with application criteria, the characteristics of target clients, and institutional ability-- will not generate a reliable estimator. In order to have a reliable estimator of the impact of solidarity group lending on repayment rates, many suggest that the measurement should be conducted through a randomized field experiment in which the targets of microfinance programs are chosen randomly (Hisaki 2006; Gine and Yang 2009). Surprisingly, in their case study on Malawi, Gine and Yang (2009) claim that solidarity group lending does not effectively reduce adverse selection, moral hazard, and strategic default. Similarly, Hisaki's (2006) case study in Vietnam also suggests that solidarity group lending can cause serious free-riding problems leading to strategic default and low repayment rates.

Solidarity group lending has encountered several problems other than selection bias. First, it may be difficult to ask clients to do something which is considered a microfinance institution's responsibility. For example, in their case study in Bolivia, Ladman and Afcha (1990) show that it is difficult to find potential clients to volunteer to be the group leaders who spend so much time on arranging group meetings and

monitoring their group members. The cost of monitoring and enforcing contracts can be costly, even when group members live in close proximity.

Second, peer pressure can bring too many or too few social sanctions to the members who fail to repay loans. On the one hand, peer pressure can bring serious harm to defaulters. For example, in BRAC Bank's own research document, Khan and Stewart (1992) find that defaulters have been forced to give their assets (such as livestock and cooking pots) away to cover their outstanding loans<sup>45</sup>. As a result, poor defaulters' lives are made even worse. In an extreme case, peer pressure may force defaulters to commit suicide. For instance, in Bangladesh, several defaulters committed suicide which was allegedly caused by having too much peer pressure from other group members (Hulme and Mosley 1996). Again, peer pressure can be compromised by members' close relationships. Members of a group can even collectively refuse to pay back their instalments to microfinance institutions.

Third, the group contract can easily collapse when group lenders encounter unforeseen disasters. For example, when a severe flood hit Bangladesh in 1998, thousands of Grameen Bank members had great difficulty paying back their loans because most of their properties were simply swept away. To help borrowers to restart their income generating activities or rebuild their houses, Grameen Bank decided to

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<sup>45</sup> Cited from Montgomery, R. 1996, 'Disciplining or protecting the poor? Avoiding the social costs of peer pressure in micro-credit schemes', *Journal of International Development*, 8(2), 289-305.

issue fresh loans. However, having fresh loans means extra financial burdens. As a result, group members withdrew from their weekly meetings and stopped paying back their loans. To solve this problem, Grameen Bank changed their lending method from group lending (GCS Grameen Classic System) to individual lending (GGS Grameen Generalised System) in 2002. Under the GGS, clients can have loans that have any kind of duration (such as, 3 months, 6 months, 9 months or any number of months and years) individually and can regularly upgrade their loan sizes if they keep repaying their loans on time. But if borrowers have trouble repaying their loans, their loans will be transferred to 'flexible loan', which allows clients to reduce the instalment size by extending their loans period.

Fourth, the group lending method is not as profitable as the individual lending method; therefore it is unattractive to microfinance institutions which consider that being self-sustaining is an essential objective (Armendáriz and Morduch 2000, 2004; Cull, Kunt, and Morduch 2007). Individual-based clients not only provide microfinance institutions with substantial loans and higher average profit levels, but they produce a much lower administrative cost than that of group-lending customers. For example, if the average administration cost per client is \$1, then the cost of lending a person \$1,000 will be very different from the cost of lending 100 clients \$1,000. While the former costs only \$1, the latter costs \$100.

Although, on a theoretical level, solidarity group lending with joint liability seems to be seen as an effective approach to high repayment rates, recent empirical studies seem to suggest there is a mixed result as to its impact on repayment rates. A possible explanation is that unless social sanctions are sufficiently strong, group lending may cause greater problems of strategic default and free-riding. Such an explanation implies that if a microfinance institution has clients who are unable to impose enough social sanctions on one another, then it should apply individual lending mechanisms. These empirical studies propose a possible explanation of recent shifts by microlenders from group-based mechanisms to individual lending approaches, for there is no change in default rate between individual lending and solidarity group lending. Moreover, group lending has difficulty in addressing and coordinating divergent individual specific needs. Finally, group lending is not as effective as individual lending in terms of supporting maturing clients seeking larger loans, allowing microfinance institutions to earn higher profit. For these reasons, many microfinance experts suggest that solidarity group lending does not appear to be a necessary component of the microfinance model and that several other lending mechanisms can be used with or without solidarity group lending.

### **6.2.2 Why do microfinance institutions prefer female clients?**

Many microfinance experts and practitioners not only argue that solidarity group lending can significantly reduce adverse selection and moral hazard, but also suggest that MFIs should target female borrowers. Why are most clients women when microfinance institutions adopt a solidarity group lending approach? One reason is that women are more reliable clients, because some say they succumb more easily to peer-pressure (Kevane & Bruce 2001; Hossain 1998; Khandker et al. 1995; Hulme 1991). Thus, from a financial point of view, it is better for microfinance institutions to invite women to solidarity group lending groups. For example, Hossain (1988) argues that in Bangladesh 81 percent of female borrowers had no repayment problems versus 74 percent of male borrowers in 1984/85. Similarly, Khandker, Khalily, and Khan (1995) find that 15.3 percent of male borrowers were struggling, whereas only 1.3 percent of women were having difficulties.

The other reason for microfinance institutions to favour female clients is that they believe that granting women funds may have a stronger positive impact on development. But why does the practice of granting women microloans deliver a stronger impact on social development? One reason is that targeting women increases the impact of microfinance institutions because women are more likely than men to invest their earnings in better health and education for the whole household (Thomas,

1990; Behrman & Rosenzweig, 2002). I return to this shortly. Furthermore, enhancing women's economic role through microfinance may increase their social status within the society, leading to greater gender equality (Hashemi et al. 1996). A study done by the World Bank indicates that discriminating against women brings greater poverty, slower economic growth, weaker governance, and a lower standard of living<sup>46</sup>. Thus, making women more economically productive increases the opportunity cost of their time, which tends to reduce their fertility and can gradually induce behavior that leads to qualitative improvements for the smaller family (Rankin 2002). For instance, a report (State of the World's Children) by UNICEF (United Nations International Children's emergence) suggests that if women had larger decision-making roles in more families, there could be a 13 percent reduction in malnutrition in some areas.

Another reason for microfinance institutions to target women is that women are more likely to channel their earnings into food, medical care, and education for their family. For example, according to Women's Entrepreneurship Development Trust Fund (WEDTF) in Zanzibar and Tanzania, while 55 percent of a female's increased income is designated to purchase household related items, 18 percent and 15 percent are spent on education and clothing (Cheston & Kuhn 2002). Another study conducted

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<sup>46</sup> World Bank, *Engendering Development: Through Gender Equality in Right, Resources, and Voice – Summary* (Washington, D.C.: World Bank, 2001): [www.worldbank.org/gender/prt/endendersummary.pdf](http://www.worldbank.org/gender/prt/endendersummary.pdf).

by Chant (1997) indicates that women living in Latin America spend a greater percentage of their income on their families than men do. While male clients contribute 50 percent of their income to households, females spend 68 percent of their income.

The final reason why microfinance institutions target women is that women are still the poorest of the world's poor. In its 1995 Human Development Report, 70 percent of the 1.3 billion people living on less than \$1 per day were women<sup>47</sup>. Moreover, according to the World Bank's gender statistic database, women have a higher unemployment rate than men in literally every country<sup>48</sup>. These statistics provide microfinance institutions a strong moral ground to give priority to increase women's access to microloans in the sense that women in general are more disadvantaged than men.

### **6.2.3 Dynamic incentives**

#### **5.2.3.1 Types**

One of the main tasks of MFIs is to create dynamic incentives for borrowers to pay back loans. To do so, several lending methods associated with dynamic incentives have caught the attention of researchers and practitioners: progressive lending,

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<sup>47</sup> UNDP, *1995 Human Development Report* (New York, UNDP, 1996:4).

<sup>48</sup><http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/AFRICAEXT/EXTAFRREGTOPGENDER/0,,contentMDK:22616451~pagePK:34004173~piPK:34003707~theSitePK:502360,00.html>

non-refinancing threat lending, flexible group lending, and Sequential lending.

**a) Progressive lending**

The first form of dynamic incentives is progressive lending, through which ‘a typical borrower receives at first very small amounts, which increase with good repayment conduct’ (Egli 2004:505). The main idea behind progressive lending is to induce borrowers to repay by offering larger loans as a reward, for a normal initial microfinance loan is tiny, usually 2000 Taka (\$27), and borrowers have substantial needs for further loans to develop their ongoing projects. In progressive lending, microfinance institutions target individuals rather than groups. According to Morduch (1999), progressive lending has become a popular practice among well-established microfinance institutions (Grameen Bank, Banco-Sol, Bank Rakyat, Badan Kredit Desa, FINCA Village Banks). Three advantages can be found when microfinance institutions apply progressive lending (Armendáriz and Morduch 2005:125). First, progressive lending reduces the average cost of lending. Generally, the cost of filling in an application form will be no different between a person who wants to borrow \$10 and a person who wants to borrow \$1,000. Thus, if the cost of filling in an application form is \$1, then the cost of lending \$1,000 to 10 clients will be ten times higher than the cost of lending \$1,000 to one client. Second, it enables the lender to ‘test borrowers with small loans at the start in order to screen out the worst prospects



before expanding the loan scale'. Third, it increases 'the opportunity cost of non-repayment'; thus, discouraging strategic default even further. Morduch, however, reminds us that progressive lending could encounter strategic default. That is, borrowers might plan to default when the loan size has grown substantially. MFIs need to guard against this.

#### **b) Non-refinancing threat lending**

Non-refinancing threat uses the threat of non-refinancing if borrowers fail to repay their current loans. To make such a lending method work, Aleem (1990) and Boot (2000) suggests that microfinance institutions have to assure that they have relatively stronger market power and that the existing borrowers do have continuing demand for and do not contract new loans with other lenders.

#### **c) Flexible group lending**

As has been discussed earlier, solidarity group lending requires that all members of a solidarity group have to repay their loans on time. If one of them defaults and others are not able to pay that defaulting loan, then the whole group will be denied to access future loans. Many, however, argue that such a practice is not necessary for inducing borrowers to repay, suggesting that some flexibility can be introduced to solidarity group lending (Tedeschi 2006; Bhole & Ogden 2009). Under flexible group lending, whether a borrower can obtain her future loans and what size of loans she could have

depends not only on group performance but also on her individual performance. Moreover, it can prevent borrowers committing strategic default, generating higher expected welfare for borrowers than individual lending.

#### **d) Sequential lending**

Another form of dynamic incentives is sequential lending. Suppose that five people voluntarily organise a solidarity group. Under a sequential lending scheme, two members receive their loans first. If they pay their instalments on time over four/six weeks, two other members will receive their loans. If these four members continue to pay their instalments on time in the next four/six weeks, the last member – the group chairperson – will receive her loans. When serious repayment problems arise, the formal sanction of group lending is that all group members will be banned from future borrowing. Many suggest that under weak official contract enforcement, sequential group lending has higher repayment rates than either simultaneous group lending or individual lending (Chowdury 2005; Sinn 2009). However, in reality only few MFIs engage in such a practice, for borrowers do not like to wait for a long time. Moreover, borrowers with a good credit record are less likely than others to participate in sequential group lending since they can obtain loans themselves relatively easily. As a result, very few borrowers have an incentive to join sequential lending groups (Kono & Takahashi 2009).

### **6.2.3.2 Empirical evidence on dynamic incentives**

The only dynamic incentive scheme to have been subject to randomized control study is progressive lending. Empirical studies seem to suggest that progressive lending is not only sustainable, but that loans increase substantially overtime. For example, in their field study in Guatemala's FUNDAP<sup>49</sup>, Kevane and Wydick (2001) found that the size of loan increases 85 percent (from \$ 1,033 for the first loan to \$1,916 for the last loan). Similarly, in his report, Robinson (2001) reports that 12 out of 18 loans in different countries and programs have risen up to 200 percent of the initial loan. Progressive lending not only works for solidarity group lending, but for individual lending once borrowers have matured and sought larger loans.

As for the non-refinancing threat, although so far there does not exist any empirical survey investigating the correlation between a non-refinancing threat and repayment rates, nearly all moneylenders surveyed by Aleem (1990) consider the non-refinancing threat as a powerful weapon. This indicates the need of establishing credit bureaus by which any borrowers committing strategic default will be excluded from microlending services. A credit bureau, also known as a credit reference agency, is an organisation providing information relating to individuals' histories of borrowing and loan payment. By accessing a credit bureau, lenders are able to assess whether a

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<sup>49</sup> [http://www.fundap.com.gt/main.php?parent\\_id=0&id\\_area=26](http://www.fundap.com.gt/main.php?parent_id=0&id_area=26)

borrower's credit is trustworthy and therefore can reduce chance of granting loans to risky borrowers.

#### **6.2.4 Frequent repayments**

The other mechanism used by MFIs is frequent repayment, which is a very common practice both in formal and informal credit markets. In microcredit, repayments can be weekly or monthly, depending on the income flow of the borrowers. According to Armendáriz and Morduch (2005:130-132), the advantages of using weekly instalments are that: first, they serve as an early warning device by which MFI officers can notice their clients' problem at an early stage, enabling them to take any adequate measures. Second, they allow MFIs to select less risky borrowers. Since the repayment is frequent, borrowers must have some other stream of income on which to draw in order to repay the early instalments. Third, it serves as a saving device for helping borrowers who have difficulty in saving money due to 'self-control problems or pressures from neighbors and relative for handouts or from their spouse for spending on drinking and smoking' (Kono & Takahashi 2009:45-46).

One of the most reliable empirical studies relating to the impact of frequent instalments on repayment rates can be found in Michal, Chytilova, and Morduch's study (2008) in India. They find that female borrowers who have hyperbolic

discounting preferences( are more impatient now than in the future and have difficulty saving money) are more likely to participate in microcredit, which is consistent with the theoretical prediction that frequent instalment brings higher repayment rates. Moreover, a frequent instalment schedule (weekly and monthly) helps borrowers to discipline their financial lives. Although this result suggests the importance of frequent repayment for borrowers to address saving constraints, it is still not clear how frequent the repayment should be. While high frequency instalments provide higher repayment rates, they also inflict higher transaction costs both on borrowers and lenders. To investigate whether requiring less frequent instalment makes it difficult for borrowers to deal with saving constraints, Filed and Rohini (2008) randomly adjusted borrowers' repayments from weekly to monthly. According to their report, there are no significant difference in repayment between the group having weekly instalments and the group having monthly repayments. This implies the possibility of reducing transaction costs without reducing repayment rates via an adjustment of the frequency of instalments.

### **6.2.5 The requirement of non-traditional collateral**

As has been discussed earlier, a client needs to provide collateral when borrowing money from formal financial institutions. Moreover, the collateral that a client

provides must either exceed or be equivalent to the loan. In the group lending method, joint liability often serves as collateral, but under a non-traditional collateral approach, collateral could be any item that is important to the household regardless of its market value. This may include the borrower's sole domestic animal, land that is not secured by title, degree certificate, driving licence, marriage certificate. None of the items could be sold for profit without significant transaction costs to the MFIs, but they would be even more difficult and costly for the borrower to do without. In other words, what matters most is the value the borrower attaches to losing the item rather than what the lender expects to recover from selling them. The Bank Rakyat Indonesia (BRI) is a leading microfinance institution and, as one of five state-owned foreign exchange commercial banks in Indonesia, has been effectively using this approach for many years. As of December 2003, BRI's microloans amounted to about Rp.18,146 billions and the repayment rate was 99.4 percent<sup>50</sup>. The non-traditional collateral approach, indeed, is philosophically interesting, because it shows that some collateral is not an asset –i.e. does not add to the value of just anyone's possessions.

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<sup>50</sup> [http://www.bwtp.org/arc/indonesia/II\\_Organisations/MF\\_Providers/BRI.htm](http://www.bwtp.org/arc/indonesia/II_Organisations/MF_Providers/BRI.htm).

### **6.2.6 Compulsory savings**

Another way to secure loans is to require a borrower to transfer a certain percentage of her loan into her savings account as collateral at all times. Such a practice has been considered an effective tool to secure a high repayment rate by many microfinance institutions, for their savings portfolios have been expanded rapidly for the last couple of years. For example, SafeSave<sup>51</sup>, a microfinance institution in the slums of Dhaka, requires that 1/3 of a borrower's loan has to be put in her savings account as collateral at all times. The savings and loan portfolios, which had increased by 24% and 23% between June 2005 and June 2006, have further increased by 17% and 9% between June 2006 and June 2007. As of 2007, clients had a total of 19,735,687 Taka deposited with Safesave. Loans outstanding numbered 7,908 (up by 2% from June 2006) and totalled 30,013,388 Taka (\$ 416,852). To take another example, at Grameen Bank, borrowers have had to deposit between 5 and 50 taka per week into obligatory personal savings accounts since 2003. In particular, when a loan is less than 8,000 taka (about \$145), Grameen Bank requires a client to open a personal savings account and a special savings account. As for the personal savings account, a client has to deposit 2.5 percent of her loan into this account, but she can withdraw whatever she likes for any purpose. Moreover, a deposit earns fluctuating interest at 8.5 percent. As

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<sup>51</sup> see its web page: <http://www.safesave.org/>.

for the special savings account, it requires a client to deposit 2.5 percent of her loan for three years before it can be liquidated. After three years a withdrawal may be made, subject to a minimum balance of 2,000 taka (about \$30). The account pays the same interest as the personal account. If the loan is larger than 8000 taka, Grameen Bank requires the client to open a Grameen Pension Savings (GPS) account. GPS is a commitment-savings account based on the commercial banks' 'Deposit Pension Scheme', which has long been popular among middle and wealthy classes in Bangladesh. Under GPS a fixed sum per month, minimum 50 taka (less than \$1) is deposited for a five or a ten year term. At maturity depositors get back their deposits with interest, and they may take this accumulated lump sum in cash or leave it on deposit with the bank and take interest earnings each month as income. GPS is no longer limited to borrowers; it is now available to employees of the bank as well. As of 2005, Grameen's savings portfolio had expanded significantly from \$146 million in mid 2002 to \$344 at end 2004 (Rutherford 2006).

To summarize, I have shown that group lending is just one of the mechanisms to secure high repayment rates. Several other devices (including targeting of female borrowers, progressive lending, and repayment with weekly instalments) also make microfinance work effectively. In fact, several well-known microfinance institutions such as Grameen Bank and BancoSol that used to defend group funds have abandoned



group lending. Such a change of lending method reflects a growing split within the microfinance movement. As a result, many microfinance institutions realise that the practice of granting the poor microloans does not necessarily involve ‘groups’ and high repayment rates can be secured when dynamic incentives, frequent instalment, non-traditional collateral are properly incorporated into individual lending.

### **6.3 The mechanisms to tackle administrative costs**

Lending money to the poor involves not only the cost of acquiring and evaluating information on poor clients, but high administrative costs including group formation and training, loan processing, disbursement, monitoring and recovery.

#### **6.3.1 Incorporating existing banking practice into microfinance institutions**

In order to reduce high costs, many MFIs have incorporated existing banking practices into their day to day operations. They have started to take into account the following considerations: good governance, effective operational strategies, risk mitigation through internal control and external auditing, and human resource management (Hulme & Mosley 1996; Robinson 2001; Armendáriz and Morduch 2005).

Good governance involves institutional linkages and governing board. Regarding

institutional linkage, MFIs need to define procedures for owner control and select a management team professionally to run daily operations. As for a governing board, the boards of MFIs have to set out their objectives clearly, allocating clear functional responsibility to various members of the board.

Effective operational strategies require an MFI to provide a strategy that can provide long term direction, adapted to environmental conditions, and efficiently allocate and prioritise its limited resources.

Internal control and external audit also play important roles in the prevention and their detection of fraud. MFIs usually have appointed managers, who could misuse their resources to attain certain personal objectives instead of meeting the needs of the target group or maximizing profits. Thus, MFIs need to set up an effective control environment, undertake risk assessment, establish control policies, monitor operations and facilitate communication.

Human resource management also plays a significant role in reducing administrative costs, for MFIs heavily depend on their staff to implement their strategies, policies and daily operations. In order to assure employees can achieve various goals, four aspects associated with human resource management have to be considered:

- Recruitment: rigorous selection corresponding to job levels and aimed at minimising costs of replacement.
- Development: a formal training-needs assessment system, on the job training and refresher courses.
- Motivation: standard performance measurement, appraisal among a number of objective and subjective parameters and incentives linked to performance.
- Maintenance: training programs, fast track promotions and rewards for good performers.

MFIs not only learn lessons from successful commercial banks; they also implement various strategies based on profitable organizations to reduce their administrative costs. For example, SKS used branch expansion strategies borrowed from Starbucks' 'hub-and-spoke' model. More importantly, MFIs have started to introduce various new technologies to reduce high administrative costs. In the next section, these new technologies will be discussed in turn.

### **6.3.2 The introduction of new technologies**

The previous discussion shows that it is difficult to deliver microfinance services to poor people. Serving poor people requires microfinance institutions to overcome several obstacles, such as high transaction costs, moral hazard issues, and adverse selection problems, which have perplexed microfinance experts and practitioners for so many years. Several technologies have been introduced in the microfinance industry during the last decade in the hope that these barriers can be eliminated.

#### **a) Mobile phone technology**

One of the main obstacles excluding poor people from accessing microfinance services is the high transportation expenses of reaching banks. As Bob Christen<sup>52</sup> (2009) has pointed out “it costs a bank in developing regions around US\$1 to conduct a financial transaction at a teller’s window”, “it costs the customer between US\$1 and US\$5 in travel expenses to reach the bank”<sup>53</sup>. This indicates that there is lack of a motivation for either borrower or lender to get together. Currently, while about 3 billion people do not have bank accounts, 1 billion unbanked people have mobile phones<sup>54</sup>. If these 1 billion unbanked mobile phone users were able to access financial services, that could bring a tremendous positive impact on poverty reduction.

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<sup>52</sup> The Director of Financial Services for the Poor Development in Bill and Melinda Gates Foundation.

<sup>53</sup> Mobile Money Summit,

[http://www.mobilemoneysummit.com/mms\\_news\\_daily/mms\\_news\\_daily\\_5.shtml](http://www.mobilemoneysummit.com/mms_news_daily/mms_news_daily_5.shtml).

<sup>54</sup> <http://www.cgap.org/p/site/c/template.rc/1.26.10806/>

The provision of microfinance services through mobile phones can be divided into two categories: mobile banking and mobile payments services. While mobile banking services<sup>55</sup> are provided by partnerships owned by formal financial institutions and mobile operators, mobile payments services<sup>56</sup> are provided by partnerships owned by mobile operators and retailers. Mobile banking and payment services providers do not reach unbanked people by establishing their own branches. Instead, the mobile banking and payment service providers sign contracts with ‘bank agents’ (retail, lottery, and postal outlets), which in turn will provide banking services to poor people<sup>57</sup>. In other words, by combining bank agents and mobile phone technology, *a bank without branches* can provide financial services to unbanked people who subsist in rural areas<sup>58</sup>. Recently, several international mobile phone companies have joined with local formal financial institutions or mobile phone providers to start using mobile phone technology to deliver financial services to rural areas. For example, in October of 2009, Bank of the Philippine Islands (BPI) and Globe Telecom, the biggest telecom company in the Philippines, launched a mobile microfinance institution called Philipinas Saving Bank Inc. (PSBI), which is planning to provide \$ 10.8 million

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<sup>55</sup> Including “information (account balance retrieval, transaction history); transfers (transfers of money between accounts, including bill payments); Cash-in and cash-out services, deposits, withdrawals, remittances” (Nokia Expanding Horizons 2008/1: 3).

<sup>56</sup> Including “usage of prepaid or post-paid accounts for paying for goods and services, utilities, vending machines and so on; transferring value between prepaid and post-paid accounts” (Nokia Expanding Horizons 2008/1: 3).

<sup>57</sup> <http://www.cgap.org/p/site/c/template.rc/1.26.5205/>

<sup>58</sup> This approach can also be named as ‘partnership model’.

wholesale loans (\$ 10.8 million) to microfinance institutions. In Kenya, the largest local mobile phone provider (Safaricom) and Vodafone, the world leading mobile communication company, have launched a system providing subscribers with the services of transferring, saving, and withdrawing money. In South Africa, the well-known example is the virtual bank Wizzit, launched in 2005 by a group of entrepreneurs supported by the National Council of Trade Unions (NACTU) and major mobile operators in South Africa. Wizzit's customers can not only use their debit card to purchase and withdraw money from ATMs, but can also use their mobile phone to pay, transfer money, and even purchase pre-paid electricity vouchers or movie tickets. A study by Scotland's University of Strathclyde found that the average expenditure in fees was about 20 percent less for Wizzit virtual banking customers than for traditional banking customers in South Africa<sup>59</sup>. Moreover, in 2009, CGAP, a microfinance group based at the World Bank joined Wizzit to deliver mobile banking services to remote rural communities. The trend of combining microfinance institutions with world leading mobile phone companies not only connects microfinance services with rural customers, but also provides rural customers with relatively cheap mobile phones and calling rates. For example, Bharti Airtel, the largest Indian cell phone service provider, backed by Nokia, has offered the 1650

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<sup>59</sup> Global Technology Forum, [http://globaltechforum.eiu.com/index.asp?layout=rich\\_story&doc\\_id=11066&title=South+Africa%3A+From+mattress+to+mobile+banking&categoryid=31&channelid=4](http://globaltechforum.eiu.com/index.asp?layout=rich_story&doc_id=11066&title=South+Africa%3A+From+mattress+to+mobile+banking&categoryid=31&channelid=4)

model phone with 25 monthly instalments of 85 Rupees, or 1.7 USD<sup>60</sup>. In Brazil, currently there are about 105,000 bank agents<sup>61</sup>.

Mobile phone technology is not limited to providing banking services. Some mobile phone companies even go further to provide unbanked mobile phone users with other services. For example, Nokia, the world's leading mobile phone supplier, started selling cell phones in Andhra Pradesh (an Indian State) through SKS microfinance institutions in early 2009. It launched the 'Life Tools' service, providing agriculture (seed, fertilizer, and pesticide costs, prevailing market prices for crops, and weather), education, and entertainment to the rural people living in Maharashtra (an India state) in June 2009. The Life Tools services are delivered to the main commerce markets through Maharashtra State Agricultural Marketing Board (MASAMB)<sup>62</sup>. Similarly, in 2006, Grameen Bank, a leading microfinance institution in Bangladesh, launched an initiative – AppLab (Application Laboratory) with Google– by which the poor can receive information involving marketplace prices, health updates, and tips of farming through their mobile phones.

#### **b) Internet Bidding: connecting borrowers and lenders**

Recently, companies such as Zopa and Prosper have operated their microfinance

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<http://www.microcapital.org/microcapital-story-indian-sks-Microfinancemicrofinance-teams-up-with-mobile-phone-vendors-nokia-and-bharti-airtel-to-provide-service-for-rural-customers/>.

<sup>61</sup> CGAP (2009) "Banking Agents – The Key to Successful Mobile Banking Services",

<http://www.cgap.org/p/site/c/template.rc/1.26.5102/>.

<sup>62</sup> [http://www.domain-b.com/companies/companies\\_n/Nokia/20090612\\_nokia\\_life\\_tools.html](http://www.domain-b.com/companies/companies_n/Nokia/20090612_nokia_life_tools.html).

business by using a new business model – internet bidding – to address the costs of searching and delivering loans. This business model is also known as “E-Bay for Loans” because the business model they use is similar to that of E-Bay. They provide a bidding market in which lenders and borrowers can invest in or acquire loans on terms without being charged the extra fees by intermediaries. Borrowers initiate the bidding process by describing themselves, their plans to use the loans, and how much money they want to borrow. Following that, lenders bid competitively for loans. Each bid starts from a 0.05% annual interest rate and the maximum loan size is up to \$25,000. The duration of each loan ranges from three to five years. As in the microfinance industry, the practice of lending in internet bidding can also be divided into individual and group lending. Moreover, group leaders can charge their members a certain percentage of commission for their efforts to maintain their groups’ credibility.

Zopa and Prosper use systems such as Experian ScoreX<sup>63</sup> and Equifax<sup>64</sup> to rate each borrower’s credibility (from High Risk to AA), and charge lenders and borrowers service fees in each transaction. Zopa and Prosper have caught the attention of a lot of private investors and successfully received funding from some of them (such as Benchmark Capital, Fidelity Ventures and Accel Partners, Bessemer Venture,

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<sup>63</sup> <http://www.experian-da.com/>.

<sup>64</sup> [http://www.equifax.com/home/en\\_us](http://www.equifax.com/home/en_us).



and Wellington Partners). As of June 2009, Prosper had 28,950 active loans totalling \$ 178 million. The average interest rate is about 13.08 percent (ranging from 8.95 to 14.26 percent). While the current loan outstanding rate (30 days past due<sup>65</sup>) is about 19 percent, the late outstanding rate (31-120 days past due) is about 2.19 percent<sup>65</sup>. Although the internet bidding approach for profit-lending purposes has only been implemented in the United States and the United Kingdom, it has shed light on using the E-Bay lending model to reduce the costs of operating microfinance businesses in developing countries.

### **c) Biometric verification and smart card technology**

The high administrative costs of microfinance institutions are not only caused by high travel expenses, but by high levels of illiteracy among microfinance borrowers. Illiterate microfinance borrowers often find themselves in difficulties when trying to sign their names or fill out documents to access their accounts. As a result, either microfinance borrowers withdraw from microfinance institutions, or microfinance institutions have to spend a considerable amount of money and time to help borrowers to access their accounts. To reduce the high administrative costs created by illiteracy, some microfinance institutions have adopted biometric verification and smart card technologies. Biometric verification technology refers to a system by which a person

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<sup>65</sup> Prosper's performance data can be checked by everyone through their website: <http://www.prosper.com/welcome/marketplace.aspx>.

can be identified by his distinguishing biological traits such as fingerprints, hand vein geometry<sup>66</sup>, earlobe geometry, facial features, retina and iris patterns, and voice waves. Consequently, microfinance institutions can save a significant amount of time and money by assisting their customers to access their account or financial services.

The smart card technology generally consists of “any pocket-sized card with embedded integrated circuits which can process data”<sup>67</sup>. As more and more microfinance institutions have been established, microfinance borrowers have started to have more choices. But if there is no communication among microfinance institutions, there will be a tendency for borrowers to take out loans from several microfinance institutions at the same time and only pay back loans to one of them. To solve this problem, smart card technology has been introduced to track borrowers’ real-time credit histories, enhancing the ability of microfinance institutions to be properly informed about their customers. Since late 2006, several Indian banks have started implementing ATMs equipped with biometric technology and smart card readers. For example, in 2005, ICICI Bank, the second largest bank in India, announced the installation of 500-600 biometric ATMs in smaller areas<sup>68</sup>. In early February 2007, Dena Bank deployed Biometric ATMs in Balwa, a small village near

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<sup>66</sup> Bradesco, the largest bank in Brazil, started deploying the ATMs equipped with palm vein scanners from 2007.

<sup>67</sup> Wikipedia: [http://en.wikipedia.org/wiki/Smart\\_card](http://en.wikipedia.org/wiki/Smart_card).

<sup>68</sup> <http://www.financialexpress.com/news/Banks-line-up-biometric-ATMs-with-fingerprint-technology/60925/>.

Gandhinagar. Andhra Bank also announced they were going to install 150 Biometric ATMs in 2007. Apart from banks in India, Indonesia's Danamon Bank also employs smartcard and biometric technology to simplify loan and account transactions in some of its branches.

#### **6.4 Microfinance products**

So far I have discussed the roots of modern microfinancing and how microfinance institutions secure high repayment rates and reduce high transaction costs through innovative lending approaches and new technologies. In this section, the financial products the MFIs provide will be discussed.

##### **6.4.1 Paradigm Shifts**

Microfinance products have evolved from microloans to more complicated financial services such as savings, insurance, and pensions. The current development trend of microfinance products corresponds to two paradigm shifts in the microfinance field.

As already noted, from the 1960s to 1980s microfinance focused on agri-credit offered by governments or donors. Since the second half of the 1980s, there has been a paradigm shift in financial policy from subsidized credit to financial sustainability (Adams 1998). The force driving the first paradigm shift is that the old

paradigm of sector-directed, supplied and subsidised credit was grounded on faulty assumptions about the willingness and ability of poor farmers and entrepreneurs to pay for financial services. The first paradigm shift focuses on the building of cost-efficient MFIs, reducing high transaction costs and risks caused by moral hazard, adverse selection, and strategic default. (Robinson 2002, Zeller & Johannsen 2006).

The second paradigm shift begins in the middle of the 2000s. This shift was from microfinance to financial inclusion, which is defined as “access to formal financial services including savings, credit insurance, and payments through a formal financial intermediary, at an affordable cost”<sup>69</sup>. Inclusive finance entails that a wide range of financial providers working within their comparative advantages to serve poor and low-income people, as well as micro and small enterprises. In 2004, the CGAP (Consultative Group to Assist the Poor) endorsed the ‘key principles of microfinance’<sup>70</sup>. These principles suggest that the mass of poor people could access financial services when financial services for the poor were integrated into three level of the financial system: micro, meso, and macro (Helms 2006). Micro level services

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<sup>69</sup> IMF WP/08/62

<sup>70</sup> The key principles are summarised as follows:

1. The poor need a variety of financial services, not just loans.
2. Microfinance is a powerful instrument against poverty.
3. Microfinance means building financial systems that serve the poor.
4. Financial sustainability is necessary to reach significant numbers of poor people.
5. Microfinance is about building permanent local financial institutions.
6. Microcredit is not always the answer.
7. The interest rate ceiling can damage poor people’s access to financial services.
8. The government’s role is as an enabler, not as a direct provider of financial services.
9. Donor subsidies should complement, not compete with private sector capital.
10. The lack of institutional and human capacity is the key constraint.
11. The importance of financial and outreach transparency.

consist of financial service providers that offer services to poor and low-income clients. The meso level includes the basic financial infrastructure and the corresponding services. The macro level consists of an appropriate government legislative and policy framework.

The second paradigm shift can be seen as a shift from a product-orientated to a client-orientated approach. As Cohen notes, it was for a long time taken for granted in microfinance that 'we have the products, demand is unlimited and the clients will come' (Cohen 2001: 143). Most microfinance institutions only provided one kind of service – loan and recovery – to the poor. However, in the second paradigm shift, microfinance institutions have moved to providing all kinds of financial services due to increasing competition and withdrawal rates. Microfinance experts realise that increasing competition not only allows clients to take multiple loans at a time, but creates the risk of their defaulting on some of their microcredit. As a result, new attention is being given to the relation between clients and products, namely, how to develop products to match the needs of their customers. Microfinance has moved from enterprise investment to household money management. At this stage, microloans are no longer limited to enterprise investment only. Poor people can also have a savings account and take out loans for other purposes (Dunn 2002).

## 6.4.2 Products offered

In order to meet poor borrowers' various financial needs, several financial products that non-poor have always enjoyed have been offered by many MFIs:

**a) Microloans** for enterprise purposes remain the dominant product provided by MFIs.

However, many have started to offer consumption and emergency loans (Woller 2002).

The types of microloan generally include working capital, fixed asset, small business, agricultural, home improvement, consumer, and emergency loans.

**b) Microsavings** could be compulsory or voluntary with fixed or flexible amounts.

Microsavings make sense for a number of reasons. From a low income person's view,

access to savings services can make them less vulnerable to events requiring large

sums of money, which include life-cycle events (marrying daughters, funerals,

childbirth, education and so on), emergency events (sickness or injury, unemployment,

burglary, and various natural disasters), and investment opportunities (buying land

and productive assets or investing in new businesses) (Rutherford 2006: 3-5). A

reasonable estimate of the market for savings among the poor suggests that savings

demand substantially exceeds the demand for enterprise loans.

**c) Microinsurance** is protection for low-income people against specific peril in

exchange for regular monetary payments (premiums) proportionate to the likelihood

and cost of the risk involved. Key risks that the poor usually have to deal with include

death, illness or injury, loss of property (e.g., theft, fire), and natural disaster (e.g., earthquake, drought)<sup>71</sup>. Although microinsurance is in the early stages of development, efforts are being made to formalise and sophisticate the process. According to a survey conducted by the Micro Insurance Centre, as of 2007, there are 357 microinsurance products (separate from social security schemes), 246 micro insurers (separate from government providers of social security), and 78 million people having micro insurance in the 100 poorest countries<sup>72</sup>.

**d) Micropensions** are long- term savings vehicles for clients who have low income and work in the informal sector. When their pension has matured, they can take this accumulated lump sum in cash or leave it on deposit with the MFI and take interest earnings each month as income. Although the microfinance industry has expanded rapidly, micropensions are still in the early stage of development (Basu 2006). A survey done by WWB GNBI (Women's World Banking Global Network for Banking Innovation) shows that only 5 out of 57 (9%) leading regulated microfinance institutions offered products related to improving their member's old age security in 2001. As of 2007, only 5 institutions were providing pension style products (including Grameen Bank's GPS scheme, CARD's Retirement Savings Fund, BRRO's Contractual Savings, SEWA Bank's micropension scheme, and Mann Deshi Bank's

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<sup>71</sup> <http://www.cgap.org/p/site/c/template.rc/1.9.2351/>.

<sup>72</sup> See <http://www.microinsurancecentre.org/UI/DocAbstractDetails.aspx?DocID=634>.

micropension scheme). However, Grameen Bank's GPS scheme and BRRO's Contractual Savings are not considered real pension products but rather hybrids between saving and pensions, for the maturity in both schemes is not linked to a specific age. Moreover, neither scheme is used predominantly as a way of saving for old age. According to Rutherford (2006), marriage and the education of children are the most frequent illustrations of what might be done with GPS. Similarly, BRRO's Contractual Savings are also seen as vehicles to accumulate reserves for marrying-off daughters, improving housing facilities or buying small parcels of land (Wright & Hossain 2001). The microfinance institutions offering real micropensions are the SEWA Bank's micropension scheme, Mann Deshi Bank's micropension scheme, and CARD's (Center for Agriculture and Rural Development) Retirement Savings Fund. In July 2007, SEWA Bank had enrolled 31,000 women in its pension scheme and 1,950 female clients joined Mann Deshi Bank's micropension scheme. As for CARD's Retirement Savings Fund, the total amount was \$899,169 (PHP 42,800,435) in 2006<sup>73</sup>.

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<sup>73</sup> Source: Dr Jaime Aristotle Alip, President, CARD MBA: February 23.2007. [www.icmif.coop/icmif/images/stories/.../ICMIF-Case-Studies-1.pdf](http://www.icmif.coop/icmif/images/stories/.../ICMIF-Case-Studies-1.pdf).



## **6.5 Types of microfinance institutions**

The classification of microfinance institutions relates to their lending model. Microfinance institutions can be generally divided into individual-based lenders and solidarity group lenders<sup>74</sup>. Individual-based lenders are institutions ‘that use standard bilateral lending contracts between a lender and a single borrower. Liability for repaying the loan rests with the individual borrower only, although in some cases another individual might serve as a guarantor. The individual lending method is the oldest form of microlending and most closely resembles traditional commercial bank lending. As has been discussed earlier, advocates of the individual lending method attempt to modify bank methods to better meet the needs of poor borrowers while allowing banks to earn a reasonable profit. Individual lending has been applied most successfully to urban clients. Typical individual loan amounts range from \$100 up to \$3,000 and loan periods from three months to one year. Solidarity group lenders, as noted earlier, serve borrowers who are allowed to form a group (usually of between three and six and each one can not be related), within which each member agrees to guarantee the loans of the other in the group.

The organization of the lending bodies yields a further classification of lenders into

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<sup>74</sup> Microfinance institutions can also be distinguished by their legal status: credit projects, credit unions, village banks, and private-for-profit micro-banks (Zeller 2007).

seven subcategories, which are summarised as follows<sup>75</sup>:

### **Type 1: Association**

An association is formed by the poor in the target community, offering microfinance services to poor people themselves. The association, which can form in terms of gender, religion, political and cultural orientation, then gathers capital and intermediates between banks and MFIs on one hand and its members on the other.

### **Examples**

#### **a) NABARD's (National Bank For Agriculture and Rural Development) SHG Bank Linkage Program**

A well-known example is NABARD's (National Bank For Agriculture and Rural Development) SHG Bank Linkage Program. The SHG-Bank Linkage Program was launched by NABARD in 1992. Between 1992 and 1999, only 32,995 groups participated in this program. Since then the participating group have been growing rapidly. According to NABARD, as of March 31st 2009, the bank loans outstanding to the SHGs aggregated Rs. 226798.50 million (about \$4535.97 million), whereas cumulative refinance availed of by the banks aggregated Rs. 96880.90 million (about \$1937.618 million).

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<sup>75</sup> Explained in detail at GDRC's website: <http://www.gdrc.org/icm/model/1-credit-model.html>

## **b) Self Help Groups (SHGs India)**

The SHG scheme in India represents a unique approach to financial intermediation. According to Reserve Bank of India, 'a Self Help Group (SHG) is a registered or unregistered group of micro entrepreneurs, having homogenous social and economic backgrounds, voluntarily coming together to save small amounts regularly, to mutually agree to contribute to a common fund and to meet their emergency needs on a mutual help basis. The group members use collective wisdom and peer pressure to ensure proper end-use of credit and timely repayment'<sup>76</sup>. SHGs are formed with the assistance of self-help promotion institutions (SHPIs), which include non-governmental organizations (NGOs), government agencies or banks. SHPIs not only help SHGs to arrange their group formation, but they also offer other support such as training and monitoring. Occasionally, SHPIs offer SHGs start up capital to lend to their members, but more typically, SHGs use their members' savings as the initial seed capital. After a period of time, most SHGs eventually borrow money from an external source, usually a bank. This bank linkage makes SHGs in India distinctive MFIs. As of March 2006, there were 2.23 million SHGs serving about 33 million members.

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<sup>76</sup> <http://www.rbi.org.in/scripts/FAQView.aspx?Id=7>.

## **Type 2: Bank Guarantees**

A donor or government agency guarantees microloans made by a microfinance/commercial bank to an individual or groups borrowers. Compulsory deposits by borrowers in such banks are also included in this model.

### **Examples**

**a) AfriCap Microfinance Fund**, established in 2001, who the first African private equity fund<sup>77</sup> engaging in the microfinance industry and has raised about \$50 million to date. Over the past 9 years, AfriCap Microfinance Fund has invested in 20 microfinance institutions across Africa<sup>78</sup>, including \$ 1 million in loans and debt securities to Pride Uganda and \$1.59 million equity stake in Equity Bank in Kenya. As of 2010, AfriCap Microfinance Fund has served about 370,000 borrowers and 2 million savers.

**b) Bellwether Microfinance Fund** The Bellwether microfinance fund, launched in 2005, is an Indian on-shore equity and debt fund investing in start-up and mid-sized Indian microfinance institutions. As of March 2009, Bellwether

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<sup>77</sup> A private equity fund is a collective investment scheme used for making investments in various equity securities according to one of the investment strategies associated with private equity. [http://en.wikipedia.org/wiki/Private\\_equity\\_fund](http://en.wikipedia.org/wiki/Private_equity_fund).

<sup>78</sup> The invested MFIs include **Woman World Bank**, Ghana (WWBG); **SOCREMO Bank**, Mozambique; **SUSU Microfinance**, Nigeria; **Afrique emergence & Investissement**, Ivory Coast; **ASUSU**, Niger; **WIZZIT**, South Africa; **FERLO**, Senegal; **Finance Salone**, Sierra Leone; **UTB**, Sierra Leone; **La Regionale**, Cameroon; **Opportunity International Bank of Malawi (OIBM)**; **Tutigenge**, Tanzania; **Pride**, Tanzania; **Sofipe**, Burkina Fasso. **Kingdom Finance**, Botswana; **Equity Bank Limited Company**, Kenya; **Pride**, Uganda; **Quality Finance International (QFI)**, Egypt; **Union Trust Bank**; **Cap Microfinance**, Senegal. <http://www.meceneinvestment.com/displaysection.php?zSelectedSectionID=sec1223557537>.

Microfinance Fund had invested in 10 microfinance institutions<sup>79</sup>, serving about 1 million clients.

### **c) India Financial Inclusion Fund (IFIF)**

The India Financial Inclusion Fund (IFIF) is a \$90 million fund set up in August 2008 as an off-shore India-focused equity fund, investing in high-growth, small to medium MFIs and enablers. As of November 2009, IFIF has made 8 investments in Indian microfinance institutions<sup>80</sup>.

### **d) Latin American Bridge Fund (LABF)**

The Latin American Bridge Fund is a guarantee fund for microfinance institutions, which was created by ACCION International in 1984. Since it was established in 1984, the Latin American Bridge Fund has provided \$70 million in loans, enabling 23 microfinance institutions in 12 countries<sup>81</sup>. As of 2005, these

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<sup>79</sup> The invested MFIs include **A Little World; Arohan Financial Services; Equitas Micro Finance; Janalakshmi Financial Services; MAS Financial; Mimoza Enterprises Finance Pvt Ltd; Sahayata Microfinance; Sonata Finance Pvt Ltd; Trident Microfin; Ujjivan Financial Services.**

<sup>80</sup> See its websites: <http://www.caspian.in/ifif.aspx>.

<sup>81</sup> These Microfinancemicrofinance institutions include Apoyo Integral (EL Salvador), BancoSolidario (Ecuador), Finamerica (Colombia), Mibanco (Peru), Actuar Quindio (Colombia), Actuar Tolima (Colombia), ADMIC (Mexico), Ceapes (Brazil), Coop Groups Solidarios (Colombia), Corfec (Ecuador), Fundacion (Paraguay), WWB (Colombia), Actuar Bogota (Colombia), Autoempleo (Ecuador), Fundacion Ecuatoriana de Desarrollo (Ecuador), Fundacion Eugenio Espejo (Ecuador), Funtec (Guatemala), Avance (Costa Rica), Fademi (Ecuador), Corposol/Finansol (Colombia), Propesa (Chile), Emprender (Argentina).

microfinance institutions have issued \$140 million in microloans to about 300,000 microentrepreneurs (Lopez & Angulo 2005).

### **e) Microfinance Credit Guarantee Facility**

As of July 22, 2009, the State Bank of Pakistan (SBP) had established the Microfinance Credit Guarantee Facility through which Rs 215 million would be disbursed to the microfinance sector over the next five years. The Microfinance Credit Guarantee Facility is part of a GBP 50 million program supported by the UK Department for International Development (DFID). The loans portfolio under the guarantee scheme will be administered by banks.

### **Type 3: Village banking**

Village banking also known as community banking or Grameen Banking refers to semi-formal, member-based institutions promoted by international NGOs (Westley 2004). Each branch of a village bank 'forms a single, large group and is given a degree of self-governance'. Village Banking is probably the most practised kind of Community-Managed Loan Fund.<sup>82</sup> The Village Banking methodology was developed by the Foundation for International Community

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<sup>82</sup> Waterfield, Charles and Duval, Ann, "CARE Savings and Credit Sourcebook", CARE, 1996. Chapter 6.

Assistance (FINCA), a U.S. based nonprofit organization that specializes in rural credit. Programs using this methodology have been widely replicated in different parts of the world by other NGOs. As of 2004, about 31 microfinance institutions provide 400 village schemes in 90 countries (Hatch 2004).

A Village Bank is initially financed through loans provided by a lending institution and is an informal self-help group of 20-30 members (most of them women). Generally, about 50 percent of all new members joining a village bank will be extremely poor with a daily per-capita expenditure of less than \$1. Over time, member savings, share capital and accumulated interest are expected to grow large enough so that no external funding will be necessary. In general, the objective is for each Village Bank to be administratively and financially autonomous by the end of three years, maximum. Savings mobilization is an integral component of the Village Banking methodology. Savings is more central to the Village Bank model than to either the Grameen Bank model or the Latin American Solidarity Group model. Village Bank members are required to save prior to receiving a loan and to continue saving during the loan cycle.<sup>83</sup>

The Village Bank manages two accounts. The “External Account”, consisting solely of funds lent to the Village Bank by the lending institution, and the

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<sup>83</sup> Ibid.

“Internal Account”. The internal account consists of funds belonging to the Village Bank. The two primary ways the Village Bank accumulates funds in its internal account are:

- a) Through regular member savings deposits (savings could be voluntary or compulsory);
- b) If the Village Bank loans funds to members at an interest rate greater than that charged by the NGO or lending institution, interest payments made by members in excess of interest owed to the NGO flow into the internal account

Village Bank members determine the rules for borrowing or using funds from the internal account. Typically, funds that accumulate in the internal account are used to make additional loans to members, or to make up some deficit, should a member default on a loan. Village banks may choose to make higher-interest loans to non-members from the internal account.

The primary goal of the Village Banking model is for the resources in the internal account to grow over time, and obviate the need to borrow from a lending institution or NGO. As the Village Bank becomes independent of the lending institution, bank policies become determined democratically by its own members and the bank becomes autonomous and self-sufficient. A criticism of the Village



Bank model is that Village Banks may not be able to meet this goal because credit demand tends to grow faster than the Village Banks' ability to mobilize savings.<sup>84</sup>

## **Examples**

### **a) Grameen Bank**

The well-known Grameen<sup>85</sup> bank began as an economic research project by Dr. Muhammad Yunus during the period 1976 – 1979. After obtaining a PhD in economics in 1969 and then teaching in the United States for a few years, Muhammad Yunus returned to Bangladesh in 1972. Following its independence from Pakistan in 1971 and two years of flooding, Bangladesh was trapped in a terrible famine where over 80 percent of the population was living in very difficult circumstances. In 1974, Yunus started to investigate the village Jorba which was near his teaching place – Chittagong University. He soon realised that it was the people in the village lack of access to credit that held people in the poverty and lent \$27 of his own money to 42 women as stool makers. This was known as the origin of microfinance (Yunus 2003). After that he launched the Grameen Bank project in 1976. The objective of this project was to improve poor people's economic conditions and create opportunities for self-employment by providing

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<sup>84</sup> Waterfield, Charles and Duval, Ann, "CARE Savings and Credit Sourcebook", CARE, 1996. Chapter 6.

<sup>85</sup> The term 'Grameen' refers to village or rural in Bengali language.

microloans without the need for collateral. In 1983, the government decided to transform the project into an independent financial institution called Grameen Bank, providing 60 percent of the initial capital with 40 percent owned by the borrowers. Grameen Bank provides financial services ranging from loans, savings accounts, pension loans, and loan insurance to the rural poor of Bangladesh<sup>86</sup>. As of June 2010, borrowers of Grameen Bank own 95 percent of the total equity of the Bank, while the other 5 percent equity is owned by government. The total number of borrowers is 8.28 million and 97 percent of them are women. 2,564 branches with 22,807 staff have been established in 81,362 villages. The total amount of loan disbursed by Grameen Bank is Tk 546.16 billion (about \$9.43 billion). In particular, while Tk 484.66 billion (about \$8.36 billion) has been repaid, the amount of outstanding loans stands at Tk 61.50 billion (about \$887.44 million).

#### **b) Pro Mujer Bolivia**

Pro Mujer Bolivia (PMB), a microfinance institution established in 1990, is the founding program of the Pro Mujer network of four microfinance institutions located in Bolivia, Peru, Nicaragua, and Mexico. Pro Mujer is an international

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<sup>86</sup> The detail can be checked from its website:  
[http://www.grameen-info.org/index.php?option=com\\_content&task=view&id=26&Itemid=175](http://www.grameen-info.org/index.php?option=com_content&task=view&id=26&Itemid=175).

women's development and microfinance organization that attempts to alleviate poverty by providing financial services, healthcare, and training to poor women entrepreneurs. PMB introduced individual loans in 2003 and started piloting village bank loans for self-employed teenagers and youth. In 2006, PMB also introduced a microinsurance scheme covering the outstanding debt of a borrower in the case of her death. As of December 2006, PMB was reaching almost 75,000 borrowers from 49 branches in eight of Bolivia's nine provinces.

#### **Type 4: Cooperatives**

According to the International Co-operative Alliance (ACI), founded in 1895, an independent non-governmental association endorsed by the United Nations, a cooperative is a cooperative model of business enterprise in which:

An autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations, through a jointly owned and democratically controlled enterprise<sup>87</sup>

In other words, it is a cooperative model of business enterprise designed to enable people to reach their personal and community development goals. Currently, 800 million individuals participate in cooperatives in 91 countries worldwide.

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<sup>87</sup> <http://social.un.org/coopsyear/background.shtml>.

## Examples

### a) Cooperative Rural Bank of Bulacan (CRBB)

Established in May 1975, the CRBB is a rural bank owned and controlled by 180 primary organizations in Bulacan, Philippine. CRBB registered with the central bank, Bangko Sentral ng Pilipinas (BSP) as a stockholding company in April 20, 1978. As of 2008, CRBB has 144 Primary Cooperatives as its members, and its total paid up share capital is PHP 15 million (\$ 294,695). Over the years, CRBB has broadened its objective to provide financial services to all types of clients in its 12 branches. Moreover, over the past twelve years, CRBB has launched several microfinance programs to provide microloans to entrepreneurial poor women which include PNCB, PPSB, WLSF, LCAP, Production Loan Program, and MicroSOLO (Microfinance for Sustainability, Outreach and Livelihood Opportunities)<sup>88</sup>. Among them, PNCB, which started in June 1998 with financial and technical support of PCFC and CARD Bank, is the largest microfinance program, constituting about 20 percent of overall gross outstanding portfolio. As of December 2005, microfinance programs of CRBB have 50,358 clients<sup>89</sup>.

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<sup>88</sup> For details of the projects please see its website:  
<http://www.crbbulacan.com.ph/Microfinancemicrofinance.html>

<sup>89</sup> For details of CRBB's Microfinancemicrofinance programs:  
<http://www.crbbulacan.com.ph/Microfinancemicrofinance.html>;  
<http://www.Microfinancemicrofinancegateway.org/p/site/m/template.rc/1.9.31028/>.

## **Type 5: Credit Unions**

A credit union is a not for profit cooperative financial institution owned and controlled by its members. The purpose of a credit union is to provide its members with a full range of financial services. Compared to village banks, credit unions are smaller and non-profit oriented as well as charging much cheaper interest rates. Credit union membership is free to all, and follows a democratic approach in electing the director and the committee representatives.

### **Example**

#### **a) World Council of Credit Unions (WOCCU)**

The WOCCU is an international trade association and development agency for credit unions headquartered in Madison (Wisconsin, U.S.A). As of August 2009, WOCCU's member associations account for over 49,000 credit unions with 177 million members worldwide. Currently WOCCU has launched 9 microfinance programs in 8 countries<sup>90</sup>. As of August 2010, the scale of outreach is 5.9 million people, savings driven growth is \$3.9 billion, and the total amount of loans outstanding is \$3.5 billion.

## **Type 6: Non-Governmental Organizations (NGOs)**

Unlike village banks, NGOs are external organizations (they do not have internal

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<sup>90</sup> Countries include: Afghanistan, Colombia, Ethiopia, Haiti, Kenya, Mexico, Nicaragua, and Sri Lanka.

accounts that can obtain funds through their members) providing many services to the poor. NGOs not only provide microfinance services such as loans, savings, and insurance, but they are also engaged in improving credit rating of the poor, training, education, and research. NGOs also act as intermediaries between the poor and donor agencies (UN, ADB, World Bank), operating locally or globally.

### **Example**

#### **a) ACCION International**

ACCION International, headquartered in Boston (Massachusetts, U.S.A), is a non-profit organization that provides small, short-term loans and business training to poor women and men who start their own businesses. The organization was founded by a law student, Joseph Blatchford, who raised \$90,000 from private companies to address poverty in Latin America's cities in 1961. ACCION's partner microfinance institutions have provided various microfinance products and services including credit, housing, insurance, remittances, and savings in 25 countries in Latin America, Asia, Africa, and the United States. Over the past 10 years, ACCION partners have disbursed more than 17.9 million loans totalling more than \$12.3 billion; 97 percent of the loans have been repaid. ACCION offers several microfinance services:

**Microcredit** has two types of products: group lending and individual loans. The products and services that Group lending provides include solidarity group loans,

expand solidarity group loans, and village banking services. Individual loans include working capital, fixed asset, small business, agricultural, home improvement, consumer, emergency, parallel loans<sup>91</sup>, and lines of credit<sup>92</sup>.

**Housing microfinance** provides low income families with loans (loan amounts average \$1,000~\$1,500 with average loan terms of 18~24 months) to build their houses ranging from adding water and sanitation facilities to improving roofing. As of December 2006, ACCION has provided housing microfinance in 9 countries<sup>93</sup> with a portfolio of more than \$75 million and nearly 38,000 borrowers.

Notable examples include ACCION International (headquarters in USA), KIVA (headquarters in USA), Kashf Foundation (Pakistan).

**Microinsurance** includes Life, Health, Accidental Death, Disability, and Property products. As on December 2008, ACCION took a \$1.2 million equity share in Paralife, a Swiss microinsurance holding company, offering financial protection to low-income populations and people with disabilities in Mexico and Colombia. In the year, ACCION also announced a \$3 million investment in LeapFrog Investment, a \$137 million microinsurance investment fund headquartered in Mauritius.

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<sup>91</sup> Parallel loans, also known as back to back loans, are an arrangement in which two companies in different countries borrow an equivalent amount from each other in their respective currencies. <http://financial-dictionary.thefreedictionary.com/Parallel+Loan>.

<sup>92</sup> Line of credit is 'an arrangement between a financial institution and a customer that establishes a maximum loan balance that the bank will permit the borrower to maintain. The borrower can draw down on the line of credit at any time, as long as he or she does not exceed the maximum set in the agreement': <http://www.investopedia.com/terms/l/lineofcredit.asp>.

<sup>93</sup> Countries include Peru, Nicaragua, El Salvador, Colombia, Ecuador, Haiti, Paraguay, Mexico and Uganda: <http://www.accion.org/Page.aspx?pid=704>.

## **b) Bangladesh Rural Advancement Committee (BRAC)**

BRAC, established in 1972 and located in Bangladesh, is (as of May 2010) the largest NGO in the world by far. BRAC currently operates various programs including microfinance and education over nine countries (Afghanistan, Bangladesh, Liberia, Sierra Leone, Southern Sudan, Tanzania, Uganda) and reaches more than 110 million people. While BRAC's microfinance products involve microloans and savings in Bangladesh, it only offers the other eight countries a microloan service. Moreover, BRAC's microloans are exclusively directed to low income women who are not served by other microfinance institutions. As of December 2009, the total membership of the microfinance program was 8.46 million, the total number of borrowers was 6.61 million, the amount of cumulative disbursement was TK 412,220.97 million(USD 6.715.25 million), and the repayment rate was 99.29 percent<sup>94</sup>. In addition, BRAC generates 80 percent of its annual budget via a number of commercial enterprises such as 'Aarong', a chain of retail handicraft stores, BRAC Dairy & Food Project, BRAC Agriculture & Livestock Enterprises, BRAC Printer, BRAC Print Pack, BRAC Tea Estates, Ayesha Abed Foundation, and BRAC Solar & Biogas.

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<sup>94</sup> <http://www.brac.net/content/stay-informed-key-statistics>.



## **Type 7: For-profit microfinance institutions**

For profit banks are commercial banks and specialized microfinance banks offering various financial services to the poor. Unlike other types of microfinance institutions, the aims of for profit banks not only include social development and financial progress, but high return on investment well beyond what is required for institutional economic sustainability. Well-known examples include Bank Compartamos (Mexico), SKS and Khushali Bank (Pakistan).

### **Examples**

#### **a) Bank Compartamos**

Bank Compartamos, the largest microfinance bank in Mexico, was founded by José Ignacio Avalos Hernández, a devout Catholic who in 1990 converted a nonprofit organization donating food and clothing to the deprived into one that made loans guaranteed by borrowers' neighbors. Clients, mostly women, gather weekly in groups of 12 or more. They can borrow only for *small businesses, not consumer purchases*, and they agree to see that the creditor gets its money back, even if the group has to make up the difference when a member falters. Peer pressure substitutes for motorcycle-mounted collection agents.

In 1998, Compartamos formed a strategic alliance with ACCION International and transformed itself into a regulated financial institution called Sociedad Financiera de

Objeto Limitado (SFOL). In 2002, Compartamos took a unique step for a microfinance institution, and became one of the first microfinance institutions to issue public debt, listing itself on the Mexican Stock Exchange. In order to seek greater scale and to provide more services, such as savings and insurance programs, Compartamos became a commercial bank in 2006. Compartamos was one of the first MFIs to raise additional capital funds through the sale of domestic bonds and was the first MFI in Mexico and one of the first in Latin America to offer a bond sale in 2002.

On Friday April 20th 2007, Compartamos made an initial public offering (IPO) of 30 percent of the Bank's assets to stock market in New York (80%) and Mexico (20%), raising \$468 million<sup>95</sup>. As of June 2010, Compartamos had 1.625 million clients. With 345 branches and 8,591 employees, the bank operates in 29 of 32 Mexican states.

Compartamos has a 60 percent share in the market of loans to microentrepreneurs and 85 percent of the enterprising loans are based on group lending. The bank offers financial services to low-income un-banked clients, essentially small working capital loans ranging from Ps 900 (\$71) to Ps 85,000 (\$671) for microentrepreneurs. 98 percent of clients are women<sup>96</sup>. Net income reaches Ps.477 million, a 45.9 percent increase compared to same period of 2009.

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<sup>95</sup> ACCION Insight: [www.microcreditsummit.org/.../2007-07\\_Accion%20Compartamos%20Article.pdf](http://www.microcreditsummit.org/.../2007-07_Accion%20Compartamos%20Article.pdf)

<sup>96</sup> JP Morgan Latin America Equity Research 2008: [www.morganmarkets.com](http://www.morganmarkets.com).

## **b) SKS**

SKS Microfinance Ltd. is India's largest microfinance institution. Started in 1998 as an NGO, SKS transformed itself into a for-profit microfinance institution (also known as Non-Bank Financial Company NBFC) and is regulated by the Reserve Bank of India (RBI). The company follows the group-lending model, which closely resembles Grameen solidarity group lending which involves 6 processes<sup>97</sup>. While group loans have a term of 50 weeks, individual loans bear a term of 12 to 24 months. As of March 31st, 2010, SKS had 6.78 million women borrowers and total disbursement worth more than Rs. 14,000 crore (\$3 billion). With 2,029 branches and 21,154 employees, SKS operates 354 districts in India.

As of August 2nd 2010, SKS had raised about \$358 million in an IPO after pricing the sale at the top end of the indicated price band. People were attracted by the business model of the company, which has been backed by global investor George Soros, venture capitalist Vinod Khosla and Infosys Technologies funder N.R. Narayana Murthy<sup>98</sup>.

## **c) Banco Solidario**

Banco Solidario started out in the mid-to-late 1980s as the Fundacion para Promocion

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<sup>97</sup> Village selection, projection meeting, mini-projection meeting, group formation, compulsory group training, and centre meetings: <http://www.sksindia.com/methodology.php>.

<sup>98</sup> <http://www.reuters.com/article/idUSSGE67209X20100803>

y el Desarrollo de la Microempresa (PRODEM), a non-governmental organization (NGO) and provided small capital loans to groups of three or more people dedicated to entrepreneurial activities. By 1992, PRODEM serviced 17,000 clients and disbursed funds totaling \$4 million dollars. Constrained by the legal and financial regulations governing an NGO, the board of directors decided to expand their services and PRODEM became the commercial bank, Banco Solidario, later that year (1992). Currently, Banco Sol has 48 branches in seven cities with over 110,000 clients and a loan portfolio of more than \$172 million. As of March 31, 2007, Banco Sol reported a past-due loans level of only 1.78 percent. An important distinction between Grameen and Banco Sol is the latter's emphasis on returning a profit, with poverty alleviation stated only as a secondary goal. Banco Sol offers credit, savings, and a variety of insurance products. Their initial loan offering was based on Grameen-style joint-liability lending, offering a maximum of \$3,000 per client to groups of three or four individuals with at least one year of experience in their proposed occupation. Using dynamic incentives, the size of the loan is gradually increased based on a good repayment history. Annual interest rates average between 12 and 24 percent and can be anywhere from 1 to 60 months in length (120 months for a housing loan).<sup>10</sup>With these higher interest rates, Banco Sol does not rely on subsidies and, at the end of 2006, posted returns on equity of 22.8 percent.

## **6.6 Objectives of microfinance**

So far I have discussed the roots of modern microfinance institutions, the mechanisms of microcredit that might contribute to high repayment rates, the management of microfinance institutions and new technologies that might reduce high administrative costs, the paradigm shift in microfinance field, and the microfinance products that microfinance institutions offer and the types of microfinance institution. In the present section, I will now discuss the changing objectives of microfinance. The objectives of microfinance have changed in keeping with the paradigm shifts in microfinance. The goal of microfinance has expanded from poverty reduction to the empowerment of women and building a sustainable system allowing people with low income to access financial resources.

### **6.6.1 Poverty alleviation**

The main objective of microfinance programs is to eradicate poverty. That is, it aims to raise income levels and to broaden financial markets by providing financial and non-financial services to financially excluded people. The rationale behind the idea of reducing poverty through microfinance can best be summed up in a speech of Former UN Secretary General Kofi Annan delivered in 2005 at the opening of the Microfinance Symposium on investing private capital in micro and small business

finance:

...Microfinance is gaining general acceptance. A small loan, a savings account, an affordable way to send a pay cheque home, can make all the difference to a low-income family, or to a small-scale enterprise. With access to microfinance, people can earn more and better protect themselves against unexpected losses and setbacks. And with the ability to collateralize their assets, they can move beyond day-to-day survival, towards planning their future. That means they can invest in better nutrition, housing, health, and education for their children. They can create productive business, and recover quickly in the aftermath of natural disasters. In short, they can take real strides towards breaking the vicious cycle of poverty and vulnerability...Microfinance is a way to extend the same rights and similar services to low-income households that are available to everyone else. It protects people against shocks, and allows the majority of the population to become part of a country's economic activity<sup>99</sup>.

Several implications can be drawn from Kofi Annan's speech: first, the term 'poor' refers to low income households. This understanding is in line with the dominant definition of poverty in the field of microfinance in which poverty is defined as shortfall in consumption from some poverty line (Hulme & Mosley 1996; Wood & Sharif 1997; Yunus 2007). The poverty line can be set in relative or absolute terms. Relative poverty refers to the position of an individual or household compared with the average income in the country, such as a poverty line set at one-half of the mean income, or at the 40<sup>th</sup> percentile of the distribution. Relative poverty lines vary with the level of average income. Absolute poverty refers to the position of an individual or household in relation to a poverty line whose real value is fixed over time. The

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<sup>99</sup> The full speech draft is available from United Nations:  
<http://www.un.org/News/Press/docs/2005/sgsm10151.doc.htm>.

benchmark of the absolute poverty line is about one US dollar a day<sup>100</sup>. Although the poverty line can be defined in relative or absolute terms, in the microfinance field it can be set as equal to one US dollar or less. For example, in *Creating a World Without Poverty: Social Business and the Future of Capitalism*, Muhammad Yunus explicitly expresses such a view (2007:19):

There are almost as many definitions of poverty as there are individuals and groups studying the problem. A recent World Bank study mentions thirty-three different poverty lines developed and used by particular countries in addressing the needs of their own poor people... [W]henver I refer to poverty with no more specific explanation, this dollar-a-day definition may be assumed.

The second implication of Annan's speech is that access to microfinance is the key to breaking the vicious cycle of poverty and vulnerability. This view is also in line with dominant thinking as to the role of microfinance in poverty reduction. Microfinance experts do not deny that in order to alleviate poverty, other social interventions such as employment, education, and health care, are necessary, but they argue that being able to access financial services is the foundation making other social interventions become sustainable. As Littlefield, Murdoch, and Hashemi put it (2003: 7),

No single intervention can defeat poverty. Poor people need employment, schooling, and health care. Some of the poorest require immediate income transfers or relief to survive. Access to

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<sup>100</sup> In 2008, the World Bank came out with a revised figure of \$1.25 at 2005 purchasing-power parity (PPP).

financial services forms a fundamental basis on which many of other essential interventions depend. Moreover, improvements in health care, nutritional advice, and education can be sustained only when households have increased earnings and greater control over financial resources.

Thus, giving poor people access to microfinance is seen as the right approach to tackling poverty.

### **6.6.2 The empowerment of women**

The other objective of microfinance is the empowerment of women. Although this objective is not always stated explicitly, it is easy to connect the empowerment of women with microfinance, for microfinance programs have generally and mostly targeted women as clients. Littlefield, Morduch and Hashemi (2003) suggest that women constitute over 80 percent of the client membership for the 34 largest microfinance institutions around the world. By 2002, about 14.2 million of the world's poorest women now have access to the financial services provided by specialised MFIs to invest in micro-businesses that they own and operate themselves according to Cheston and Kuhn (2002:4). If the empowerment of women is an important objective for most microfinance institutions, then what benefits do they attempt to bring to women? Before answering this question, we should understand what it means when microfinance experts mention empowerment. According to the United Nations, the empowerment of women has five components: "women's sense of



self-worth; their right to have and to determine choices; their right to have access to opportunities and resources; their right to have the power to control their own lives, both within and outside the home; and their ability to influence the direction of social change to create a more just social and economic order, national and internationally”<sup>101</sup>. Among these five components of the empowerment of women, microfinance institutions hope that putting capital into women’s hands will help to promote women’s right to access resources and bargaining power within the household ( Armendáriz & Morduch 2005; Khandker 2003).

### **6.6.3 Financial Sustainability**

The third objective of microfinance is financial sustainability. The notion of being financially sustainable started to gain its momentum and was considered as one of the important objectives of microfinance institutions after the publication of work by Ohio State University. Indeed, the idea that MFIs must cover their costs led to the first paradigm shift of microfinance and has been approved by several well-known organisations such as CGAP (Consultative Group to Assist the Poorest; a donor consortium housed within the World Bank), the US Agency for International Development, the US Agency for International Development, and the United

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<sup>101</sup> UNITED NATIONS POPULATION INFORMATION NETWORK (POPIN):  
<http://www.un.org/popin/unfpa/taskforce/guide/iatfwemp.gdl.html>

Development Program (e.g. The UNDP Support Program for the Development of a Sustainable Microfinance Sector for Nigeria<sup>102</sup>).

### **6.6.3.1 Why should microfinance be sustainable?**

As has been discussed in the last section, sustainability is considered an essential objective by the majority of microfinance institutions. But why is it important for MFIs to be sustainable?

As has been discussed earlier, if we want more poor clients to have access to financial services, we have to ensure that poor clients can be served by *durable* microfinance institutions that efficiently provide a continuing source of credit and that microfinance institutions have the ability to expand the size of their business. According to GGAP (Consultative Group to Assist the Poorest) the total demand for microcredit will be \$90 billion (200 million persons) by 2025. However, such a massive demand for financial services is far beyond the donor community's ability to provide. If microfinance institutions keep relying on subsidies, their scale of operations will be limited. Even if donors had enough resources, they are not reliable

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<sup>102</sup> The UNDP Support Program for the Development of a Sustainable Microfinance Sector for Nigeria was implemented starting November 2006. It was designed to deepen microfinance intermediation to the poor. Implemented by the CBN (Central Bank of Nigeria), the program is hosted in the Microfinance unit. The detail can be found in its mid-term evaluation report: [web.ng.undp.org/publications/poverty/Microfinance.pdf](http://web.ng.undp.org/publications/poverty/Microfinance.pdf)

long-term sources of funds. As Pischke notes, donors could easily distance themselves from microfinance programs if they find something else is interesting and has “a supportive political base” (2002:102). Morduch raises a similar concern that “donors tend to grow restless and eager to move on to the next project and a new set of concerns microlenders need to prepare for the day when subsidies disappear as donors choose to move on.” (2005: 253). If MFIs cannot rely on donors, they must generate the resources for their long-term survival internally.

Subsidy could undermine MFIs’ motivation for seeking more efficient and innovative ways of running their businesses (Hulme and Mosley 1996, Pischke 2002, Armendáriz and Morduch 2005). Moreover, since the demand for financial services from poor people is far beyond donors’ capacity to provide, donors have to choose which microfinance institutions should be subsidized, and this could cause unfair competition between subsidized and non-subsidized microfinance institutions. Furthermore, accepting subsidies implies that microfinance institutions have to provide nonfinancial activities (such as, social services and training), which can distract the focus of microfinance institutions on financial activities and, therefore, “dilute the benefits of specialization” (Pischke 2002).

Another reason favouring sustainability is that subsidised credit often goes to non-poor households. As has been discussed earlier, many governments in developing

countries have been relatively corruptive and incompetent; thus, elites and powerful political groups often used their economic and political influences to obtain a lion's share of subsidised credit back to 1960s or 1970s.

If microfinance is seen as an effective way to deliver financial services to poor people and subsidy is not a good option, then what kind of method is suitable? For many microfinance experts<sup>103</sup>, the answer is to allow microfinance institutions to be commercialized, which requires microfinance institutions to cover the full cost of delivering financial services. In short, the future of the microfinance industry may lie in large-scale, profit-seeking microfinance institutions that provide effective financial services to poor clients.

#### **6.6.3.2.1 Commercialization: lending method and interest rates setting**

To be commercialized, microfinance institutions must generate enough profit to cover costs, which generally include the cost of lending, loan defaults, and administration.

To be profitable, the advocates of the sustainability of microfinance institutions argue, microfinance institutions must address their interest rate and lending method.

Regarding to lending method, not surprisingly, they argue that the individual lending method is a better way for microfinance institutions to be more profitable given the

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<sup>103</sup> Dale Adams, Carlos Cuevas, Gordon Donald, Glaudio Gonzalez-Vega and J.D. von Pischke, Elisabeth Rhyne, and Maria Otero.

fact that it can attract clients who are able to borrow larger loans, which significantly reduces the administrative costs. The contrast between the individual lending method and the group lending method could be even sharper when microfinance institutions deal with their maturing clients because those maturing clients show themselves to be trustworthy (lower monitoring costs) and seek larger loans over time (greater profit).

If microfinance institutions can be sustainable and thus become a profitable, microfinance institutions can be seen as a profitable investment by global investors. International capital markets started seeing microfinance as a profitable business from 2004. Since then, several debt and equity issues for microfinance have been available in world financial markets. For example, Pierre Omidyar, the founder of eBay, invested \$100 million in a microfinance investment project of Tufts University in November 2005. TIAA-CREF (Teachers Insurance and Annuity Association - College Retirement Equities Fund) invested \$100 million in chosen microfinance institutions worldwide in its Global Microfinance Investment Program (GMIP) in September 2006. By 2008, nearly 1 billion US dollars had been raised and invested in microfinance in seeking commercial returns (Swanson 2008). Approximately, by the end of 2006, 133,030,913 clients had been served by 3,316 microfinance institutions (Arun and Hulme 2008).

Institutional investors, including international banks such as Citibank, global investment banks such as Morgan Stanley, and global insurance companies such as

TIAA-CREF, and emerging markets private equity investors such as Sequoia, Blackstone Group, Carlyle Group and Dubai-based Legatum have also dipped their toes in developed microfinance markets such as Mexico, India, and Bangladesh since 2004. As of June 2010, IFC, a member of the World Bank Group had arranged a syndicated loan of up to \$165 million to Brazil's Banco Daycoval S.A. with the participation of 11 international banks which included Itau Europa, Standard Bank, HSBC, Calyon, Citibank, Oberbank, Banco Santander, Standard Chartered, WestLB, Commerzbank and ING<sup>104</sup>.

Moreover, two leading microfinance institutions – Compartamos and SKS Microfinance – have successfully launched initial public offerings (IPO) in 2007 and 2010 respectively. While Compartamos got its \$400 million from charitable sources (such as the Accion microfinance network, Mexican billionaire Alfredo Harp, and the eBay Founder: Pierre Omidyar), SKS raised \$358 million from traditional mainstream investors (including a Silicon Valley venture capital powerhouse: Sequoia Capital, Sandstone Capital, George Soros, and Indian outsourcing billionaire: Narayana Murthy).

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<sup>104</sup> International Finance Corporation: "IFC Mobilizes 11 Banks in \$165 Million Syndication for Brazil's Banco Daycoval," June 23, 2010: <http://www.ifc.org/IFCExt/pressroom/IFCPressRoom.nsf/0/0FBB931651BE09178525774B004A1654?OpenDocument>

## **6.7 Commercialisation of microfinance institutions and interest rate setting**

In the previous sections, I discussed how microfinance contributes to poverty reduction and the empowerment of women from the viewpoint of Sen's capability approach. In the current section, two important ethical issues relating to the commercialisation of microfinance institutions and the interest rate settings for micro-loans will be discussed. In particular, (1) are commercial microfinance institutions susceptible to mission drift – microfinance drift from their original mission of serving the very poor to focusing on the richest of the poor with larger loans? And (2) how should microfinance institutions set the interest rates of their micro-loans?

### **6.7.1 Commercial microfinance institutions: mission drift?**

As has been discussed earlier (chapter 5), there is a growing fondness for allowing microfinance institutions to be commercialised. However, some economic welfarists and philosophers argue that commercialisation, which relies on implementing the individual lending method, charging interest rates that cover costs, and international capital investment, could lead microfinance institutions to focus on the upper income market with larger loans, forsaking the poorest (Woller, Dunford, and Woodworth 1999; Christen and Drake 2002; Morduch 1998, 2007). Are commercial microfinance

institutions susceptible to mission drift? From a moral point of view, commercial microfinance institutions should give priority to the poorest clients when deciding loans. This is not just because the poorest suffer the most, but because microfinance has often been thought to be a device for the alleviation of the poverty of the poorest. However, asking commercial microfinance institutions to help the poorest clients does not imply that they have to help every extremely poor person. As has been discussed, microfinance is generally not helpful to the poorest individuals because they often lack the relevant abilities to convert microfinance into their economic well-being. But some of them can still be ‘reliable clients’ who have the relevant abilities to make use of microfinance and need relatively small loans. Thus I argue that, in a narrow sense, mission drift occurs if the *poorest potential clients are deliberately and systematically denied by commercial microfinance institutions*. So far, no evidence suggests that the poorest potential clients have been deliberately and systematically excluded by commercial microfinance institutions. Although it is true that microfinance institutions are unsuccessful in reaching every extremely poor individual, that does not negate the fact that they do reach a lot of less poorer potential clients in the poorest countries. According to the micro-credit Summit Campaign (2009), as of 2007, 154,825,825 clients have been reached by microfinance institutions. Of these clients, 106,584,679 (about 68%) were among the poorest, whose daily consumptions were



less than US\$1 when taking their first loan<sup>105</sup>. Thus, it seems to me that commercial microfinance institutions do not drift from their original mission of serving the poor.

### **6.7.2 Interest rate setting for micro-loans**

Although there is still a debate about whether subsidizing microfinance institutions is an adequate approach to reaching poor people (Armendáriz and Morduch 2005), most microfinance experts have agreed that MFIs should charge their clients interest rates that are high enough to cover costs. An interest rate covering costs is, however, usually high. As Rosenberg (2008) has pointed out, the annual interest rates charged by hundreds of microfinance institutions were about 28 to 100 percent in 2006. While the median interest rate was about 35 percent, rates above 50 percent were not unusual and some were even higher than 80 percent.

For example, in April 2007, Compartamos, a major microfinance institution based in Mexico, started charging its customers a 100 percent annual interest rate. Although Compartamos insists that the purpose of charging 100 percent interest rate is to cover ‘costs of future expansion and all retained earnings remain at the service of its customers’, the practice of charging such a high interest rate is still questionable and worrying because the future expansion might be too motivated by profit-seeking and

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<sup>105</sup> Daley-Harris, Sam. 2009. State of the Microcredit Summit Campaign Report, Microcredit Summit Campaign: Washington, DC. PDF version Available at [www.microcreditsummit.org/uploads/socrs/SOCR2009\\_English.pdf](http://www.microcreditsummit.org/uploads/socrs/SOCR2009_English.pdf)

not enough by saving the poor.

On the one hand, some microfinance experts argue that mandatory interest rate ceilings should be implemented in the microfinance industry because the practice of charging high interest rates conflicts with the social mission of microfinance institutions, which is to relieve the poverty of poor people. For example, Muhammad Yunus, the 2006 Nobel Peace Prize Laureate, argues that “Micro-credit should be about helping the poor to get out of poverty by protecting them from informal moneylenders, not creating new ones” and a reasonable interest rate should be “comfortably under the cost of funds plus ten percent, or plus fifteen percent at the most” (State of the Microfinance Summit Campaign Report 2007: 29). The policy of establishing an interest rate ceiling is also upheld by some governments. As of 2004, 23 out of 30 developing countries have adopted interest rates ceilings (Helms and Reille 2004)<sup>106</sup>.

On the other hand, people who are against interest rate ceilings argue that the interest rates charged by microfinance institutions are not usurious. In most cases, high interest rates mirror not profit but the costs of providing microfinance services

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<sup>106</sup> The countries with interest rate ceilings are Armenia, Brazil, Burkina Faso, Cameroon, Central African Republic, Chile, China, Colombia, Côte d’Ivoire, Ecuador, Ethiopia, Guatemala, Honduras, Laos, Mali, Nicaragua, Niger, Paraguay, Senegal, South Africa, Tunisia, Venezuela, and Vietnam. The countries without interest rate ceilings are Bangladesh, Bolivia, Egypt, Indonesia, Morocco, Peru, and Sri Lanka.

(Morduch 2005; Rosenberg 2007, 2009). The costs of offering poor people micro-loans are high because they generally have no credit history, no collateral, are illiterate, and live in remote areas. Moreover, since the amount of each loan is tiny, it makes the cost of lending inevitably higher than normal bank lending. For example, the cost of lending \$1,000 to one client is far lower than that of lending \$1,000 to one hundred clients. Further, the adoption of interest rate ceilings often puts microfinance institutions in a more difficult position to cover their costs, driving them out of the market. As a result, potential poor borrowers lose their access to microfinance services. In addition, poor clients are not only willing and able to repay micro-loans, but also benefit from it. Thus, people who oppose interest rate caps argue that it is reasonable to charge poor clients interest rates that cover costs. The argument for charging interest rates covering costs can be summarised as follows:

- (1) High interest rates charged by microfinance institutions are nothing but costs caused by harsh business environments;
  - (2) Micro-loans increase poor clients' incomes;
  - (3) Poor clients choose to use micro-loans.
- Thus, it is morally acceptable to allow microfinance institutions to charge poor clients interest rates that cover costs.

Is this a sound argument for charging poor borrowers interest rates covering costs?

Let me first discuss the proposition (2): Micro-loans increase poor clients' incomes. As has been discussed earlier (chapter 5), there is no solid evidence suggesting that micro-loans are increasing poor borrowers' incomes or consumption. Not only do poor clients lack money, they also have far lower capacities to turn their investment into successful businesses. Moreover, they often run their businesses with a great deal of exposure to unusually great hazards, such as flood, drought, theft and so on. Once their micro-businesses go wrong, they will be forced to sell their productive assets, which will further damage their already fragile financial structures. In other words, microfinance is only *potentially* helpful in increasing the income of the poor. The result will depend on poor households' abilities to start or expand their business and to pay back loans. Thus, the proposition that 'Micro-loans increase poor clients' incomes' is questionable.

Now let us look into proposition (3) 'poor clients choose to use micro-loans' and proposition (1) 'high interest rates charged by microfinance institutions are nothing but costs caused by harsh business environments'. When a person as an agent chooses to accept a specific interest rate, that choice must be made by himself autonomously according to Sen. To do so, we have to assure that the bargaining power between commercialised microfinance institutions and their clients is fair and is exercised in a market which is governed by democratic institutions and some other relevant policies

such as the introduction of the indicators of efficiency, competition, and consumer protection laws. However, if we look into the current state of the microfinance industry, it is not difficult to notice that those who choose to accept a specific interest rate for a micro-loan in most developing countries are not protected by democratic institutions and social policies that are necessary for building up their power to negotiate with microfinance institutions. Moreover, the micro-credit market itself is far from being a free and competitive market. As Nimal Fernando, a microfinance expert working at the Asian Development Bank (ADB), has pointed out, “in many countries in the region [Asia], the majority of micro-credit is provided by a few leading institutions, and competition among them is mostly on non-price terms” (2006: 3). Further, most borrowers’ financial literacy is so low that they are not able to discern the risks micro-loans can cause. For example, a study by Tiwari, Khandelwal, and Ramji (2008) indicates that only 17 percent of respondents were able to solve a simple mathematic problem such as “divide 8,000 by 10”, and only 3 percent of respondents were able to answer the question “multiply 4,500 by 18”. With such low levels of numeracy, it is very difficult for them to make an appropriate choice such as comparing two loans with different terms. The combination of a monopolised micro-credit market without necessary regulation and vulnerable consumers, (low level of financial literacy and no alternative means to make ends meet), leads to a

huge bargaining power imbalance between commercialised microfinance institutions and poor borrowers. Poor borrowers have to agree to whatever terms the commercialised microfinance institutions are offering them so as to survive. It is the commercialised microfinance institutions that are made free to set the interest rates of micro-loans. The resulting agreement could be essentially tantamount to the exploitation of poor borrowers. Faced with the criticism of monopolisation, commercialised microfinance institutions often claim that high interest rates are nothing to do with monopoly status, but that they are solely a result of high costs caused by poor business environments (poor road, transportation, and telecommunication systems, the size of the loan, and high administrative expenses). But in his analysis of 101 commercialised microfinance institutions in Mexico, Ecuador, and the Philippines, Waterfield (2009) finds that there is a wide range of loan prices (from 38 percent to 90 percent) within similarly sized loans. This appears to me to show that though poor business environments contribute to high interest rates, the monopoly power of commercialised microfinance institutions also plays a significant role in high interest rates. Thus, when evaluating the interest rates of micro-loans, we have to focus not only on their impact on the borrowers' valuable functioning and capabilities, but also the procedure for reaching agreements on the interest rates of micro-loans. That is to say, even assuming that poor people choose to

accept specific interest rates, which can benefit them, such an assumption is still not sufficient to legitimise any interest rate set by commercial microfinance institutions.

We have to make sure that micro-credit borrowers can fairly participate in negotiating with microfinance institutions. Since the current state of the micro-credit market is far from being a free and competitive market, it is reasonable to ask governments to impose ceilings on the interest rates of micro-loans. However, the use of an interest rate ceiling should cease if the micro-credit industry transforms itself into a free and open market in which bargaining power is fairly shared between commercialised microfinance institutions and their clients. Moreover, measurements including the transparency on loan terms, true disclosure of the total borrowing costs, and the prohibition on using abusive lending methods and various forced loan recovery practices should also be introduced. Setting an appropriate interest rate, which is high enough to cover costs and reasonable profits and not so low as to wither the development of the micro-credit industry will never be an easy task. Nonetheless, interest rate ceilings could possibly be made by involving independent observers who are citizens but not subjected to the parties of clients or microfinance institutions (Hudon 2006). The independent observers can be grouped as administrators of the board or ethic committees, which will gather all the relevant information and set the maximum interest rate that a microfinance institution can charge a borrower for an

adjustable rate loan.

## **6.8 Concluding remarks**

In this chapter, I have discussed the recent development of microfinance ranging from the roots of microfinance, the mechanism to tackle asymmetric information, and high administrative costs to the paradigm shifts of microfinance, products microfinance institutions offer, major types of microfinance institutions, and the objections to microfinance institutions. Over the past forty years, we have witnessed several significant changes in the field of microfinance. First, through innovations in group lending, dynamic incentives, and individual lending, microfinance institutions have been able to lend to the people who are traditionally ignored by formal financial institutions. Second, there is no ‘one-size fits all’ model in microfinance. There are a number of distinctive models of microfinance and types of microfinance institutions reflecting the fact that microfinance has evolved differently within different circumstances. Third, the paradigm has shifted from providing microcredit alone to offering a full range of financial services. Fourth, the introduction of new technologies ranging from mobile phone technology, internet bidding, biometric verification and smart card technology can help microfinance institutions to optimise their financial management, lower their administrative costs, and ultimately, to reach a



larger number of customers. Fifth, more and more individual investors and formal financial institutions including commercial banks, large financial groups and specialized microfinancing banks, have involved in microfinance. As a consequence, these fundamental changes have become to an increase in the scale and the complexity of microfinance industry. In the last section (5.7) I consider two questions: (1) Have commercial microfinance institutions drifted from their original mission of serving the poor? And (2) how should microfinance institutions set their interest rates for micro-loans? So far, mission drift has not occurred in that commercial microfinance institutions do not deliberately reject the poorest potential clients and have successfully reached a lot of poorer potential clients in the poorest countries. Regarding interest rate setting, commercial microfinance institutions often assert that it is reasonable to charge their clients interest rates covering costs. However, I have shown that the argument proposed by commercial microfinance institutions is questionable.

## Chapter Seven

### **The assessment of microfinance through the lens of Sen's capability approach**

As noted already, the primary objective of microfinance is to reduce poverty. It is generally believed that microfinance is of great use in lifting poor people out of poverty by funding their micro-enterprises or smoothing their consumption. This belief has been boosted by hundreds of inspiring stories about how poor people use tiny loans to start or expand their small businesses, and experience remarkable gains not only in income and consumption, but also in health, education, and social empowerment. Moreover, microfinance practitioners use these successful stories as evidence to obtain support from international donors and investors. A claim often heard is Muhammad Yunus' claims that microfinance plays a significant role in poverty reduction and enhancing peace (Yunus 1999, 2009). Indeed, such a claim is used not only by Grameen-style microfinance institutions, but also by commercially-driven microfinance institutions (e.g. Compartamos Banco and Accion in Bolivia). However, do these anecdotal cases allow us to claim that microfinance does reduce poverty? The aim of this chapter is to examine whether microfinance contributes to poverty reduction from the viewpoint of Sen's capability approach. More specifically, this chapter examines whether microfinance decreases or increases people's substantial freedoms in terms of increasing their income, education, and

health. This chapter argues that, although microfinance can potentially contribute to poverty reduction in terms of smoothing poor people's basic consumption and increasing their basic capabilities (education and health) and empowering women, current studies and evidence seem to suggest that there is no automatic positive link between microfinance and poverty reduction. Microfinance does not necessarily expand freedom.

### **7.1 How is the impact of microfinance on poverty reduction measured through the lens of Sen's capability approach?**

As discussed earlier (chapters 2 and 6), an adequate definition of poverty is of great importance not only in identifying who the poor are, but also in the assessment of microfinance. There is widespread agreement, within the industry at least, that poverty should be defined as a shortfall in consumption from some poverty lines in general, and should refer - in particular - to those whose daily consumptions are no more than \$1. But why is poverty defined as the lack of income? Surprisingly, very little attention has been paid to this issue in the field of microfinance as if defining poverty as the lack of income is evident to everyone. However, as demonstrated in chapter 1, defining poverty as the lack of income is questionable. First, it is quite true that the concept of poverty does have an irreducible economic connotation. Yet, in

reality ‘poverty’ means not only inadequate personal income, but ‘insufficient command over publicly provided goods and services’ as well as ‘inadequate access to communally owned and managed resources’. In other words, the more relevant concept is not income but the broader concept of ‘inadequate command over economic resources’ (Hunt, Nowak, and Osmani 2004: 8). Moreover, the admission that poverty has something to do with one’s command over economic resources does not necessarily entail the primacy of economic concerns in the causation of poverty. For instance, what if a person is denied access to healthcare resources owing to gender or ethnicity? Admittedly, one can argue that this person is unable to have control over economic resources. Yet, the real cause lies in the social biases and political-legal framework that allows this person to be unfairly treated. It would be a mistake to think that this person would be able to access healthcare (to have greater control over economic resources) if his/her income increased. The inability to have command over economic resources plays, at best, a secondary role. Furthermore, not every individual has the same ability to convert economic resources into capabilities. For instance, people with different biological characteristics (e.g. pregnant women, elderly people) may need different amounts of food and healthcare in order to acquire the same degree of freedom to live a healthy life. It is important to realise that ‘the degree of command over resources that may be adequate for one person may not be adequate

for another' (Hunt, Nowak, and Osmani 2004:9).

It seems clear, then, that it is not a good idea to define poverty as a lack of income. A better way is to define poverty as the *absence or inadequate realization of certain basic capabilities (substantial freedoms)*. As we have learned, Sen asserts that the essence of development is increasing individuals' capabilities/freedoms, and poverty is one of the infamous forms of unfreedom. The crucial question may therefore be: does microfinance increase or decrease poor people's freedom? More specifically, does microfinance increase or decrease poor people's substantial freedoms (basic capabilities)? To answer this question, the assessment of the impact of microfinance on poverty reduction should be measured not only by income, but also by basic capabilities. In short, microfinance should be assessed in terms of income, education, health, and the empowerment of women. As will emerge, microfinance is a relative failure as a poverty-reducing approach in that it does not substantially expand the basic capabilities in question.

### **7.1.2 Is microfinance increasing poor people's income?**

The most common product provided by microfinance institutions is micro-credit. It might be argued that if poor people can invest their micro-loans in income-generating activities, their incomes will increase, which in turn will enhance their abilities to

control economic resources and financial circumstances. Is micro-credit increasing poor people's incomes? One of the early and most widely cited of the poverty impact studies is Hulme and Mosley (1996). In general, they report a positive impact on the incomes of the poor who get micro-loans (1988-92) with on average an increase over the control groups ranging from 10-12% in Indonesia, to about 30% in Bangladesh and India (Hulme and Mosley 1996, Table 8.1). However, it is the non-poor borrowers' incomes that increase the most. The gains for poorer borrowers, in particular the poorest, are minor<sup>107</sup>. Hulme and Mosley (1996: 132) propose the explanation that the core poor will be too risk-averse to borrow for promotional purposes (that is investment in the future) and therefore get a very limited benefit from microfinance schemes. Another equally influential study is Pitt and Khandker (1998), according to which micro-credit has a significant effect on the consumption expenditure of poor households whose daily consumption is less than \$1 in Bangladesh when women are the program participants. In particular, the annual household consumption increases by 18 taka for every one hundred taka lent to women, compared with 11 taka for men. Moreover, when controlling for village fixed effects (such as maximum education of household male, maximum education of household female, household land assets) and other observable characteristics, the

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<sup>107</sup> Despite the breadth of the study and its use of control group techniques, it has been criticized for a possible 'placement' bias and the quality and accuracy of some of the data, particularly in relation to the representative nature of the control groups (Morduch 1999).

micro-credit program successfully reaches the poor and considerably contributes to poverty reduction. A study done by Khandker (2005) also suggests that microfinance is of great importance in helping women out of poverty. Similarly, several other studies, such as Barnes, Gaile, and Kibombo (2001) in Uganda, Dunn and Arbuckle (2001) in Peru, Mosley (2001) in Bolivia, and UNCDF (2004) in Nigeria, Malawi, Haiti, and Kenya, find that microfinance has positive impacts on micro-entrepreneurs' incomes. Based on these findings, it is tempting to conclude that microfinance, particularly micro-credit, does increase poor borrowers' income.

However, many argue that these studies suffer from different forms of selection bias (Karlan 2001, Armendáriz & Morduch 2005; Roodman & Morduch 2009; Karlan & Zinman 2010; Banerjee, Duflo, Glennerster and Kinnan 2009; Alexander-Tedeschi and Karlan 2007). Armendáriz and Morduch point out that (2005: 223):

The challenges in evaluation arise because no microfinance program lends to random citizens. Instead, lenders carefully select areas in which to work and clients to whom to lend...Often, though, what makes clients different is not measured - borrowers may, for example, have a more entrepreneurial spirit, enjoy better business connections, or be more focused than non-participants.

To put the point differently, simply comparing borrowers with non-borrowers without considering other factors cannot lead us to the conclusion that microfinance is increasing poor borrowers' income and therefore reducing poverty. For example, if

those who apply for micro-loans are in any case more entrepreneurial and richer than those who do not borrow, then comparisons are likely to exaggerate the effect of micro-credit programs. In order to measure precisely the impact of microfinance on poor borrowers' income, any assessment must ensure that participation in the program is *determined randomly*. To date, only two studies have applied this idea - both in Indian poor neighborhoods. Banerjee *et al.* (2009) conducted an experiment in which 52 randomly chosen slums in the city of Hyderabad were given access to microfinance, while 52 other slums that were equally suitable to expand microfinance business were denied access to microfinance. Karlan and Zinman (2010) carried out a similar experiment in the Philippines. To avoid selection bias, they changed the credit-scoring software of a microfinance institution so that only random subsets of people with marginal credit histories were accepted as clients. These clients were compared with those who have the same credit ranking but were denied access to microfinance.

Did microfinance increase poor borrowers' income in these two randomized, controlled experiments? Broadly speaking, both studies found that micro-credit had no significant impact on poor borrowers' incomes and consumption in the 12-18 month timeframes. Moreover, micro-credit may not even be the most useful financial service for the poor, according to Banerjee *et al.* (2009). Only 20 percent of the



micro-loans led to the creation of a new business. Providing poor households with a saving service is more helpful in the long term. If there is no solid evidence supporting the claim that microfinance is increasing poor borrowers' incomes or consumption, then what other positive economic impacts could possibly be found in microfinance? Rosenberg argues that, while it is unclear whether microfinance raises poor people's incomes, microfinance does play a useful role in smoothing consumption, particularly for emergencies. He says (2010:4-5):

If it eventually turns out that microfinance is not moving people out of poverty as its proponents have claimed, are its other benefits worth bothering with? When we hear that the evidence about microfinance raising poor people's incomes is unclear, and that many clients use micro-loans and savings to smooth consumption rather than to grow enterprises, we tend to be disappointed, and to view consumption smoothing as a mere palliative. "If that's all it is, why bother?" we ask. But we react this way only because our own minimum consumption levels are seldom, if ever, threatened. As we have seen in financial diaries and in the observed behavior of hundreds of millions of microfinance clients, poor people think this "palliative" is enormously important in helping them deal with their circumstances.

Indeed, even if all that microfinance can bring about is consumption smoothing, it will still be seen as an effective weapon of poverty eradication from the perspective of Sen's capability approach. As we have learned, poor people are hampered not only by the lack of income, but also by life contingencies (e.g. illness, wedding, and funerals) and natural disasters (e.g. flood, earthquake, and drought). Since most the poor live in societies lacking social safety nets, their level of freedom will be seriously reduced if

they cannot deal with life contingences and natural disasters. Although a micro-loan does not increase poor people's incomes, it is still seen as a kind of *shock-absorber*.

However, it should be noted that, even if a micro-loan is helpful in smoothing consumption, there is a dark side of microfinance (Hulme 2000, Dichter 2007). When a very poor borrower takes a micro-loan, this borrower is *in debt*. A very poor borrower could be worse off in the long run if he/she has difficulty paying back the loan than she would have been without the loan. For example, suppose that a poor woman has a baby daughter, who is badly ill and needs medical treatment immediately. Suppose that she takes a micro-loan and sends her child to hospital. Suppose that later she has trouble paying back the loan. In order to pay back the loan, she may end up being forced to sell her productive assets (e.g. cows or goats), falling into a debt trap. In this case, I do not mean to say that any one who has trouble paying back loans should not save his/her family members' lives , but I do mean to say that *micro-credit does not always help people to smooth their lives in the long run*. Indeed, while many microfinance institutions show high repayment rates, the issue of indebtedness is becoming a main issue in the field of microfinance. Hulme reminds us that some poor borrowers faced serious consequences when they were unable to pay back loans (2007:20):

[i]n Bangladesh, MFI [microfinance institution] debtors have been arrested by the police, are threatened with physical violence, and the press regularly report female suicides resulting from problems of repaying loans.

Similarly, in her one-year study in Bangladesh, Karim finds that it is not uncommon to see defaulting women's poultry, rice, grains, and even houses being repossessed and sold by other members of a borrowing group (2008: 18-19):

I saw that credit-related strife amongst members and their families were routine occurrences. Women would march off together to scold the defaulting woman, shame her or her husband in a public place, and when she could not pay the full amount of the installment, go through her possessions and take away whatever they could sell to recover the defaulted sum...This ranged from taking away her gold nose-ring (a symbol of marital status for rural women, and removing it symbolically marks the "divorcing/widowing" of a woman) to cows and chicks, to trees that had been planted to be sold as timber, and to collecting rice and grains that the family had accumulated as food, very often leaving the family with no food whatsoever...In instances where everything has been repossessed because of a large default, members would sell off the defaulting member's house.

The consequences of default are not the only basis for criticizing microfinance. Increased competition has led some microfinance institutions to lend irresponsibly, which has in turn caused more people to become over-indebted. For example, in their study of MFIs in Bolivia between 1998 and 2004, Marconi and Mosley (2005) found that several new market entrants (e.g. FFPs ACCESO, CrediAgil, and FASSIL) made an already over-exposed informal credit market even more crowded, creating a serious problem of over-indebtedness. The problem of over-indebtedness also emerges in

India. An article published in *The Wall Street Journal* states that Indian households are being “carpet-bombed” with loans. Many poor households were over-indebted owing to borrowing money from multiple MFIs. As a result, the outstanding loans grew 72 percent in the year ending March 31, 2008 (Gokhale 2009)<sup>108</sup>.

It seems clear that, from the point of view of Sen’s capability approach, micro-credit could be a *double-edged sword*. While micro-credit can potentially increase people’s freedom (capabilities and opportunities), it can also potentially decrease their freedom. When poor people take micro-loans, they enter into *contracts* and are *obligated* to pay back in the future. However, the determinants of people’s abilities to pay back loans are complicated, and involve not only personal attributes (e.g. a person lacking entrepreneurial skills and knowledge of doing business can miscalculate his/her ability to pay back a loan), but also other economic or environmental factors (e.g. low wages, poor developed markets, sickness, flood, drought, theft and so on). There is no wonder that the poorest clients benefit less than the less poor when they make use of microfinance. The poorest clients do not only lack money; they also have far lower capacities to turn their investment into successful businesses (Hulme & Mosley 1996; Hulme 2007). Any repossession will inflict a heavier negative impact on the poorest clients whose financial structures are

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<sup>108</sup> [www.Microfinancemicrofinanceinsights.com/.../WSJ\\_MFArticle\\_Gokhale.pdf](http://www.Microfinancemicrofinanceinsights.com/.../WSJ_MFArticle_Gokhale.pdf).

already fragile. As a result, their freedom will be seriously reduced if they are unable to pay back loans. The question may therefore turn into ‘How do we help the poorest households pay back loans?’

From the point of view of Sen’s capability approach, two measures are considered to be helpful. The first one is to provide clients with micro-savings. The reason is plain: while micro-savings can make poor people less vulnerable to various needs and specific perils, they do not impose obligations that normally involve strict punishments, as in the case of loan defaults. In other words, if poor people’s purpose for using micro-loans is not to invest in any income-generating activities but to meet their minimum consumption or to address specific perils, then micro-savings can be more useful, despite the fact that such savings will take longer than getting credit up-front (Dupas & Robison 2008). Moreover, there is a growing consensus that micro-savings might do a better job in terms of micro-enterprise development. For example, in their observation of Bank Rakyat Indonesia, Johnston and Morduch (2007) found that approximately 90 percent of its clients save but do not borrow. Similarly, Kaboski and Townsend (2005) found a significant impact of micro-savings on long-term asset growth in Thailand. However, it is Dupas and Robinson’s (2008) experiment in Kenya that brought the most solid evidence that the most powerful element of microfinance is micro-savings, not micro-loans. In their experiment, Dupas

and Robinson paid fees to open bank accounts for micro-entrepreneurs (such as market vendors, bicycle taxi drivers, hawkers, barbers and artisans). These bank accounts were interest-free and included substantial withdrawal fees; thus the de facto interest rate on savings was negative. At a theoretical level, the demand for such an account should be zero if poor households do not face savings constraints. However, this experiment found that most female entrepreneurs do face a significant savings constraint and thus do have a need to open such savings accounts. In addition, the female entrepreneurs who took up the accounts enjoyed remarkable gains. Within six months, they were investing 40 percent more in their business, which in turn led to higher expenditure and income levels. Overall, the result of this experiment indicates that the biggest obstacle to the development of micro-enterprises is not the constraint of micro-loans but the constraint of micro-savings.

As discussed earlier, doing business always involves risks and requires certain skills and knowledge. Thus, the other measure of helping poor clients to pay back loans is to build up their business capacities. An illustration often cited is BRAC's credit plus approach in which loans are accompanied by various forms of assistance for the borrowers. This assistance includes backward linkage services, such as training in improved techniques, provisioning of improved breeds and technology, and supply of technical assistance and inputs as well as forward linkages, such as storage

facilities for produce and marketing of finished goods. BRAC also set up and trained workers and volunteers who provide technical assistance, conservation, and maintenance. Examples include BRAC's cadres of poultry and livestock vaccinators. BRAC initiated a poultry vaccinator program supported by the Department of Livestock Services (DLS) in 1983. In this program, BRAC provides poor households with a credit program which is combined with a holistic package of technical training, credit, and market linkages. In particular, this program provides poultry vaccinators a 5 day non residential induction training at the BRAC office in poultry vaccination, management and basic treatment, and prevention and control of poultry diseases. Although the training is technical and has a strong practical component with demonstrations, trials and field visits, it is designed for non-literate and semi-literate people, and is delivered by BRAC and DLS staff. After completion of the training, the poultry vaccinators are provided a free starter kit that comprises a bag, thermos, gloves and disposable plastic syringes. Vaccines are distributed every week by the DLS through BRAC, and dates for distribution are specified to the vaccinators in advance. From the production site at Mohakhali, Dhaka, to the remote delivery sites, the maintenance of the cold chain remains the top priority to maintain the maximum efficacy of the vaccine. In addition, BRAC has established a number of commercial ventures that strategically serve as safety nets, protecting its clients from facing

market failures<sup>109</sup>. As of December 2008, this program involved 2.47 million women poultry rearers, which has in turn significantly decreased poultry mortality from 21.3 percent to 7.6 percent and increased poor households' consumption of eggs from 43 to 186 and meat from 1.6 to 16.7 respectively<sup>110</sup>. Moreover, the average monthly income of poultry vaccinators increased steadily from 100 TK (\$1.36) to 550 (\$7.5) TK for the period 1990-2007 (Saleque 2007). Although BRAC's credit plus approach is convincing, it is not easily replicated by other small-scale microfinance institutions because the training is costly and requires substantial support from government and international donors. Apart from BRAC, only the Pro Mujer microfinance institution is able to offer these services.

In conclusion, we cannot automatically assume that microfinance increases poor borrowers' incomes and consumption. Instead, we can argue that microfinance is *potentially* helpful in increasing the poor's financial capital and in dealing with possible contingencies. The result will depend on poor households' abilities to start or expand their business and to pay back loans. Moreover, besides smoothing poor households' minimal consumption, micro-savings can develop micro-enterprise.

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<sup>109</sup> The detail is displayed in Brac's website: <http://www.brac.net/bracusa/content/faq-0>.

<sup>110</sup> SA PPLPP (2009) Code: BDGP01, "Mitigating Disease and Saving Valuable Assets: Poultry Vaccinators Delivering Services to doorstep of the Poorest in Bangladesh". Good Practice Note, Delhi, India: <http://sapppp.org/goodpractices/folder-for-related-files/BDGP01-GPNote.pdf>



Although microfinance may not directly increase the incomes of the entrepreneurial poor, it does help them to cover start-up costs. As Fisher pointed out “[b]y being willing to take a risk on entrepreneurial sorts who lack any other way to start a business, micro-credit may help reduce poverty in the long run, even if its short-run effects are negligible”<sup>111</sup>. Moreover, their success in doing business will make commercial banks more willing to get involved in this informal credit market, lending poor entrepreneurs larger loans.

## **7.2 Is microfinance contributing to basic capabilities?**

### **7.2.1 Which capabilities?**

Before investigating how microfinance contributes to basic capabilities, an essential point we need to clarify is which capabilities are basic. As discussed earlier, an ideal situation is to let people select basic capabilities themselves through public reasoning and democratic debate or by using a questionnaire. Yet, in reality no developing country has yet been able to let citizens choose basic capabilities by themselves. Of course, this is not to say that people living in developing countries will never have their say on basic capabilities, but the issue of selection of basic capabilities does cause difficulty in measuring the impact of microfinance on basic capabilities.

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<sup>111</sup> Fisher 2009, ‘A partial marvel’ in *The Economist*: <http://creationinvestments.com/news/microcredit-may-not-work-wonders-but-it-does-help-the-entrepreneurial-poor-economist/>.

Although Sen often emphasises the importance of letting people choose basic capabilities, he is fully aware of this difficulty and suggests, based on empirical observation, that certain basic capabilities seem to be common to all. He says (1999:36):

The substantive freedoms include elementary capabilities like being able to avoid such deprivation as starvation, under-nourishment, escapable morbidity and premature mortality, as well as the freedoms that are associated with being literate and numerate, enjoying political participation and uncensored speech and so on.

Thus, the assessment of microfinance in the context of Sen's capability theory will particularly focus on the impact of microfinance on education, health, and the empowerment of women. In what follows, the correlation between microfinance and education is examined.

### **7.2.2 Microfinance and education**

There is no doubt that education plays a significant role in human and economic development. Recent theoretical models (Barro 1991; Benhabib & Spiegel 1994; Barro & Sala-i-Martin 1995; Bils & Klenow 2000) routinely show that there is a positive correlation between schooling rate and GDP growth. For example, Bils and Klenow (2000) find that the higher schooling enrollment in 1960, which was

consistent with one more year of attainment, is associated with 30 percent faster annual growth over the period 1960-1990. The World Bank also emphasises this connection, stating:

Education is the foundation of all societies and globally competitive economies. It is the basis for reducing poverty and inequality, improving health, enabling the use of new technologies, and creating and spreading knowledge. In an increasingly complex, knowledge-dependent world, primary education, as the gateway to higher levels of education, must be the first priority<sup>112</sup>.

Education also expands individuals' freedom in terms of creating choices and opportunities and building empowerment. Indeed, many capability approach experts (Nussbaum 2000, Saito 2003) suggest that education should be universally considered as a basic capability. As Terzi puts it (2004:9-10),

The capability to be educated is basic, since the absence or lack of education would essentially harm and disadvantage the individual...Education is basic also in the sense of being a fundamental capability, and foundational to other capabilities as well as future ones...The broadening of capabilities entailed by education extends to the advancement of complex capabilities, since while promoting reflection, understanding, information and awareness of one's capabilities, education promotes at the same time the possibility of formulating exactly the value and beings and doings that the individual has reasons to value. On the other hand, the expansion of capabilities entailed by education extends to choices of occupations and certain levels of social and political participation...These considerations lead to an understanding of education as a fundamental capability, which includes basic capabilities, in terms of those enabling beings and doings that are fundamental in meeting the basic need to be educated but equally foundational to the promotion and expansion of higher, more complex capabilities.

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<sup>112</sup> <http://devdata.worldbank.org/gmis/mdg/education.htm>.

If education is a vital element in poverty reduction and economic growth, then what is the linkage between microfinance and education? To understand how microfinance could possibly promote education, we have to look into the causes that deter parents from sending their children to school. These causes are generally called the barriers to education, which can be summarised as follows (Quaeghebeur & Marthi 2005: 9):

- Income barrier: a household can not afford costs of schooling
- Child labor barrier: the benefit from wages earned by a child affects schooling decisions
- Risk management barrier: the inability to smooth income makes school attendance of child vulnerable in times of income shocks
- Gender barrier: the gender of the household's decision maker (and empowerment of women) influences the household's schooling decisions
- Education barrier: the parents' level of education influences perceived value of education

Given these barriers together, a linkage between microfinance and education becomes clear – by accessing microfinance, poor households are able to overcome these barriers and eventually send their children to school and keep them in school. Is microfinance promoting school enrollment rates? To answer this question, the relation between microfinance and these educational barriers is examined in the next section.

#### **a) Microfinance and income barriers**

It is true that microfinance can promote education if it can lift poor households' incomes high enough to cover the costs of sending their children to school. It is also

true that women spend more than men on child health and education (Lundberg et al. 1997). Yet, as we learned earlier, most microfinance institutions are only able to provide micro-credit, which, at least within a year to 18 months, does not increase poor households' incomes and thus does not deliver education, according to the latest empirical studies (Karlán & Zinman 2010; Banerjee et al 2009). These studies do not suggest that poor households do not care about their children's education, and that micro-credit does not have a positive impact on education in the long run. They show that poor households do not give priority to education when they have obtained micro-loans. One possible explanation is that, even though education has proven to be profitable on a macro level, poor households are uncertain that their investment in education will bring them positive results (Khumawala 2009)<sup>113</sup>. In order to encourage poor households to invest in education, some microfinance institutions (XacBank<sup>114</sup>, Vittana<sup>115</sup>, Qifang<sup>116</sup>, Grameen Bank<sup>117</sup>) offer loans for education at far cheaper interest rates than for micro-enterprise (XanBank:, Bittana:10-15 percent, Qifang: 8-12 percent, Grameen Bank: 5 percent).

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<sup>113</sup> <http://www.Microfinancemicrofinancegateway.org/p/site/m/template.rc/1.9.36447/>.

<sup>114</sup> XacBank, a Microfinancemicrofinance lender, headquartered in Mongolia, has started offering higher education loans (between \$700 and \$900) since 2004. So far, more than 160,000 students have received student loans. In early 2009, XacBank began collaborating with [Women's World Banking](#), [The Nike Foundation](#), and MicrofinanceMicrofinance Opportunities (MFO) to research the behaviors and attitudes of Mongolian girls and families towards financial products and education.

<sup>115</sup> Vittana, founded by Kushal Chakrabarti in 2006, who used to work at Amzon.com, is raising loans for students in five countries through "peer-to-peer" online lending.

<sup>116</sup> Qifang, founded in 2006, raises money online for Chinese students from Chinese lenders.

<sup>117</sup> Grameen Bank has introduced higher education loan program since 1997. As of 2006, the program has distributed 14,507 loans worth Tk. 337 million.

However, the student loans provided by these microfinance institutions only target higher education. The reasons for focusing on higher education are that, first, it is only with students in higher education that loan repayments are relatively enforceable. As Mr. Hutagt, the CEO of XacBank, pointed out, “students come from remote villages, no one knows them, they have no reputation to lose”. Second, student loans are much longer term (up to five years) than the standardized microfinance business loans (up to one year). This makes microfinance institutions, especially those which rely on short-term funding, reluctant to risk their money in student loans (Bishop 2010)<sup>118</sup>. So far, only SKS has been able to offer loans for primary education, and has set up 10 English schools in India<sup>119</sup>. The impact of student loans for higher education on borrowers is unclear because research has not yet been performed to examine their effects on the clients. However, what is known is that the practice of offering poor households student loans at lower interest rates is better than the practice of offering poor households micro-loans at much higher interest rates because the interest rates of student loans do not threaten the freedom of the poor as much as the interest rates of conventional micro-loans do.

## **b) Microfinance and child labor and risk management barriers**

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<sup>118</sup> Bishop, Matthew. “Microfinance for students: Making the grade,” The Economist Journal, 09/09/2010. [www.economist.com/node/16996791](http://www.economist.com/node/16996791).

<sup>119</sup> <http://prayatna.typepad.com/education/2008/07/career-launcher.html>

According to the United Nations Children's Fund (UNICEF), child labor generally involves children whose working hours exceed a minimum number of hours<sup>120</sup> and who are forced into work which harms or abuses them<sup>121</sup>. Every year, about 158 million children, aged 5-14, engage in child labor and are forced to give up their opportunities of being educated. Moreover, the failure to cope with adverse shocks makes parents more likely to keep their children at home. For example, in their study in south-western China, Jalan and Ravallion (1999) found that, while a crop failure led to a 10 percent decline in consumption for the richest third of households, a tenth of households suffered from a 40 percent decline in consumption. Similarly, Jacoby and Skoufias (1997) noticed that a 10 percent decline in agricultural income across seasons caused a decrease in school attendance of five days in a sample of six Indian villages. Does microfinance help poor households take their children out of work and put them into schools? The results are mixed. On the one hand, many recent studies suggest that microfinance can be used to reduce child labor and increase school enrollment rates. For example, Jacoby's study (1994) in Peru shows that a lack of access to credit is a major factor leading poor households to withdraw their children

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<sup>120</sup> Age 5-11: At least one hour of economic work or 28 hours of domestic work per week.

Age 12-14: At least 14 hours of economic work or 28 hours of domestic work per week.

Age 15-17: At least 43 hours of economic or domestic work per week.

<sup>121</sup> According to International Labour Organization (ILO), work which is likely to harm children includes working in a mine, exposure to toxic substances, working with dangerous equipment (sewing footballs or clothes, breaking bricks and rocks for road building, making matchsticks, and making bricks.

<http://www.ilo.org/ipec/Campaignadvocacy/Youthinaction/C182-Youth-orientated/worstforms/lang-en/index.htm>.

from school and put them into work<sup>122</sup>. Similarly, Ersado (2002) finds that increasing the availability of loans appears to be helpful in improving school enrollment rates and decreasing child labor in Nepal. Wydick (1999) also finds that an increase of access to credit decreases the chance of forcing children to drop out of school for the purpose of household business in Guatemala. Likewise, by using cross-country data, Dehejia and Gatti (2005) state that policies aimed at increasing households' access to credit could be effective in reducing the probability of child labor. On the other hand, critics argue that microfinance can actually exacerbate child labor, for micro-entrepreneurial activities can lead to an increase in child labor (Psacharopoulos, 1997; Jensen & Nielsen, 1997; Patrinos & Pascharopoulos 1997). For example, in 2007, Hazarika and Sudipta (2007) examined the relationship between micro-enterprise and child labor in Malawi. This study found that, in the season of peak labor demand, household access to micro-credit increases the probability of child labor. Similarly, a publication by the State Bank of Pakistan (SBP) shows that the availability of micro-credit has had a limited impact on the reduction of child labor in Pakistan<sup>123</sup>. Although respondents reported a rise in their income level as a result of receiving micro-loans, this alone was not sufficient to persuade all parents to take their children out of work. Likewise, in their study in Mexico, Basu

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<sup>122</sup> Jacoby, H. 1994. Borrowing constraints and progress through school: Evidence from Peru. *Review of Economics and Statistics* 76:151-160.

<sup>123</sup> Hag et al. (2009), Towards Achieving Social and Financial Sustainability: A Study on the Performance of Microfinance in Pakistan. [www.sbp.org.pk/ead/pdf/Sus.pdf](http://www.sbp.org.pk/ead/pdf/Sus.pdf)



and Tzannatos (2003) find that children from “better-off” households have, on average, the same chance of working as those from poorer households. Moreover, children’s chances of being involved in labor increase by 43 percent if the mother works. Again, Maldonado et al. (2003) find that micro-enterprises create new demand for child labor in Bolivia. Yamauchi (2007) finds that a micro-enterprise neither eliminates child labor nor promotes children’s education in rural Indonesia. In addition, critics argue that even those who involve their children in labor by eliminating their leisure time (Ravallion & Wodon 2000) can still have a negative impact on the personal development of children.

It seems clear that, while microfinance increases children’s chances of being educated, it also brings a side effect – a new demand for child work. Children may end up being forced to help with micro-enterprises or take over the household duties of their mothers and subsequently withdraw from school. Becchetti and Conzo remind us that microfinance brings positive effects on child schooling only “when parent’s income is above a certain threshold” (2010:5). In other words, although poor households are aware of some advantages from educating their children, they are not likely to send their children to school until their incomes are above a certain threshold. As Vanroose pointed out, ‘the level of income increase resulting from micro-loans may not be sufficient to make a real difference’ (2007: 11). Thus, we cannot

automatically assume that microfinance reduces child labor. The impact of microfinance on child labor will depend on the income level of the borrowers.

### **c) Microfinance and Gender Barrier**

As noted already, it is widely believed that women are more likely than men to invest their earnings in better health and education for the whole household. Based on this observation, development and microfinance experts hope that, by improving women's chances to access microfinance, their influence in family decisions can be expanded, thereby increasing children's chance of being educated. However, recent studies show that, although women are aware of the disadvantages of not sending their children to school, the precise linkage between women's chances to access microfinance and a demand for education is yet to be determined (Maldonado et al. 2003). Moreover, an equally important issue that seems to be overlooked is the gender inequality in education. According to the United Nations Entity for Gender Equality and Empowerment of Women (UN WOMEN), two-thirds of the world's 960 million illiterate adults in 1995 were women<sup>124</sup>. In those poorest countries, only 5 percent of women had any secondary education. These statistics indicate that, even if poor households have chances to send their children to school, boys are always the priority.

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<sup>124</sup> <http://unstats.un.org/unsd/demographic/products/indwm/wwpub.htm>.

However, there is no study yet that has examined the connection between microfinance and educational gender inequality.

#### **d) Microfinance and Education Barriers**

The last factor influencing parents' perception of the value of schooling is the parents' level of education. As Lillard and Willis (1994) observed, there is a positive correlation between parents' educational levels and children's chances of schooling.

Nicholas D. Kristof (2010), a journalist of The New York Times, gives us a vivid example of how parents' educational level affects their decision as to whether to send their children to school. On a trip to central Africa, Kristof met a bright fourth grader, Jovali Obamza, who was about to be expelled from school because he had not paid the fees for three months. When Kristof interviewed Jovali's parents, he found that they were extremely poor (selling straw stools for \$1 each and had not paid rent for eight months). However, he also found that Jovali's parents spend \$10 per month on cell phone and \$12 per month on drinking. When Kristof asked Jovali's father 'why he prioritizes alcohol over educating his kids', he looked pained. Kristof noticed that Jovali's father was not an unusual case in that village. In fact, Jovali's father drank less than the average man in the village. Thus, Kristof argues that 'if the poorest families can spend as much money educating their children as they do on wine,

cigarettes and prostitutes', their children would have brighter futures<sup>125</sup>. Indeed, parents' preferences about schooling are affected not only by their level of education, but also by social, religious, and cultural factors (Dollar & Gatti, 1999; Klasen, 1999).

Does microfinance change parents' preference about schooling? Although currently there is no empirical study available, many suggest that there is potential for microfinance to contribute to the greater effort of changing parents' preferences about schooling (McNelly & Dunford, 1998; Maldonado et al. 2003; Quagebeur & Marthi, 2005; Schomp 2007). Because microfinance services are provided by microfinance institutions and borrowers have to hold meetings with microfinance institutions regularly, microfinance institutions could serve as a channel to change clients' perceptions of the value of schooling. In particular, microfinance institutions can offer clients information about child education, which in turn will raise their awareness about the importance of sending children to school. Although critics argue that the provision of such a non-financial service could damage the financial sustainability of microfinance institutions (Gonzalez-Vega, 1998), several microfinance institutions have offered non-financial services that could potentially change clients' perceptions of the value of schooling. For example, Al Amana, one of the largest microfinance institutions in Morocco, initiated a media-based educational program in February

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<sup>125</sup> Nicholas D. Kristof. "Moonshine or the kids?," The New York Times, 05/22/2010. <http://www.nytimes.com/2010/05/23/opinion/23kristof.html>

2007). In this program, Al Amana offers each client a poster, a leaflet and a CD, which contains documentaries about child labor, and discussion-based topics for clients to talk about concerning child labor issues. Moreover, Al Amana has established a system by which it can monitor the condition of work of its clients' children (Schomp 2007). Similarly, CRECER, a microfinance institution headquartered in Bolivia, requires women who have received CRECER's loans to attend training sessions that are aimed at enabling them to better manage their micro-enterprises, and also to deal with health, children's education, and women's rights.

It seems clear that microfinance does increase school enrollment rates. However, how microfinance influences school enrollment rates is complicated. Moreover, we should notice that there is a nuanced difference between having higher school enrollment rates and having better academic performance. In other words, *an increase in school enrollment rate does not necessarily build up children's ability to have higher academic performances*. Worries of this nature are not mere nitpicking. A well-known project – Conditional Cash Transfers (CCTS) – explicitly displays this concern. CCTS, funded by the World Bank, are schemes that “transfers cash, generally to poor households, on the condition that those households make prespecified investment in the human capital of their children”, such as sending their children to school and bringing them to a clinic for regular physical examinations.

(Fiszbein et al. 2009: 1). Although CCTS have effectively targeted the poorest of the poor and have significantly increased school enrollment rates, Filmer and Schady (2006) find that an increase in school attendance does not lead to higher academic performance. This study indicates that bringing children to schools is only half the solution to the promotion of education, for there is no guarantee that the schools operate well. Governments have to apply themselves to improve educational quality.

### **7.2.3 Microfinance and Financial Literacy**

From the previous section we have learned that microfinance can have a positive impact on education in terms of increasing school enrollment rates. However, it is also widely believed that microfinance plays a vital role in building up clients' financial literacy. In the present section, the relation between microfinance and financial literacy is examined.

There is growing evidence indicating that providing poor borrowers with financial literacy is the key to helping them succeed in their integration into the mainstream economy and society. For example, Lusardi and Mitchell (2007) find that households demonstrating a low level of financial literacy tend not to plan for retirement. Stango and Zinman (2006) notice that households with a low level of financial literacy are likely to borrow at high interest rates. Based on this compelling evidence, policy

makers in the developed and developing world have started to advocate increasing expenditures on literacy education in the hope of increasing household savings and financial market participation, which could reduce poverty and improve poor households' long-term welfare. To name but a few policy makers, the European Commission states:

Financial education enables individuals to improve their understanding of financial products and concepts, and develop the skills necessary to improve their financial literacy, i.e. to be aware of financial risks and opportunities and to make informed decisions in the choice of financial services<sup>126</sup>.

Alan Greenspan, the former Chairman of the Federal Reserve of the United States, also expresses a similar view, emphasising that (Sebastd & Cohen 2002:2):

[financial education]...can help to provide individuals with the financial knowledge necessary to create households budgets, initiate savings plans, and make strategic investment decisions. Such financial planning can help families meet near-term obligations and maximize their longer-term well-being, and is especially valuable for populations that have traditionally been underserved by our financial systems.

Similarly, Rajat Nag, the Managing Director General of Asian Development Bank (ADB), points out that:

Financial literacy allows people to increase and better manage their earnings, and therefore better

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<sup>126</sup> European Commission. (2007) Communication on Financial Education, pg. 1.

manage life events, such as education, illness, job loss, or retirement. It also promotes the understanding and acceptance of the importance of political reforms, such as health care or pension reforms<sup>127</sup>.

But what does the term ‘financial literacy’ mean? According to Miller et al. (2009: 2), financial literacy can be defined as<sup>128</sup>:

[T]he combination of consumers’/investors’ understanding of financial products and concepts and their ability and confidence to appreciate financial risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well-being.

If financial literacy is of great importance in shaping individuals’ well-being, then what is the correlation between microfinance and financial literacy? Theoretically, it is believed that microfinance programs could build up clients’ financial literacy by providing them with a multi-session course on loan repayments, fee schedules planning, and financial management of loans and savings. However, there has been limited research on financial education in the context of microfinance. One of the few studies is Gray et al. (2009). Partnered with three microfinance institutions (CRECER, Pro Mujer, and SEEDS), Gray et al. found that when borrowers took financial literacy

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<sup>127</sup> <http://www.adb.org/Documents/Speeches/2007/ms2007089.asp>

<sup>128</sup> Indeed this definition is derived from OECD’s definition of financial literacy:

“Financial education is the process by which financial consumers/investors improve their understanding of financial products and concepts and, through information, instruction and/or objective advice, develop the skills and confidence to become more aware of financial risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well-being”. [OECE. (2005). Improving Financial Literacy: Analysis of Issues and Policies. P.26]



courses, their financial knowledge increased, which in turn led to a better performance of general savings, budgeting, and debt control. The other study is Rajendran and Raya (2010). In their field study in rural India, Rajendran and Raya found that the microfinance program brings a positive impact on borrowers' financial management of loans and savings. Although there are only two academic studies focusing on financial education in the field of microfinance, both of these studies suggest that microfinance programs could build up borrowers' financial literacy. However, critics state that providing this type of non-financial service is costly and could damage the financial sustainability of microfinance institutions. There is no doubt that offering financial literacy programs is costly. Nevertheless, it is too much to claim that offering financial literacy programs will hurt the financial sustainability of microfinance institutions. Recently, many microfinance institutions have provided documentary evidence indicating that offering financial literacy training to their clients brings higher repayment rates. For example, SKS Microfinance, India's largest microfinance institution, requires borrowers to pass financial literacy training before receiving loans. In particular, potential borrowers have to take financial literacy training and pass a test over three days to demonstrate they understand interest rates, loan installments, and repayment schedules. The process has enabled collateral-free loans with a repayment

success rate of 98 percent<sup>129</sup>. Similarly, SEWA Bank, headquartered in India, provides borrowers with a ten-day financial literacy program, which includes modules on accounting skills, interest rates, avoiding debt, long-term life-cycle planning, marketing, cost reduction, investment, and customer service. By offering the ten-day financial literacy program, SEWA Bank has seen an increase in its new borrowing and new savings. In particular, while the amount of new borrowing increased in general by Rs. 772 (\$17.27), the average amount of new savings increased in general by Rs. 63 (\$1.40)<sup>130</sup>.

The success of SKS Microfinance and SEWA Bank has made other microfinance institutions realise that improving clients' financial literacy can help to keep default rates down and therefore contribute to growth and development. Moreover, governments and private foundations have started to become involved in initiating financial literacy programs, which in turn can reduce the spending of microfinance institutions on financial literacy programs. For example, The Reserve Bank of India (RBI) launched an initiative in 2007 to establish Financial Literacy and Credit Counseling Centers throughout the country<sup>131</sup>. In fall 2008, the Russian Federation launched a Financial Literacy Program Trust Fund of US\$15 million at the World Bank. As for the private sector, the Citi Foundation, funded by Citigroup, has helped a

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<sup>129</sup> <http://www.sksindia.com/faq.php>

<sup>130</sup> <http://www.ifmr.ac.in/cmfeomf5-impactofbusiness.html>

<sup>131</sup> <http://www.rbi.org.in/scripts/PublicationDraftReports.aspx?ID=526>

number of microfinance institutions provide their clients with financial literacy programs. Currently, Citi Foundation's financial literacy program is implemented by Pro Mujer (Bolivia), Teba Bank (South Africa), Al Amana (Morocco), Equity Building Society (Kenya), SEWA Bank (India), CARD Bank (the Philippines) and the Microfinance Centre (Poland), among others. Similarly, while World Education and Pact provides financial literacy programs in Nepal, the Food and Agricultural Organization (FAO) has developed a guide on money management for farmers (Cohen and Sebastad 2003).

However, it should also be noted that although microfinance programs could build up clients' financial literacy by providing them with a multi-session course on financial literacy, recent studies (Cole 2007; Gine et al. 2006) suggest that a more effective and longer financial literacy program is needed. In addition, programs should be highly aimed at a specific area of financial activities.

To summarise, this section has examined the relation between microfinance and education. One of the main points of this section is whether microfinance helps to increase school enrollment rates. Although the answer is positive, the influence of microfinance on education is complicated. Contrary to the expectations of some, microfinance does not increase school enrollment rates by lifting poor households' incomes up to certain levels that are high enough to cover the costs of sending their

children to school. In some cases, microfinance can even create a new demand for child labor. Children may end up being forced to help with micro-enterprises or take over the household duties of their mothers and subsequently withdraw from school. Moreover, due to lack of enforceable contracts between lenders and students and short-term funding pressure, only a handful of microfinance institutions are willing to get involved in student loans for higher education. However, microfinance does bring a positive impact on school enrollment rates by removing risk management and gender barriers, and by changing parents' perception of the value of schooling. It should also be noted that there is an important difference between having higher school enrollment rates and having better academic performance. An increase in school enrollment rate does not necessarily build up children's ability to have higher academic performances. There is no guarantee that the schools operate well. Governments have to apply themselves to improve educational quality as well.

The other main question considered in this section is that of whether microfinance helps to increase clients' financial literacy. Although there has been limited attention to financial education in the context of microfinance, current studies suggest that microfinance programs could build up borrowers' financial literacy by providing them with a multi-session course on financial literacy, which includes the calculation of loan repayments, fee schedules planning, and financial management of loans and

savings. Moreover, improved financial management skills and behaviors can help keep repayment rates up and delinquency rates low, which in turn contributes to the development of microfinance institutions.

### **7.3 Microfinance and Health**

According to a survey done by the World Health Organization (WHO), every year, approximately 25 million households (consist of more than 100 million people) are forced into poverty by illness and the struggle to pay for healthcare<sup>132</sup>. Moreover, nearly two million children die from preventable illnesses each year (e.g. diarrhea, malaria, and measles)<sup>133</sup>. Furthermore, more than 1.02 billion people in the developing world are undernourished<sup>134</sup>. This, coupled with the lack of basic health infrastructure in rural and remote areas, aggravates the health condition of the poor, leaving them in a perpetual state of poverty. A study of Grameen Bank's micro-credit program revealed that "of 42% that fail to improve their socio-economic condition, 60% had experienced a serious illness within the family that drained family resources" (Ahmed et al. 2005:32). Consequently, access to healthcare (health services and protection) is a key factor in the success of reducing poverty, because

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<sup>132</sup> World Health Report 2005. *Make every mother and child count*. Geneva: World Health Organisation, 2005. [www.who.int/whr/2005/whr2005\\_en.pdf](http://www.who.int/whr/2005/whr2005_en.pdf)

<sup>133</sup> <http://www.who.int/inf-fs/en/index.html>

<sup>134</sup> The State of Food Insecurity in the World - Economic crises - impacts and lessons learned. Food and Agriculture Organization (FAO) of the United Nations, 2009: <ftp://ftp.fao.org/docrep/fao/012/i0876e/i0876e00.pdf>

being healthy is a crucial driver of social and economic development (Ofori-Adjei, 2007)<sup>135</sup>. Is microfinance promoting healthcare? Theoretically, it is believed that microfinance can improve health outcomes for women and children in terms of improving their nutritional status, food security, and basic health knowledge. Are empirical studies in line with this theoretical assumption?

### **7.3.1 Micro-credit, nutritional conditions and food security**

The impact of micro-credit on nutritional status and food security has been examined in a handful of studies, with mixed results. On the one hand, several studies indicate that microfinance programs do bring a positive impact on nutritional conditions and food security. For example, Zeller and Sharma (1998) showed that microfinance programs had positive impacts on households' total calorie intake in Bangladesh, China, and Madagascar. Similarly, Pitt and Khandker (1996) found that microfinance programs increase households' food consumption. Likewise, McNelly et al. (2003) noticed that microfinance programs had a positive and significant impact on households' food security in Ghana. Doocy et al. (2005) found that micro-credit improves food security in Ethiopia.

However, other studies suggest that microfinance programs do not have a

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<sup>135</sup> <http://www.ncbi.nlm.nih.gov/pmc/articles/PMC2350115/>.

significant impact on nutritional conditions and food security. For example, Diagne and Zeller (2001) found that microfinance does not improve food security. Schrieder (1996) observed a similar outcome in Cameroon. Likewise, microfinance programs had no significant impact on food security in Bolivia (McNelly et al, 2003). The effect of micro-credit on nutritional conditions of children is even more uncertain. For example, Schrieder and Pfaff (1997) noticed that nutritional effects were not observed in Niger. Similarly, the effects of microfinance on nutritional status were not found in Malawi (Diagne & Zeller 2001).

Overall, these mixed results reflect a rather complicated relation between micro-credit, nutritional conditions and food security. We cannot automatically assume that microfinance programs have a positive impact on nutrition and food security. The results of the impacts of micro-credit on nutrition and food security will be affected not only by experimental methodologies<sup>136</sup>, but also by country-specific and program-specific conditions, including the borrowers' ability to access adequate complementary inputs (e.g. modern agricultural facilities) (Sharma & Buchenrider 2002), geographical proximity (whether households live near microfinance institutions), and governments' attitudes towards microfinance programs (Gertler et al. 2009).

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<sup>136</sup> As discussed earlier, many studies fail to randomly choose their clients, and can thus exaggerate the impact of Microfinance on health. Moreover, impact studies have often been measured only for the most successful programs.

### 7.3.2 Microfinance and Public Health

The impact of microfinance on the borrowers' basic health knowledge has also been measured in a handful of studies, but with a positive result. For example, McNelly and Dunford (1998) showed that microfinance services, along with basic health education, led to an increase in breast-feeding practices in Bolivia and Ghana<sup>137</sup>. Babies fed breast milk were healthier than those who were not. Moreover, clients receiving health education demonstrated significant positive changes in a number of sanitation-related behaviors (e.g. giving baby food to infants and rehydration therapy to children with diarrhea). Dohn et al. (2004) found that, in the Dominican Republic, there was a significant difference between the group participating in a micro-credit program only, the group participating in health education only, and the group taking part in both micro-credit and education programs. The group participating in the micro-credit program experienced a little impact on the incidence of diarrhea. The group participating in health education experienced a 29 per cent reduction in the incidence of diarrhea. The group participating in both micro-credit and education programs experienced a reduction of 43 per cent in the incidence of diarrhea<sup>138</sup>. In Ghana, Cruze et al. (2009) found that microfinance institutions could effectively

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<sup>137</sup> McNelly B. Dunford C. Impact of credit with education on mothers and their young children's nutrition: CRECER credit with education program in Bolivia. Davis: Freedom from Hunger; 1999. Pdf file is Available from: [www.freedomfromhunger.org/.../childrens\\_nutritional\\_status.pdf](http://www.freedomfromhunger.org/.../childrens_nutritional_status.pdf)

<sup>138</sup> [www.scielosp.org/pdf/rpsp/v15n3/a07v15n3.pdf](http://www.scielosp.org/pdf/rpsp/v15n3/a07v15n3.pdf)



contribute to community and national malaria initiatives by providing clients with malaria education, leading to an increase in the use of mosquito nets and insecticide-treated bed nets (ITNs). Half of malaria clients owned a mosquito net and 11 per cent owned an ITN<sup>139</sup>. In Bangladesh, Schuler and Hashemi (1994) observed that the rates of contraceptive use were significantly higher for Grameen members (59 per cent) than for non-members (43 per cent). Freedom from Hunger's microfinance and health protection project also reported that, by combining microfinance with health education, clients demonstrate better sanitary behaviors and understanding of prenatal health, malaria, dengue fever, common childhood illnesses, and HIV/AIDS<sup>140</sup>. Recent studies also find that microfinance programs contribute to the reduction of HIV/AIDS (Human Immunodeficiency Virus/Acquired immune deficiency syndrome) in several African countries<sup>141</sup>. Perhaps the most notable study is the Intervention with Microfinance for AIDS and Gender Equity (IMAGE). Conducted by Pronyk et al., the IMAGE study illustrated that providing clients with micro-loans and gender and HIV training courses can reduce HIV risk behaviors among female participants who are under 35 years of age. Young female participants

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<sup>139</sup> <http://www.ffhtechnical.org/resources/articles/Microfinancemicrofinance-against-malaria-impact-freedom-hunger-s-malaria-education-when-deliv>

<sup>140</sup> The details can be found in its report of 'Microfinance and Health Protection Overview': <http://www.ffhtechnical.org/resources/Microfinancemicrofinance-amp-health/Microfinancemicrofinance-and-health-protection-overview>

<sup>141</sup> Sub-Saharan Africa accounts for 80 per cent of the 3 million people who die from HIV/AIDS (UNAIDS, Global Epidemic Update, 2005). About 80 per cent of the families had to contribute substantially to funeral cost, largely due to HIV/AIDS.

feel more comfortable discussing sexual matters at home and are more aware of the importance of having safe sex and voluntary counseling and testing for HIV<sup>142</sup>. In Uganda, Barnes et al. (2001) also found that 32 per cent of women receiving a HIV/AIDS prevention course tried at least one safe-sex practice compared to 18 per cent of non-clients. Similarly, in Kenya, Costigan et al. (2002) found that a combination of micro-loans and HIV/AIDS education reduces risky sexual behaviors and sexually transmitted infection (STI) rates.

Broadly speaking, microfinance programs, along with health education, have a positive impact on reproductive health, breastfeeding, child diarrhoea, HIV/AIDS prevention, sexually transmitted disease, and malaria. Microfinance can also improve health systems at a national level. A classic example often cited is the BRAC's health programs implemented in Bangladesh. Partnered with the national government, BRAC has launched several nationwide projects, including Water, Sanitation and Hygiene (WASH), Tuberculosis Control<sup>143</sup>, Malaria Control, and HIV/AIDS Prevention, in Bangladesh. BRAC's Tuberculosis Control program covers 42 out of 64 districts. Trained healthy volunteers, supervised by paid health workers, teach

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142 Pronyk PM, Kim JC, Abramsky T, et al. A combined Microfinance and training intervention can reduce HIV risk behavior in young female participants. *AIDS*. 2008 Aug;22(13):1659–65. PDF file is available at: [www.sef.co.za/.../08%20-%20Pronyk%20IMAGE%20on%20HIV%20AIDS%202008.pdf](http://www.sef.co.za/.../08%20-%20Pronyk%20IMAGE%20on%20HIV%20AIDS%202008.pdf)

143 In 2005, WHO estimated 1.7 million people died from Tuberculosis (TB) and nearly 9 million people developed active TB disease. 99 per cent of deaths occur in the developing world.

people about signs and symptoms of tuberculosis, giving patients free tuberculosis treatment. In order to motivate people to have tuberculosis examination and insure patients complete the tuberculosis treatment, BRAC requires each patient to deposit a certain amount of money (200 Taka/2.73 US dollar), which will be returned when treatment is completed<sup>144</sup>. Moreover, BRAC paid volunteer health workers when the treatment was finished. BRAC's Malaria Control program (in collaboration with the Directorate General of Health Services, the Malaria Research Group, and the International Centre for Diarrhoeal Diseases Research) has covered 13 districts since 1998. In this program, BRAC has offered early diagnosis, prompt treatment, and insecticide-treated mosquito nets. The latest health program that BRAC offers is the Water, Sanitation and Hygiene (WASH). Launched in 2006, the WASH program is aimed at providing hygiene education for 37.5 million people and improving water supplies and sanitation services in homes and schools. Another example of how microfinance improves the health system is the Uganda Private Health Providers Loan Fund (UPHPLF). Funded by the United States for International Development (USAID) and launched in January 2001, UPHPLF demonstrated that, by providing micro-loans and necessary technical support to private clinics, microfinance can play a significant

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<sup>144</sup> Before 2004, volunteer health workers were paid by patients.

role in improving the quality of private clinics and access to preventive and curative health services (Seiber and Robinson 2007).

### **7.3.3 Micro health insurance**

There is a growing consensus that microfinance programs can reduce poverty by offering borrowers micro health insurance. Although concern for establishing a sustainable and scalable micro health insurance model is growing, several microfinance institutions (e.g. Grameen Bank and BRAC) have shown that it is possible to create a nearly self-financing micro health insurance scheme<sup>145</sup>. Moreover, a growing number of microfinance institutions have partnered with insurance providers to offer micro health insurance. For example, in November 2009, the Women's World Banking (WWB), partnered with Zurich Financial Services Group, launched a micro health insurance program, Caregiver, which provides basic coverage (loss of income, childcare, transportation, portion of medical costs) to low-income households in countries across Africa, the Middle East, Asia, and Latin America. The other example is the Aga Khan Agency for Microfinance (AKAM). In collaboration with New Jubilee Life, an insurance company headquartered in Pakistan, AKAM, has

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<sup>145</sup> As of 2005, Grameen Kalyan's operating loss from 2002 to 2004 was \$388,000. However, it generated \$945,000 from investments of the profit generated from the endowment fund as well as other funds, resulting in a net gain of \$557,000 (Ahmed et al. 2005: 49). Although BRAC's Micro health insurance program had an operating loss of \$94,922 in 2005, its financial situation is improving. As of 2008, about 950 families took part in the micro health insurance program and the total cost of recovery is 34 per cent.

successfully provided micro health insurance to 60,000 clients (as of June 2010). The trend of providing micro health insurance is also encouraged by the latest academic evidence. According to their case study conducted in Bangladesh, Hamid et al. (2011) found that there is a positive correlation between the application of micro health insurance and household income, ownership of non-land assets, and food sufficiency.

In this section, the relation between microfinance and health has been examined. Although the impact of micro-credit on food security remains uncertain, microfinance is generally capable of contributing to improving public health (both locally and nationwide) and health outcomes for women and children by combining micro-financial services with health education and providing micro health insurance. This section also shows that microfinance institutions have unique abilities to facilitate health services because of their effectiveness in targeting poor households and running business in rural areas. I would like to end my discussion in this section by answering the question of why microfinance institutions should provide health services to their clients. There are two reasons for microfinance institutions to expand their services to include health. First, providing health services is a natural and fundamental extension of microfinance institutions' mission of reducing poverty. To reduce poverty, we have to make sure not only that poor households' incomes increase, but also that they are healthy enough to convert their income into their

well-being. In other words, their ability to do things they have reasons to value will not be clouded by malnutrition, diarrhoea, HIV/AIDS, sexually transmitted disease, malaria, and so on. The second reason for microfinance to provide health services is that healthier clients better serve the microfinance institutions' goal of being financially sustainable.

While recent studies show that microfinance institutions have unique characteristics suited to providing health services to poor households, we should not ignore that the costs of providing health services could further damage already weak financial structures in microfinance institutions. Governments can contribute to reducing the costs of health services provided by microfinance institutions by partnering with or subsidising microfinance institutions. Indeed, as I have shown, in the last decades, several international NGOs (e.g. Freedom from Hunger and Women's World Banking) have demonstrated that the model of subsidising microfinance institutions' costs of providing health services is practical.

## **7.4 Is microfinance empowering women?**

### **7.4.1 Sen's concept of the empowerment of women**

Although Sen does not say much about how microfinance can empower women, he does mention that microfinance, particularly micro-credit, can have two positive impacts. First, microfinance can increase women's incomes and their social status within a society, leading to greater gender equality. Second, microfinance can empower women by increasing their decision-making power over fertility and family planning. He says (1999: 201):

The remarkable success of the Grameen Bank in Bangladesh is a good example of this. That visionary micro-credit movement, led by Muhammad Yunus, has consistently aimed at removing the disadvantage from which women suffer, because of discriminatory treatment in the rural credit market, by making a special effort to provide credit to women borrowers. The result has been a very high proportion of women among the customers of the Grameen Bank. The remarkable record of that bank in having a very high rate of repayment (reported to be close to 98 percent) is not unrelated to the way women have responded to the opportunities offered to them and to the prospects of ensuring the continuation of such arrangements. Also in Bangladesh, similar emphasis has been placed on women's participation by BRAC, led by another visionary leader, Fazle Hasan Abed. These and other economic and social movements in Bangladesh have done a lot not merely to raise the 'deal' that women get, but also - through the greater agency of women - to bring about other major changes in the society. For example, the sharp decline in fertility rate that has occurred in Bangladesh in recent years seems to have clear connections with the increasingly higher involvement of women in social and economic affairs, in addition to much greater availability of family planning facilities, even in rural Bangladesh.

Can microfinance be seen through the lens of Sen's capability approach as an effective instrument for empowering women? To answer this question, we have first

to understand Sen's concept of the empowerment of women. In Sen's understanding, the concept of the empowerment of women is not only to do with the well-being of women, but more importantly with agency or a woman's direct involvement in realising things or objectives that she has reasons to value (Sen & Grown 1987; Sen 1992; Sen 1999). Many philosophers and development experts not only advocate Sen's emphasis on women's agency (Sen 1993; Kabeer 2001; Rowlands 1997; Nussbaum 2000), but also suggest that women's agency can be defined in a more comprehensive way. That is (Malhotra et al. 2002: 6):

Women should be able to define self interest and choice, and consider themselves as not only able, but entitled to make choices.

In other words, women should be touted consider as able to make choices relating to issues that are important to their lives and their families. Moreover, Sen suggests that several capabilities play a significant role in helping women to make strategic life choices and to control resources and decisions that could significantly affect their life outcomes. These capabilities include "women's ability to earn an independent income, to find employment outside the home, to have ownership rights and to have literacy, and be educated participants in decisions within and outside the family" (Sen 1999:191). Consequently, the impact of microfinance on the empowerment of women



should be assessed in terms of these capabilities. In what follows, the impact of microfinance on women's income, decision making power, and rights is examined<sup>146</sup>.

#### **6.4.2 The impact of microfinance on women's incomes**

As of December 31, 2006, over 130 million (133,030,913) people were able to access micro-loans and 85.2 percent (79,130,581) were women<sup>147</sup>. However, as I have shown in an earlier section (5.1), access to micro-loans does not necessarily or automatically empower women, because the determinants of people's abilities to pay back loans are complicated, involving not only personal attributes, but also other economic or environmental factors (Table 1). For example, the failure to pay back loans can lead to repossessions, which would exert a strong negative impact on clients whose financial structures are already weak. In addition, as shown in section 5.1, the latest empirical studies (Mahmud 2003; Banerjee et al. 2009; Karlan & Zinman 2010) indicate that micro-credit has no significant impact on poor borrowers' incomes and consumption, at least, in the 12-18 month timeframes.

What is more, even if female borrowers can successfully run their micro businesses, the actual contribution to the empowerment of women is often limited.

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<sup>146</sup> We should notice that different authors or agencies may have different ideas about which capabilities are of great importance in helping women to make strategic life choices. Scrutton and Luttrell (2007:2-6) and Malhotra et al. (2002:13) give us a useful comparison between different development agencies' definitions and operationalization of empowerment, and synthesize and list the most commonly used dimensions of the empowerment of women.

<sup>147</sup> State of the micro-credit summit campaign report 2007:  
[www.microcreditsummit.org/.../reports/.../EngSOCR2007.pdf](http://www.microcreditsummit.org/.../reports/.../EngSOCR2007.pdf)

Mayoux (2001) and Armendáriz and Morduch (2005) state that, since in many developing countries women still have responsibility for taking care of children and domestic chores, the management of a micro business can increase women's work and time burden, adversely affecting physical and mental health. Based on several previous studies (Mayoux 1995; Goetz & Gupta 1996; Ehlers & Main 1998), Rankin (2001) argued that microfinance may reinforce rather than challenge traditional gender roles. As she pointed out, "to the extent that women do initiate income-generating activity, they are often encouraged to take up enterprises, such as sweater knitting, that do not disrupt practices of isolation and seclusion within their households" (2002: 16-17). A similar situation can also be found in Cameroon. As Mayoux (2001) noted, women were unable to enter profitable businesses that were traditionally run by men because the resources and markets for these industries were also controlled by men and continued to block access to women. Indeed, the concern about the effect of micro-loans on the empowerment of women shows the importance of Sen's emphasis on women's agency. We care not only about whether women's incomes can be increased, but also about whether women are able to define their self-interest and choices when they have their incomes increased.

### **7.4.3 The impact of microfinance on women's decision power within and outside the family**

Regarding the impact of microfinance on women's decision-making power within the family, empirical studies show that microfinance can increase women's say in birth control and family planning. For example, Hashemi et al. (1996), and Amin et al. (1998) found that women participating in microfinance programs (micro-credit) in rural Bangladesh had higher autonomy, ranging from the freedom to visit the markets, the hospital, and their parents, to the freedom to use money to help their relatives or for their own purposes. Similarly, in Nepal, Ashe and Parrott (2001) observed that, by providing micro-financial services (loans and savings), along with literacy curricula including group strengthening, business development, empowerment, and community activism, microfinance institutions can increase female clients' decision-making power in areas of family planning, children's schooling and marriage, and buying and selling properties. Likewise, in the Philippines, Ashraf et al. (2006) found that microfinance, particular saving products, increased female-oriented durable goods consumption in households. Schuler and Hashemi (1994) and Mahmud (2003) also found that microfinance programs conducted in Bangladesh increased women's decision-making power over contraceptive use. Similarly, in Peru, Mitchell (1999) found that women, who took part in microfinance programs, demonstrated more

control over fertility decisions. In Vietnam, Capital Aid Fund for Employment of the Poor (CEP), a microfinance institution, reported that microfinance increased women's participation in the decisions of the household and community<sup>148</sup>.

Most empirical studies suggest that microfinance programs increased women's bargaining power over household issues such as allocation of household money, children's schooling, use of contraceptives, and family size. However, there is no solid evidence indicating that women's participation in microfinance leads to an increase in decision-making outside the family (e.g. business investment, marketing, and repayment) (Goetz & Gupta 1996; Mayoux 1998; Kabeer 2001; Mahmud 2003). But why is it difficult for women to participate in decision-making outside the family? Empirical studies suggest that it is the social structures dominated by men that make it difficult for women to take part in decisions outside the family. For example, a study conducted in Bangladesh suggests that it is often men who control micro-loans investment and income (Goetz & Gupta 1996). Similarly, in Nepal, Shrestha (1998) found that a considerable number of micro-loans were actually invested in 'male' activities such as ricksha<sup>149</sup>. Likewise, Mayoux (2001) observed that microfinance can channel women into a limited range of narrow economic niches which are

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<sup>148</sup> CEP (2006) An Impact Assessment of the Microfinance Institution Capital Aid Fund for Employment of the Poor. Available at <http://www.cep.org.vn/?page=publications>

<sup>149</sup> A small covered passenger vehicle with two wheels which is usually pulled by one person (Cambridge Dictionary 2006:1092).

saturated and unprofitable. Again, in their study in Bangladesh and India, Hunt and Kasynathan (2001) found that only a minority of female borrowers are able to control their loans. In most cases, “women are merely postboxes: passing on the full amount of their loans directly to their husbands, sons or sons-in-law, with little or no access to the income generated and receiving back only enough money to make weekly loan repayments” (Hunt & Kasynathan 2002:20).

Although gender bias towards women’s role in decision-making outside the family is anchored in deep-rooted social structures and ideological norms, several empirical studies suggest that the approach of providing micro-loans, along with technical and social awareness programs as part of the group lending approach, could be helpful in increasing women’s participation in decisions outside the family (Sebastad & Cohen 2002; Zaman 1999; Holvoet 2005). For example, in their study in South India and Bangladesh, Holvoet and Zaman found that women’s bargaining power over non-household issues (e.g. loan use, marketing, and repayment) increased when loans were disbursed through groups and combined with technical and social awareness courses. The effects of microfinance on women’s bargaining power over non-household issues are even more salient when women have been group members for a longer period. Indeed, these empirical studies indicate that, although solidarity group lending does not appear to be a necessary component of the microfinance

model in order to secure high repayment rates and could exert too many or too few social sanctions on the members, who fail to repay loans (see chapter 5), it is helpful in empowering women's role in decision-making (within and outside the family). But why is the group lending approach better than individual lending in terms of empowering women's participation in decision making outside the family? In their examination between social capital and credit group participation, Sebastad and Cohen (2000: 91) give us a possible explanation: "The [credit] groups provide a means for women to know and be known by other women; a forum for learning leadership and public speaking skills; and a basis for developing trust, friendship, and financial assistance". In other words, the credit groups can consolidate the relationship between women, encouraging them to accept knowledge of the empowerment of women and to participate in decision-making within and outside the family. Thus, if peer pressure of the credit groups can be properly controlled (i.e. neither too many causing serious harm nor too weak causing strategic defaults), then solidarity group lending has stronger empowering effects than individual lending does.

#### **7.4.4 The impact of microfinance on the political participation and rights of**

## **women**

Does women's participation in microfinance empower women politically? The only available academic evidence, to date, is Hashemi et al. (1996). By comparing Grameen Bank and BRAC microfinance programs, Hashemi et al. found that, because of combining micro-financial services with women's rights and political empowerment programs, BRAC's microfinance program has a stronger effect on the political empowerment of women (women more actively participate in political activities and public protests) than that of Grameen Bank.

While there is little academic evidence, several microfinance organisations have provided documentary evidence suggesting that microfinance has a positive impact on women's rights and political awareness. For example, Opportunity International, a microfinance institution providing micro-financial services (loans, savings, insurance, and training) in 20 countries, reported that female clients gained leadership experience through its leadership training program and several of them were elected as leaders at a community level in the Philippines. Similarly, in India, Working Women's Forum (WWF), an organisation attempting to bring better wages and working conditions to women, reported that over 98 percent of its members had taken up civic action for pressing problems in their neighborhoods (Cheston and Kuhn 2002; Dheepa and Barani 2010). Likewise, Freedom From Hunger, an international development

organisation working in 17 countries, reported that in Bolivia, women participating in its credit with education program were significantly more likely to take part in community political life, speak at the community's general assembly meeting, and run for public office or be a member of the community's sindicato (trade union) (MkNelly and McCord 2001:11). Moreover, as Cheston and Kuhn (2002) note, willingness to participate in community political life and run for public office is a reflection of women's self-confidence and of improvement in the community's attitude towards women's role in public affairs. Thus, microfinance can potentially play a role in building up women's self-confidence and status in the community.

#### **7.4.5 Impact on domestic violence**

Beyond the potential contributions to women's income, decision making, and rights, it is believed that women's participation in microfinance programs can also reduce domestic violence and strengthen family relationships. Does microfinance have a positive impact on domestic violence? Before answering this question, let me briefly discuss the concept of domestic violence and its current trend.

According to the United Nations Declaration on the Elimination of Violence against Women (1993), domestic violence includes "violence perpetrated by intimate partners and other family members" and is shown and demonstrated through (United



Nations Children's Fund Innocenti Research Centre Report 2000:4):

“**Physical abuse**, such as slapping, beating, arm twisting, stabbing, strangling, burning, choking, kicking, threats with an object or weapon, and murder. It also includes traditional practices harmful to women, such as genital mutilation and wife inheritance (the practice of passing a widow, and her property, to her dead husband's brother).

**Sexual abuse**, such as coerced sex through threats, intimidation or physical force, forcing unwanted sexual acts or forcing sex with others.

**Psychological abuse** which includes behavior that is intended to intimidate and persecute, and takes the form of threats of abandonment or abuse, confinement to the home, surveillance, threats to take away custody of the children, destruction of objects, isolation, verbal aggression and constant humiliation.

**Economic abuse** includes acts such as the denial of funds, refusal to contribute financially, denial of food and basic needs, and controlling access to healthcare, employment, etc”.

Although reliable statistics of domestic violence are hard to obtain, the World Health Organization (WHO) estimated that, on a global scale, between 15 to 71 per cent of women have experienced domestic violence<sup>150</sup>. Moreover, the greatest violence was reported by women living in a rural area setting in Bangladesh (62 per cent), Ethiopia (71 per cent), Peru (69 per cent), the United Republic of Tanzania (56 per cent), and Thailand (47 per cent)<sup>151</sup>.

Does microfinance contribute to reducing domestic violence? Most studies suggest that women's participation in microfinance has a positive impact on domestic

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<sup>150</sup> World Health Organization (2010) ‘Violence against women by intimate partners’ available at [http://www.who.int/gender/violence/who\\_multicountry\\_study/summary\\_report/chapter2/en/index.html](http://www.who.int/gender/violence/who_multicountry_study/summary_report/chapter2/en/index.html)

<sup>151</sup> *ibid.*

violence. For example, in Bangladesh, Hashemi and Rojas-Garcia (2004) found that, in their survey of 1,300 households, non microfinance females were 3 times more likely to be beaten than Grameen female clients and 2 times more likely to be beaten than BRAC clients. Working Women's Forum (WWF) also reported that 40.9 percent of its female members were able to stop domestic violence and 28.7 per cent of its female borrowers were able to end violence through group action<sup>152</sup>. In Nepal, the Centre for Self-help Development (CSD), a Financial Intermediary Non-Government Organization (FINGO) providing microfinance programs in Nepal, reported that there was a considerable decrease in wife beating (Cheston & Kuhn 2002). In South Africa, Kim et al. (2007) found that women's participation in microfinance reduces domestic violence.

While most studies suggest that women's participation in microfinance leads to a decrease in domestic violence, some argue that it could lead to an increase in domestic violence or make their husbands resentful of them (Goetz & Gupta 1996; Mayoux 1999; Marcus and Porter and Harper 1999). There is no doubt that, in some cases, microfinance can aggravate domestic violence. However, it is too much to claim that microfinance increases domestic violence. These cases are rather an understandable reaction of a patriarchy that is challenged by microfinance. Since domestic violence is

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<sup>152</sup> WorldPulse (2010) '5 Myths of Microfinance' available at <http://www.worldpulse.com/magazine/articles/5-myths-of-Microfinancemicrofinance>

deeply rooted in social structures and ideological norms that favour patriarchal societies, it inevitably causes ‘social frictions’, which sometimes turn into domestic violence when old and new attitudes towards gender roles collide. As Nowland-Foreman (2001) pointed out, in Bangladesh men become defensive and more abusive when excluded from credit opportunities<sup>153</sup>. They may even feel shame - earning less than their wives. In other words, although microfinance can lead to a decrease in domestic violence in the long run, it can sometimes lead to a short-term increase in violence. Overall, microfinance can potentially contribute to the empowerment of women. However, how microfinance empowers women is complicated. Contrary to the expectations of some, an increase in women’s incomes may not be seen as the genuine empowerment of women, for it can create a long-term negative impact on women’s physical and mental health, enhancing traditional gender roles. On the other hand, microfinance does increase women’s participation in decision making, in particular decision-making concerning birth control, family planning, children’s schooling and marriage, and buying and selling properties. Although the impact of microfinance on women’s participation in decision outside the family is limited, empirical studies suggest that the approach of providing micro-loans, along with technical and social awareness programs based on solidarity group lending,

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<sup>153</sup> [www.cid.org.nz/training/Microfinancemicrofinance.pdf](http://www.cid.org.nz/training/Microfinancemicrofinance.pdf)

could be helpful, for it can consolidate relationships between women, inspiring them to accept knowledge of the empowerment of women and to participate in decision-making outside the family. Microfinance can also empower women politically. Microfinance can increase women's rights and political awareness through the advocacy of programs that can nurture their knowledge of participating in political parties, being community leaders, and running for public offices. In addition, women's participation in microfinance can create conditions for long-term improvement in self-confidence, and decrease violence.

## **7.6 Conclusions**

The aim of this chapter has been to establish whether microfinance increases or decreases poor people's basic capabilities (substantial freedoms). The effects of microfinance on poverty reduction can further summarised as follows:

- There is no solid evidence supporting the claim that microloans increase poor borrowers' incomes or consumption. Moreover, microloans can potentially decrease people's freedom. Since the determinants of people's abilities to pay back loans are complicated, any repossession will exert a negative impact on clients, whose financial structures are already fragile, when defaults happen. Although microfinance may not directly increase the incomes of the entrepreneurial poor, it

does help them to cover start-up costs and smooth their consumption.

- The poorest clients benefit less than the less poor when they have access to microfinance, for they do not only lack money, but they are also less capable of starting and expanding their business and paying back loans. In order to help poor people in general to have better investments in their micro businesses or to pay back loans, two measures might be helpful. One is to provide clients with microloans in the context of business-capacity building programs. The other is to offer clients microsavings or microinsurance services.
- The influence of microfinance on education is positive. Microfinance does improve school enrollment rates by removing risk management and gender barriers and by changing parents' perception of the value of schooling. Microfinance also helps to increase clients' financial literacy. However, contrary to the expectations of some, microfinance does not increase school enrollment rates by lifting poor households' incomes up to levels that are high enough to cover the costs of sending their children to school. In some cases, microfinance can even create a new demand for child labour.
- Microfinance programs, along with health education, have a positive impact on reproductive health, breastfeeding, child diarrhoea, HIV/AIDS prevention, sexually transmitted disease, and Malaria. Microfinance can also contribute to public health

and health system at national level. By providing microloans and necessary technical supports to private clinics, microfinance can play a significant role in improving the quality of private clinics and access to preventive and curative health services.

- Microfinance can potentially contribute to the empowerment of women.

Microfinance increases women's participation in decision making and in particular in decision within family such as birth control, family planning, children's schooling and marriage, and buying and selling properties. In addition, if peer pressure within credit groups can be properly controlled, solidarity group lending could have stronger empowering effects on women's decisions outside the family than individual lending. Women's participation in microfinance can, too, empower women politically by offering female clients political awareness courses. Moreover, microfinance can create conditions for the long-term improvement in self-confidence and decreased violence. However, we should note that increasing women's income may not necessarily empower women, for it can create a long term negative impact on women's physical and mental health, enhancing traditional gender roles.

The findings summarised above lead us to the conclusion that there is no automatic positive link between microfinance and poverty reduction. Microfinance does not

necessarily expand freedom. From the viewpoint of Sen's capability approach, a better design for a microfinance program is not to provide microloans, but to provide microsavings and microinsurance, along with other non-financial services programs including businesses, basic education, basic health, and political empowerment courses. In saying this I do not mean we should stop granting poor people microloans, but that the microfinance industry should deemphasize microcredit, for it can potentially bring a much stronger negative impact on people's substantial freedoms than microsavings and microinsurance.

## **Conclusion**

The main questions I have tried to answer in this thesis are: (1) Is Sen's capability approach a better approach to the evaluation of well-being and poverty (discussed in chapters 2, 3, 4 and 5)? (2) What are the contributions of microfinance to poverty reduction from the viewpoint of Sen's capability approach (discussed in chapters 6 and 7)? My answers to these questions can be summarized as follows: Although Sen's capability approach has drawbacks, both as a general moral theory and as a theory of justice, in that it does not give us an idea about either what justice is or what the difference is between right and wrong', it does bring up important aspects of development and poverty reduction. That is, any social policies and arrangements relevant to development and poverty reduction should be assessed in the terms of their impact on an individual's ability to convert resources into well-being, or their substantial freedoms to do things they have reason to value. Sen's idea of linking basic capabilities with poverty has shed much light on the issue of measuring poverty. Basic capabilities do not refer to wide-ranging freedoms, but to an individual's real freedom to do things considered necessary for survival or to avoid serious deprivations, or to move over a threshold of well-being. Such a link is particularly useful when assessing the current situation in developing countries. When development and poverty are understood in this way, we are able to pay attention not



only to the income and various physical and mental conditions of individuals, but to the basic political institutions, social norms and arrangements that have significant impacts on our daily activities and life plans.

Moreover, when compared with other approaches of development and poverty reduction (e.g. a monetary approach and a basic needs approach), Sen's capability approach has a more sophisticated and relatively well-established philosophical foundation, which consists of elements reminiscent of Aristotle, relativism, and agency. The influence of Aristotle on Sen's capability approach can be found in Sen's emphasis on functionings and the capability to function as a moral space for assessing well-being and development. Income or commodities are only instrumentally important. Their importance lies in their contribution to a good quality of life. The end of economics and politics is the common promotion of human freedom – capabilities or real opportunities to pursue things and a life that they have reasons to value. Sen's stress on relativism is mainly derived from his dissatisfaction with the failure of utilitarianism and John Rawls' theory of justice to attune to the difference in the condition of human beings globally. In other words, personal heterogeneities (mentally, physically, socially, and geographically) can significantly promote or deter an individual's actual opportunities to determine his or her fate. Sen's recognition of human diversity and praise for agency – an individual's ability to act on his own

behalf, and by assessing his achievements against his own objectives – have forced him to admit that the idea of what are deemed basic capabilities is inescapably pluralist. Although some argue that Sen’s enthusiasm for allowing people’s values as the basis of the selection of basic capabilities underestimates the situation in which people’s values and beliefs have been occupied by social biases and prejudices, I have shown that (discussed in chapters 4 and 5) Sen’s further elaboration of rationality, agency, and democracy can well address the issue of selection bias.

With respect to the question of the evaluation of microfinance, microfinance has been touted by many, including Sen, as a poverty-reducing measure. When the empirical evidence is combined with criteria from the capability approach, microfinance is a relative failure as a poverty-reducing approach. In other words, microfinance does not substantially expand people’s real freedom or capability to do things they have reasons to value. The evidence that micro-loans reduce poverty is weak, and there are moral arguments against the group lending approach that is used to assure repayments. Other services sometimes associated with microfinance – savings and insurance — do help the poor, however. Sen’s capability approach does help, moreover, to articulate these conclusions. However, we should notice that the conclusion I propose here does not exclude the possibility that perhaps microfinance does help promote some other freedoms that are of significance locally.

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