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Abstract: Fair prices have been recently addressed through debates on fair trade or fair wage. This paper addresses the fairness of credits to the poor. It first analyzes a few definitions of fair interest rates. It then determines the extent of the 'just' range of a price, its major constraints and the methodology to assess the fairness of the distribution. Based on Gauthier's (1986) work on imperfect markets, a contractarian position is presented.

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1. Introduction

Debates on fair prices have a long historical background, starting with Aristotle's denunciation of interest as the unnatural fruit of a barren parent. More recently, the fair trade movement started to lobby for a fair remuneration for the low-income countries' workers.

Microcredits have been developed to offer fairer prices to small entrepreneurs in developing countries. Today, many poor citizens in developing countries can only access credit through informal lenders. Two and a half billion citizens lack access to financial services. When they have access to microcredits, they receive loans at a lower price than with these informal lenders. Through the Grameen Bank and M. Yunus, the peace Nobel Prize jury recently rewarded microfinance institutions (MFIs) "efforts to create economic and social development from below" (Nobel Prize, 2006). Nevertheless, and except for a few countries where the microfinance market is very competitive, microfinance institutions still charge very high interest rates, partly due to the high transaction and operating costs of the small loans. These rates often range between 20 to 60% per year, according to the environment or the loan's methodology. Compartamos, one of the fastest growing sustainable MFIs in Latin America, is even charging an annual rate of 120% per year, after fees and taxation (New Yorker, 2006).

While high interest rates are still sometimes discussed and challenged inside the microfinance sector, the new and growing ethical inflection is currently coming from outsiders, these being the civil society or the politic world. During the summer of 2006, around fifty branches of two major MFIs were closed by district authorities in Andhra Pradesh State (Fouillet, 2006). The authorities denounced what they considered usurious interest rates with forced or unethical recovery practices (Shylendra, 2006). Ethical issues and particularly debates on the interest rate levels are thus now widely accepted as a major threat to the whole microfinance sector's sustainability.

This article will analyze the ethical dimensions of lending to the poor and try to determine what fair interest rates would entail. We will focus on the cases when borrowers can afford interest rates that cover lending costs. Major theories of justice

address liberal societies (Rawls) or hypothetical perfect markets (Nozick or Hayek) and are often not gender equal (Okin). The problem of imperfect markets and their very high prices relates to two different rationales: the ethical or moral issue (deontological approach) and the bargaining one (market-related arguments). Interest rates in imperfect markets are therefore not only an ethical question but also a bargaining one. We will build on Gauthier's bargaining (1986) theory on incomplete or uncompetitive markets and will balance it with ethical arguments.

The structure of the article is as follow. The next section will review some empirical evidences on the debates on interest rates. Section 3 and 4 will assess some approaches to interest rate fairness. Section 5 will consider the different actors involved in the fairness discussion. The three last sections will present a contractarian approach on interest rates' fairness.

2. Relationship between interest rates and background inequalities in developing countries financial systems

It is generally very difficult to compare interest rate levels. The lenders' social and economic environments, the customs, taxes currencies or laws can easily differ (Homer and Sylla, 2005). Cultural and historical aspects may further impact interest rate policies. Nevertheless, as Homer and Sylla (2005, p. 9) also argue, 'we should not refuse to compare effects because causes have changed'.
The debate on the importance of the interest rates has long been contested in the ethics and economic literature. Egalitarian economists have always argued that interest rate levels matter since they represent a major mechanism of inequality in the distribution of income. This question is certainly relevant for interest rates on loans since they are less equally divided than aggregate income or employee compensation.

The traditional response to their argument was that even if they are proportionally very unequally distributed, interest payments have a fairly moderate effect on the inequality of income distribution because of their absolute low level of share in income generated. The effect of the unequal distribution would then be unimportant[2].

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[2] Conard (1959), pp. 99-101.

The very concept of diminishing marginal return to capital suggests that enterprises with little capital should be able to earn a higher return on their investments than larger, better capitalized enterprises. The poorest entrepreneurs should thus be able to afford to pay higher interests, and money would then flow from rich depositors to poor lenders[3]. The Nobel-winning economist Robert Lucas has calculated the difference in return based on the marginal return of capital and found that under the classical assumptions, the poor Indian borrowers should be willing to pay fifty to eighty times as much for capital as borrowers in the United States[4].

In poor areas, the weight of interest rate in total income is certainly still small for many poor entrepreneurs active in very productive sectors, even if it may not be dismissed as negligible. As argued by many donors or microfinance institutions, poor borrowers have proven that they can easily repay from their income-generating activities. Interest rate levels should not problematic because the high turn-over of the activities of the poor clients enables them to pay high interest rates[5].

Even at the bottom of the income pyramid, very poor borrowers active in petty trade or selling goods in small markets in developing countries repay rapidly thanks to the very high margins and turn-over of their income-generating activity. In short, the borrowers targeted by microfinance activities should be insensitive and not responsive to price changes. There is however very few broad evidence on the returns and the weight of the interest rate in the poor' profit and loss.

For instance, one of the most quoted surveys (Rosenberg, 2002), done by Castello et al. (1991), is based on the detailed study of nine micro-entrepreneurs[6]. Many of the world's poorest people, however, are still active in agriculture or other activities with much lower productivity and have at best a monopolistic source of funding (if not only by moneylenders).

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[3] Armendariz de Aghion, B. and J. Morduch (2005), *The Economics of Microfinance*, MIT Press: Boston.

[4] Luchas, R. (1990), Why does not capital flow from rich to poor countries?, *American Economic Review Papers and Proceedings*, 80, 2, pp. 92-96.

[5] Helms, B., Reille, X. (2004), Interest rates ceilings and microfinance: The story so far, *CGAP Occasional Paper*, 9, CGAP: The World Bank Group.

[6] Very few studies exist on the part of the interest rate costs on the revenues. A case study of Morrocan micro-entrepreneurs however suggest that for some activities, such as the farmers, interest rates can represent until 45% of total benefits (PlaNet Finance, 2006). Another survey found that interest rates charged by the institution are one of the two main selection criteria (Wright and Rippey, 2003). In line with Dehejia et al. (2005), one could thus assume that the poorest clients such as the farmers are more sensitive to the interest rates level.

Some empirical evidences show that, if MFIs are not largely subsidized and thus dependent on public funding, institutions targeting the very poor clients charge higher rates than the traditional banking institutions (Hudon and Traca, 2006). Therefore, through more expensive financial services, microfinance could increase some basic inequalities.

Inequality between microfinance and traditional institutions is even reemphasized inside the microfinance sector since data gathered by the MIX Market suggest that MFIs targeting the lowest-end of the population, the poorest, charge higher interest rates than the others (MIX Market, 2006). Finally, the poorest clients seem to be more sensitive to the interest rate levels such as Dehejia et al. (2005) results suggest. Based on these data, one could be tempted to rapidly judge interest rate policies of MFIs as unfair. Interest rate settings however reflect broader inequalities in the access to financial services. Without this service, inequality would even be higher. Inequalities are not created by microfinance itself but it reflects basic inequalities since 'markets are functioning as mirrors' (Kanbur**,** 2003). Even if the pricing policy of microfinance as the whole credit market amplifies inequalities, banning this market will not solve the problem; the inequalities are the cause of the problem not the interest rates.

By giving access to cheaper credits, MFIs undeniably provide additional opportunities or freedoms to the poor. Since they can greatly influence the economic entitlements that the poor are able to secure, availability and access to finance are, for instance, core economic facilities in Sen's system of instrumental freedoms (Sen, 1999, p. 39). A recent survey also found out that access to credit is correlated with economic development (Beck et al., 2006). Credit constraints have been widely acknowledged as major constraint for economic development, both at the micro and macro level. Rawls (1999) even considers credit access as part of a global justice framework. In *The Law of People,* Rawls explains that the parties will formulate, under the veil of ignorance, guidelines for setting up two cooperative organizations. One of the two cooperative organizations is a central bank to allow borrowing from a cooperative banking system, similarly to the World Bank (Rawls, 1999, p. 42).

Furthermore, after decades of un-sustainable development credit projects, some of these institutions, such as ASA in Bangladesh, have further proven to be able to sustainably serve very poor clients without needing additional public funding (Armendariz de Aghion and Morduch, 2005).

In short, on one hand, one should refuse an easy condemnation of microcredits' interest rates as unethical because of their absolute high level. On the other hand, even if a financial institution is doing a very valuable work offering financial services at a much lower price than the second-best informal lenders, a better or cheaper service is not automatically a fair one. High interest rates may also potentially harm some poor if they don't get large returns with their activity.
The debate on the fairness of microcredit interest rates can be embedded in the larger debate on fair prices. While the literature on the fairness of microcredit interest rates is pretty new, one will find some very relevant and valuable insights in the riper literature on fair prices.

3. Is there such a thing as a "fair price"?

The existence of a fair interest rate or a fair wage has long been - and still is - a controversial topic. In this section, we will review some of Smith's and Bentham's insights on fair prices, and suggest what a libertarian and Rawlsian analysis of fair price would be.
It is well-known that Adam Smith considered that by pursuing his own interest, one frequently promotes society's interest more effectively than when one really intends to promote it (Smith, 1776, p. 400). Through the market and Smith's 'system of natural liberty', seemingly opposed interests of different individuals fully harmonize (Gauthier, 1986, p. 83). Contrary to Bentham, he was however in favor of a state restriction on interest rates, where the law would fix the highest interest rate than could be charged to prevent from extortion of usury (Smith, 1776, p. 376). According to Bentham, there are no ways in which usury laws can do any good. There are however several, in which they can do mischief (Bentham, 1816, p. 9).

'The man of ripe years and sound mind, acting freely and with eyes open ought to be hindered (...) from making such bargain, in the way of obtaining money, as he thinks fit: nor anybody hindered from supplying upon any terms he thinks proper to accede to (Bentham, 1816, *Defence to Usury*).

More recently, a libertarian interpretation of fair prices has come about through Nozick's principles of justice. The fair transaction would be judged on the

concordance with the principles of justice in holdings. The money should thus not be previously possessed by anyone or then should be properly and voluntarily transferred. If one of these two principles is violated, then the principle of rectification of injustice comes into play (Nozick, 1974, p. 230). According to Nozick (1974, pp. 151-2), a distribution is just if it has arisen in accordance with this set of rules.
The perfectly competitive market (PCM) interpretation of fair prices is even more straightforward. In a PCM with many buyers and sellers, no agent should be able to influence the price of the transaction. A neo-classical economist considers a fair interest rate as the intersection between the demand and the supply of credit. Therefore, perfectly competitive markets are considered morally free zones. The market is a moral-free zone because there is no morally just way to distribute surplus or fix the costs supported by all actors. As also argued by Gauthier (1986, p. 96), in perfectly competitive markets, "choice is neither morally right nor wrong because the coincidence of utility-maximization and optimization in free interaction removes both need and rationale for the constraints that morality provides". According to Hayek (1978), social justice is not relevant in a market[7]. Therefore, there is little ground on what fair prices would be. He later moderates or clarifies his view arguing that what we mean by fair price is the customary price, the return which past experience has made people expect or the price that would exist if there were no monopolistic exploitation (Hayek, 1994, p. 122).

A few arguments have been opposed to the concept of morally-neutral perfectly competitive markets, mostly against its assumptions. For instance, the assumption of externalities' inexistence or Gauthier's assumption of non-coercion in the initial bargaining position is commonly criticized as very irrational. Moreover, one cannot automatically assume a perfect market in the real world. For instance, while truly competitive markets require that transactions take place at prices that institutions cannot affect, we know that real-life business practices can reduce competition and thereby influence prices[8].For instance, interventions by central banks to prevent inflation or unemployment inevitably results in rates different from those that would be established in a free market[9]. Some instrumental constraints may also limit a firm's

[7] Hayek, F. (1978), *Law, Legislation and Liberty*, vol. 2 (*The Mirage of Social Justice*), chap.9.
[8] Sen, A. (1993), p. 222.
[9] Conard, J. (1959), p. 106.

ability to freely pursue its objective of profit maximization. Some business practices may be ruled out as ethically or legally unacceptable, even if they enhance the promotion of this objective[10].

Specifically, in the business of lending to the poor, the market can certainly not be considered as open and fully competitive. Money does not flow primarily to poor entrepreneurs whose enterprises are the most credit constrained. Borrowers lack collateral, which creates potential problems of adverse selection and moral hazard for institutions[11]. In addition, both parties lack the complete information that is assumed in perfect markets. Banks might lack complete information about the borrowers' situation[12], and borrowers might lack complete information about all financing options that may be available. As a consequence of all these factors, market interactions create a joint social surplus and the fairness of the distribution of this surplus depends at least partly on the patterns of pre-existing distributions[13]. Each of these market imperfections entails moral consequences, and the whole issue becomes therefore morally significant.

A Rawlsian interpretation of the fairness of price is also cumbersome (Hudon, 2006). There is not direct condemnation of prices in Rawls theory. Nevertheless, even if prices are only secondary norms, high prices especially can lead to injustice in the system and therefore be unfair. It happens when the interest rates are so high that none of their additional effects in the system can compensate for the defects caused by that price (Hudon, 2006). Except this case, Rawls emphasises that it is the whole system and not the price that must be assessed.

Under some conditions, both libertarians and Rawls may, thus, accept very high prices and deep inequalities as part of a just framework. Aside the interpretations of these two major philosophical approaches, some other criteria have been developed to assess the fairness of the interest rates.

4. Ethical debates around interest rates in the microfinance sector

[10] Sen (1993), p. 204.

[11] Contrary to the neo-classical premise, entrepreneurs with less capital could have lower marginal return than rich entrepreneurs. This difference can be explained by differences in education levels, business savvy or commercial contacts, all factors held constant among all actors in the neo-classical theory. See: Armendariz de Aghion and Morduch (2005)

[12] Stiglitz and Weiss (1981)

[13] Sen (1985)

After a short historical background to the interest rate debate during the emergence of the microfinance sector, this section will present some existing approaches to handle the fairness of microcredits.
Before the 70s, interest rates charged to poor entrepreneurs, particularly the rural ones, were very small in development projects. In the 70s and 80s, very severe debates started on these low interest rates policies, and further developed with the emergence of the very costly microcredit loans. For example, Adams et al. (1984) seminal book *Undermining rural development with cheap credit* or other papers from the Ohio School scholars were a response to the view that the rural poor should have low, but also very subsidized interest rates. Cheap credits would destroy the incentives to save in financial forms and distort the way lenders allocate funds (Adams et al., 1984, p. 75). The rationale is that "low interest rates on loans to rural people end, paradoxically, by restricting their access to financial services" (Von Pischke, 1983, p. 176).

Four main approaches and criteria of fairness of interest rates can be identified. The first one refers to deontological arguments. The second one approaches the question through the marginal impact on the client's financial situation. The third one is market-based and focuses on the demand. The fourth and last one suggests a procedural definition of fair interest rate based on the fair wage literature.
The deontological approach, the **first** and oldest one, has a long historical background. Aristotle already denounced interest as the unnatural fruit of a barren parent[14]. Similarly, heated theological debates on the legality of interest have flourished for centuries[15]. The Council of Nice condemned interest in 325 AD, on the basis of the Old Testament's prohibition of interest among fellow Jews. Usury laws, prohibiting interest rates or limiting their maximum level, have historically flourished based on these religious backgrounds. Additionally, some of the proponents of usury laws root their arguments in the defense of the borrower against what the Marxist notion of exploitation or "super-exploitation", when the borrower has to pay a

[14] Conard (1959), p. 97.
[15] Sen (1993); Conard (1959)

surplus-value[16]. Similarly, Keynes (1936, pp. 378-379) hoped that pure interest rates could be driven to zero within one generation, to bring about the euthanasia of the *rentiers*. All religious, Marxist and Keynesian motivations refer to the intrinsically unjust or potentially harmful interest rates gained by the lenders. Usury laws, often based on a combination of these motivations, are designed as a tool to constrain lenders' activities and protect the clients against potentially extortive interest rates. Usury laws are very used in developed and developing countries. Helms and Reille (2004) recently listed about forty developing and transitional countries that have introduced regulations about interest rate ceilings of some kind.

Nevertheless, some of the proponents of the new microfinance schemes have constantly challenged the effectiveness of those laws. Gonzalez-Vega (1977) already argued thirty years ago that any limitation on the interest rate level would have counter-productive effects. Low interest rates or usury laws would make the institutions concentrate their portfolio on fewer clients, the most profitable and powerful ones. Concretely, a usury law putting a low interest rate as maximum would force the institutions managers without additional resources or sufficient margins to provide larger loans to decrease their operating costs, and therefore exclude the poorest segment of their portfolio. Higher and more flexible interest rates would result in a more equitable income distribution (Adams, 1984).

The **second** approach, a consequentialist one, addresses the fairness through the amelioration or worsening of the client's situation. To assess the fairness of interest rates, one should evaluate the clients' costs if the absence of the lender institution. In microfinance, it refers to the fact that, even if microcredit interest rates are high, they are much lower than interest rates of the loans that the microentrepreneurs previously took. The interest rate is fair since all previous and second best opportunities are much more expensive[17]. For instance, Aleem (1990) reports an interest differential between formal and informal lenders of more than 50 percentage points.

Two critiques can be made. First, taking the informal lenders' interest rates as acceptable comparison, one accepts as reference point situations where the

[16] In Chapter 27 of Volume 3 of the Capital, Marx (1894) explains that: "The two characteristics immanent in the credit system are, on the one hand, to develop the incentive of capitalist production, enrichment through exploitation of the labour of others, (…) ; on the other hand, to constitute the form of transition to a new mode of production".

[17] In some cases many institutions are active in the same area with similar rates; in these cases, the argument should thus be broadened to the microfinance sector rather than an MFI.

background system of financial exclusion is undeniably unjust in almost all theories of justice[18].

Second, the requirements for this criterion of fairness can be very lax. Imagine, for instance, an institution to be started in a very remote area where no formal financial institution is active and where informal lenders such as moneylenders charge usurious rates, even if pretty reasonable within moneylenders' standards, for instance 15% a month. Imagine that this institution decides to charge exorbitant interest rates, 10% per month, partly because of their high operating costs but mainly because of inefficient management and their poor know-how or technologies. If one follows a definition of fairness focusing only on the impact of the loan on its clients in comparison with the previous situation, the 10% margin is fair even if it would let a very small profit margin to the borrower. This can be related to the widely used example in the ethics literature of the drowning person[19] and the one who can help him. If the only concern is what he could expect in the absence of the person who could save him, any solution is acceptable, even if it involves totally unmerited deals with irrecoverable consequences.

The **third** widely displayed approach to the ethical dimension of microcredit interest rates focuses on the demand of credit. It uses the high repayment rates and the repetitive loans as instrumental proxies of fairness. High repayment and constant demand would reflect the affordability of the loans and thus its fairness. If the client decides to take these microcredits, repay them and often take additional loans, the service must be very valuable to him. The emphasis should be put on the access to credit rather than the interest rate level since the returns are very high for their productive activity.

These arguments are, for instance, similarly used in the trade debate. Opponents of the inclusion of fairness considerations in the trade negotiations often argue that the agreements are voluntary. All agreements that the developing countries think would make them worse off will then be refused (Stiglitz and Charlton, 2006).

Nevertheless, in non-competitive markets, the client may well decide to retake a loan since it is the best offer he gets and even if the price is exorbitant. Still, as in the trade case, the distribution of the benefits may well be disproportionate. The poor may also,

[18] We will come back to this point in Section 7 and 8 on the contractarian conception of fair price.

[19] See for instance Gauthier (1986)

for instance, lack the bargaining power to influence the price or approach another lender.

The **fourth** and last perspective we will study is a procedural one. Two models of procedural justice can be construed. We have already described a first one in Hudon (2006), based on what Hooker (2005) calls *formal* fairness. Assuming a well-organized market, fairness would then only require that its rules be correctly applied, impartially and equally to all customers.

The second one is based on the interpersonal comparison of the interest rate levels. To develop this approach, a parallelism with the fair wage concept may be very enlightening. While the concept of fair interest rate has not been recently much debated in the literature, the fair wage is much more present in the ethic and economic literature. For instance, in 1885, Belgium already issued fair wage clauses, based on the presumed natural justice of a system of free private enterprise (Johnson, 1938, p. 176). Fair wages for public contracts were to be equal to those paid by reputable employers in the private sector.

Similarly to the fair interest, many interpretations of fair wage have been designed. For instance, fair wage can be determined by the market wage (whatever this may be) as in Akerlof and Yellen (1990). Alternatively, one can also assume that the wage is at least as high as the one paid before (Levine, 1993 ; Akerlof, 1982).

A major alternative doctrine is that the fair wage recommends that work of equal, skill or unpleasantness should be equally compensated (Johnson, 1938, p. 177). Pull (2006) argues that worker fairness conceptions might be similar to what the result of a co-operative game would be. Fairness conceptions are then influenced by what a fair arbitrator would have suggested. The fair wage then becomes a function of worker outside options, employer commitment in the contractual relation, employment level, returns and the sensitivity of returns with respect to wages.

The fair wage is thus related to what a fair arbitrator would have suggested based on what a neutral individual may expect. The fair arbitrator would base his evaluation on the current evidence or knowledge on the relationship between an individual's characteristics and his wage. For instance, the more the employer has "invested" in worker specific human capital, the better the worker's bargaining position and the higher the fair wage (Pull, 2006).

A parallelism with interest rates can easily be made. Credit scoring plays a similar role of assessing the clients' characteristics. Before accepting a new client or giving an additional loan, financial institutions use credit scoring to assess the probability of their clients or future clients' repayment. As defined by Schreiner (2004), "scoring is the use of the knowledge of the performance and characteristics of past loans to predict the performance of future loans".

The clients are scored based on a scale using various characteristics. Even if it is practically very difficult, one could well imagine that an institution, which has a lot of information on its clients and potential clients, propose loans with interest rates related to the clients' characteristics and scoring. Hence, scales of credit scoring or fair wages both aim at giving information to assess the value or risk of the client or the employee.

The main potential flaw of this approach of fair interest rates lays in the scoring indicators that are used to determinate the interest rate. One may decide to use the indicators best correlated to wage levels or repayment performances. Specifically in credit scoring, marital status, age, place of residence, and ethnicity are among the most predictive characteristics for scoring in microfinance are gender (Schreiner, 2004). The choice of the indicator can be economically neutral, it is clearly not neutral ethically. Some indicators may well conflict with our conception and principles of justice. For instance, many databases on wages will see a significant influence of the gender of the worker. Men are very often better paid. Could a man who earns a similar salary than his female colleague claim that his salary is unfair because men tend to earn more? Gender discrimination is very often highlighted in labor economics and is now hardly fought, but other discriminations may well persist or even be amplified.

The principle of equal opportunity of chance can also undeniably be affected with decisions based on the person's profile. By taking the current background as given, whatever this one contains, this approach is likely to maintain basic inequalities in wage or interest rate pricing. Scoring assumes that the future will be like the past (Schreiner, 2004). If it is well-managed, it can be very helpful to manage the loans and the risks faced by the institution. It should however not be used as a measure of fairness.

Many microfinance actors agree with the second and third perspectives. They argue that lower interest rates should be promoted but not imposed. They should be targeted in the long term. Two traditional instruments to decrease the rates are the transparency of the pricing policy and the development of competition in the sector[20]. They therefore implicitly tolerate some high interest rates but try to create a framework that would make them impossible.
It would however be wrong to assume that the whole sector agrees that high interest rates should only be a goal. For instance, with deontological arguments on the fragility of the clients, Muhammad Yunus considers that MFIs charging higher rates than the costs of funds plus a 15% margin should be considered as imitating the money-lending activity (RESULTS, 2006).

After the analysis of four different approaches to fair interest rates, it is evident that all definitions share a trade-off between the institutions and the clients' interest. The deontological approach puts the emphasis on the clients and aim at protecting their interests; it would easily put the institutions at risk. Both the second and third approaches based on the marginal benefit to the customer and on the demand of the loan start from the client's use but intrinsically foster the institution's development with very limited requirements. Finally, the procedural approaches someway ignore both the clients and the institutions' interest by simply following guidelines or benchmarks. None of these approaches satisfy our requirements for fairness. As preliminary to build an innovative approach on fair prices, the next section will study the conflict of interest between the institutions and the clients.

5. Fairness and conflicts of interest between clients, future clients and institutions: A fair price to whom?

The microfinance discussions have long been divided in two camps. First, "institutional" arguments put the emphasis on the MFIs' sustainability. Interest rates should make sure that the institutions sustain, and thus that the poor will keep access

[20] Helms and Reille (2006)

to cheaper institutions than informal lenders[21]. Second, “welfare” arguments would base their analysis on the clients’ personal development through credit. Interest rates should enable the poor to start their way out of poverty. One could thus assume that the fair distribution of interest rates follows this division and balances the clients’ and the institutions’ interests. Even if innovative solutions can bring both interests together, there is still an intrinsic conflict of interest between the institution and the clients’ interests. This conflict of interest is even emphasized in the economic literature where concepts such as moral hazard emphasize the low trust or non-cooperative relationship of the agents (Lapavitsas, 2003).

Nevertheless, the debate on fair interest rates enables to open a new perspective since many proponents of institutional arguments surprisingly use welfare perceptions to justify their rates. The welfare is however not the welfare of the clients but the one of the potential future clients that would be harmed if not reached by MFIs.

For instance, E. Rhyne, Vice-President of Accion, defines fair pricing as pricing “that allows the institution to operate as a going concern, but at the same time is as low cost to the customer as possible”. Accion consumer pledge considers that “interest rates will not provide excessive profits, but will be sufficient to ensure that the business can survive and grow to reach more people” (Accion, 2004).

Accion’s pledge, the main one of this kind, is certainly a first step in the right direction. The pledge is however voluntary, a sort of gentlemen’s agreement, and if other institutions in the same area prefer not to adopt it, they could easily spoil the market with bad practices. A few questions remain. To which extent does the going concern of the institution’s operation could conflict with the lowest possible costs to the customers?

This definition does not directly refer to the customers’ situation since the reference to the lowest cost to the customer aims at refraining the institutions to impose an additional burden on the poor. This concern is however addressed through the avoidance of overindebtedness[22] and other consumer protection policies.

[21] Usurers and informal lenders are not a new phenomenon in developing countries. The New York Times of January, 17, 1955 report the case of a laundryman of Karachi, Pakistan, who took a loan of 100 rupees and paid 3,925 rupees in interest, at the rate of 25% a month for 13 years and one month.

[22] The pledge states that “members will not lend any costumer more than the customer can repay”.

Institutions' operations and survival prevail in Rhyne and Accion's definition[23]. The concern that the rates should allow the institutions to grow to reach more people is however in contradiction with the objective of lowest possible costs to the borrowers. One should then assume that to operate as a going concern requires sufficient margins to reach more people. There is thus an additional trade-off between the clients and the potential future clients.
After the critical review of the multiple definitions of fair interest rates, we will address Gauthier's contractarian theory.

6. Gauthier's contractarian approach of justice

In *Morals by Agreement*, David Gauthier provides a major contribution to the theories of justice in non-competitive markets. Gauthier's theory is particularly useful in microcredit cases. Gauthier's main contribution starts by the statement that the perfect market is a morally free zone, a zone in which the constraints of morality would have no place (pp. 84-93[24]). He directly acknowledges that the perfect market is not the majority of our daily activities. His concern is to show that there would be a morally free zone in ideal interaction not its existence in the daily life. Morality would arise from market failures. The perfectly competitive market interaction makes a few assumptions that make it very improbable. In this market, all products and factors of production should be privately owned. Circumstantial uncertainty and strategic calculations are removed. It also assumes the absence of externalities that occur when "an act of production or exchange or consumption affects the utility of some person who is not party or who is unwillingly party to it" (pp. 85-86).

The assumption of absence of externalities makes PCM fairly implausible. In the microfinance case, one of the main externalities with a low interest rate is that an institution charging very low interest rates because of cheaper or subsidized funding may force other institutions to change their pricing and charge unsustainable rates. It could also impact un-served clients since they may have used the additional margin to

[23] Because of the primary role played by E. Rhyne in the coordination of Accion's consumer pledge, we will assume that both statements go together.
[24] In the rest of the paper, page numbers between brackets will refer to Gauthier (1986)

reach un-served clients by the sector. Nevertheless, it is Gauthier's contribution on imperfect markets that is of interest in our case.

In the absence of competitive, institutions may easily charge much higher interest rates and still find some demand. These institutions benefit from a rent, a return over and above the cost of supply. "She receives more than what is needed to bring her factors to the market" (Gauthier, p. 98). This rent is due the scarcity of the factor that they control; money and credit in this case. According to Gauthier, the rent comes from an accidental situation and not the intrinsic nature of the factors. It however depends on the relation between the factors he controls and the factors controlled by the other.

Following a contractarian approach, Gauthier argues that 'Justice is the disposition not to take advantage of one's fellow, not to seek free goods or impose uncompensated costs, provided that one supposes others similarly disposed' (Gauthier p. 113)

Gauthier's co-operation principle, influenced by Hobbes' Leviathan (Hobbes, pp.60-62), is justified by the awareness of each other as competitors. According to Hobbes, given scarcity and mutual unconcern, each views the others as competitors for the goods needed. While scarcity also creates a preference for dominating his fellows, co-operation arises to avoid mutually destructive conflicts.

Money's scarcity in many developing countries creates unequal bargaining powers and puts the lenders in a very favorable situation to dominate their clients. If materialized, this domination would create some rents and impose unfair interest rates.

Gauthier's bargaining theory enables to incorporate the active involvement of the operators. A rational bargain ensures the participation in reaching an agreed outcome (Gauthier, 1986, p. 128). Gauthier considers the voluntary involvement of the actors as a requirement and gives therefore a "moral" value to the voluntary agreement.

7. Why a bargaining and contractarian approach in microfinance?

Even if one challenges Gauthier's argument that the deliberation or the agreement are in themselves valuable such as Elkin (2004) does, participation of the actors can be

instrumentally valuable, for instance to tackle the unequal distribution of bargaining powers. Borrowers often lack bargaining power, because of their weak property rights and wealth that determine each party's relative ability to hold out for more acceptable terms (Satz, 2003).

Participation can be instrumental to reach fairness since some empirical evidences suggest that bargaining and cooperation are associated with more fairness in the distribution. For instance, Frey and Bohnet (1995) found that fairness norms are more likely to be activated when the parties are allowed to interact more.

The involvement of the actors also matters for the sustainability of microfinance operations. Sustainability of the institution is a major goal for policy makers since many microfinance markets are still non-competitive. In this case, the withdrawal of some institutions would bear heavy social costs. Therefore, even if the price is suggested with the help of an impartial observer it is crucial that the private owners of the institution agree on its fairness as well.

Similarly, the involvement of the clients also matters to prevent crisis that would arise from the movement of default or the civil society. A large part of microfinance institutions are still very fragile. Even if some of them have impressively resisted to macro-economic crises such as in Indonesia (Rosengard et al., 2001), only five to ten percent of these institutions are self-sufficient. They are thus subject to the risk of default of borrowers and particularly to the domino effect. The domino effect occurs when at least one member of a credit group defaults due to the defaults of other members (Godquin, 2004). The high degree of covariant income is a major risk of domino effect in microfinance, primarily in agrarian societies[25].

If well designed, we will also argue that a contractarian approach to the lending transaction can partly resolve the inequality of the bargaining powers. The agreement procedure is also at the core of the fair trade movement. According to the International Fair Trade Association (IFAT), "a fair price in the regional or local context is one that has been agreed through dialogue and participation[26]".

[25] For instance, Paxton et al. (2001) report that in one urban sector in Burkina Faso that experienced widespread default rumours of unethical behaviour led the entire sector to collapse. Dichter (1999) reports that one third of his sample of NGOs active in microfinance has experienced a domino effect

[26] IFAT website: http://www.ifat.org/ftrinciples.shtml consulted on January, 5, 2007.

Nevertheless, if the lenders benefit from such a favorable situation, what would make them collaborate with the clients? Gauthier argues that the co-operators are rationally moral, and do not take advantage is a reasonable constraint (p. 201).

Both deontological and consequentialist arguments may justify the existence of a fair co-operation between lenders and borrowers. From a deontological approach, one could argue that the contractarian approach is directly justified by the differences of bargaining powers between lenders and borrowers and the potential social impacts they would create. The difference of bargaining powers is critical in all imperfect markets but it is even more important in non-competitive ones, with many illiterate clients without or with little education[27]. Based on an analysis of fair return, Johnson (1938, p. 174) argues that when competition is absent, the basic condition, which generates the justice and harmony in the market, lack. Hence, "a regulated price, ostensibly equal to what could have been attained by natural law economics must be determined by law". Therefore and normatively, one could argue that co-operation must anyway prevail, even if imposed by some regulation.

Instead of deontological arguments, one may argue for co-operation based on a consequentialist rationale. Three arguments should legitimize co-operation between the two actors and force us to think that a co-operational framework will easily develop. These three arguments are not mutually exclusive and may even reasonably reinforce each other.

First, the lender (whether an individual or an institution) might be guided by some social concerns or some ethical norms that would push him to co-operate. Even if some institutions charge very high rates in comparatively stable macro environments, empirical evidence disputes that most MFIs would be willing to maximize their profits. In many areas where the ethical debate is less prominent and the regulators widely open to the development of the sector without any constraint, one can easily assume that MFIs could have charged much higher interest rates, close to informal lending, without discontent from the political world or the civil society. Theoretically, MFIs starting operations in an un-served area are someway in a similar situation as

[27] For instance, Reille (2006) report a study of 600 borrower households in India. 92% of the sample did not know the interest rate level and 28% did not know the repayment amount.

the first player of the *ultimatum games*. In these games, the first player can divide a given amount of money with a second player who can decide whether to accept this division or walk away (in which event none of the two gets anything) (Pull, 2006). When they enter a new area where the only competitors, the informal lenders, charge interest rates often much above 10% per month[28], institutions may well set rationally their interest rate just under these rates. Nevertheless, and similarly to what empirical evidences suggest for the *ultimatum games*[29], interest rates charged by MFIs are most often still much lower than the informal lenders. Such as in the *ultimatum games* and Pull's (2006) analysis of wages, even if they are not directly bargaining or in negotiation with the borrowers, some of them act in contrast to what a rational economic agent aiming to maximize profits would do. For some of them, they even act in "as if co-operation" would exist with the borrowers. MFIs might be led by some internalized norms of fairness and equity when offering more than marginal amounts. These norms can be related to the social bottom line of the microfinance sector. Microfinance double line includes the social and the financial performances (Copestake et al., 2005). Many institutions implicitly (for instance to analysis of the demand's capacity) or explicitly, co-operate with their clients to fix their prices.

Second, co-operation may arise due to pressure from some stakeholders of the institutions. With the emergence and the publicity around the development of MFIs, the civil society (for instance, non-microfinance NGOs) is increasingly interested in microfinance. Since this new interest is someway felt as a potential threat to the sector[30], co-operation is a response to the critics that the civil society may make on the price of the loan.

Borrowers or clients of MFIs are also stakeholders. In institutions where clients are represented in the board of directors, co-operation is likely to be fostered, for instance, through the interaction with the clients' representatives. Donors who finance the

[28] Interestingly, such very high interest rates are also charged in some instances in high-income countries. Homer and Sylla (p. 428) for instance report that still in the 20th century a favorite range for illegal small loans in American cities was a weekly dollar for loans of 5 USD.

[29] Camerer and Thaler (1995, p. 210) found that, contrary to what is assumed by a "rational" behavior of player two where only a marginal amount should be given to player 2 who should accept it is better than nothing, the first player offers typically average about 30-40 percent of the total, with a 50-50 split often the mode".

[30] E. Littlefield, executive director of the central World-Bank based Consultative Group to Assist the Poor (CGAP) for instance stated during the 2006 Global Microcredit Summit "Remember Jubilee 2000, canceling Third World debt, imagine if these social activists focus on the fact that many of our very good microfinance institutions are charging 100% and making returns higher than banks".

institution may also favor co-operation as an instrument to achieve their mission. One can consider that donors should have dual objectives of poverty alleviation but also sustainable institutions. Co-operation between the lenders and the borrowers is a main facilitator that enables reaching these potentially contentious goals.
Third, the lender might be willing to co-operate and lend to a borrower not to loose the potential fruits of its capital. If no other or better investment alternative exists to fructify its capital, co-operation makes sense, even if it would induce a decrease of the profit margin.

Proponents of a deontological or consequentialist justification may argue for co-operation to fix fair interest rates. If we agree on a co-operative process, which procedure should be followed?

8. Methodology[31]

The problem of imperfect markets and very high prices relates to two different rationales. Many interpretations of fair interest rates whether focus on the ethical issue (deontological approach) or the bargaining one (market-related arguments)[32].
It is an ethical or moral issue because of the disastrous socio-economic consequences that it creates. It is a bargaining process since interest rate policies also fall under the bargaining alternative that Habermas (1996) defines as negotiation between success oriented parties who are willing to cooperate. The emergence of financial institutions in these areas depends on their willingness to enter more difficult markets. We will therefore argue for a bargaining process complemented with moral issues.

In this section, we will determine a new contractarian approach to fair interest rates. A main constrain to the application of the contractarian approach is the original situation. One may argue that the reference for the initial co-operation or bargaining should be the non-cooperation outcome. Since the background conditions are not entirely fair, the outcome could easily be unfair or at the advantage of the actor with the strongest bargaining power. Getting back to the parallelism with the international

[31] The first part of this section relies on Hudon (2006)
[32] See Habermas (1996) for the distinction between moral, ethical and bargaining issues. The moral issues are, for instance, the social or tax policies or the distribution of social wealth and life opportunities.

trade debate, the question is to what extent does fairness and equity demand the current agreement not reflect past injustices? Higher tariffs for developing countries, even taking into account the "preferences" of trade partners, are part of an unjust historical framework (Stiglitz and Charlton, 2006, p. 77). Exorbitant interest rates to the poor by informal lenders are similarly unjust.

As we already argued in our criticisms of the second definition of fair interest rates, taking the initial situation as reference is in someway judging the initial background fair while it can be full of elements that would violate our conceptions of justice. The initial situation will however play another role since it influences the parties' decision to enter the transaction or not. The initial rate of the client or return of the lender will be taken into account to this end.

The fair co-operation should however not be based on potentially unfair initial conditions. Gauthier agrees that the initial position must not be coercive (p. 200), without free-riders, force or fraud (p 132).

After this clarification, the first step is to determine what the reference point will be for the bargain. Gauthier (p .130) argues that the bargainers are concerned with the distribution of the gains which co-operation may bring them, the co-operative surplus. Nevertheless, as for other definitions of a fair distribution, Gauthier's co-operative surplus is independent from the client's capacity. The emphasis on the co-operative surplus should thus be balanced with concerns on the clients and institutions' capacities, through their reservation price. We will therefore argue that the fair interest rates should be analyzed based on what we called a fair bargaining range (Hudon, 2006).

The methodology is as follows. Fair interest rates' evaluation should start with the bargaining range between the lender's and the borrower's reservation prices. The institution's reservation price could be the price required to cover its costs. The borrower's reservation price depends on his or her income, the profit margin if the loan is used for an income-generating activity. It would be sort of a "living interest rate", with a similar role as the living wage as described by Johnson (1938, p. 177). Fair reservation prices should then be calculated. These fair reservation prices are the actors' reservation price minus, in some cases, the price of some elements that do not fulfil our principles of justice (Hudon, 2006). An easy and practical way to analyze

the fairness of a price margin is to evaluate if an institution active in a similar environment would need to charge this extra margin.

It is the distribution of this bargaining range, what we called the *fair bargaining range* that should be fair. This range could be practically very difficult to establish between the two actors. Impartial spectators, disinterested observers who need not be members of the society[33], could somewhat tackle the potential conflict of interest between lenders, borrowers and even with potential future clients. They could help gather the information needed to fix the fair reservation prices and determine the fair bargaining range (Hudon, 2006). They can also moderate the bargain between the lender and the borrower.

Even if they would not determine directly the interest rate policy, these observers can be very useful in the procedure. Ellingsen and Johannesson (2005)'s empirical results suggest that impartial reasoning lead to more moral behavior. People behave more morally when they have first reasoned about matters from an impartial perspective. Independent observers would thus be instrumental to this end. Furthermore, since the potential clients are not part of the negotiation, the impartial actor could represent or take their interests into account.

Gauthier provides a methodology for the bargaining process. His procedure of bargaining entails two stages (p. 133). During the first one, each party advances a claim and proposes an outcome. In our case, both claims may vary. If the information on both fair reservation prices is displayed, a rationale outcome would be that the institution would claim the borrower's reservation price, the "living interest rate". This is in line with Locke's proviso on which Nozick and Gauthier refer. Locke's proviso ensures that there would be enough and as good for others so that their situation is not worsened (Nozick, 1974, p. 175). If the borrower's reservation price is sufficient to cover the institution's costs, there is a rationale to think that a moral institution will not ask for a higher rate than this rate as first claim.

Similarly, one could assume that the clients would claim the institution's fair reservation price. Nevertheless, the limitation of the interest rate at the institution's reservation price could be challenged. Is it just that the poor pay the price of the

[33] Sen, A., What do we want from a theory of justice, mimeo, pp. 25-27.

unjust background and the lack of competition financial system? If fact, the fair institution's reservation price can be related to what market prices would be if there would be competition in this region or location.

Gauthier rejects initial positions of coercion, for instance when the slaves accept an agreement given the costs of resistance that are due to the master's powers (p. 195). Similarly, the lack of access to financial services can be seen as an "economic coercion" for the poor. Access to affordable credit could then be sort of a right, or even a human right such as the Peace Nobel Prize Laureate M. Yunus claims. In the absence of this economic coercion, the poor would probably not access much higher interest rates than what competition would bring. The poor's claim could thus be the price as-if competition would exist. This goes well further than what Gauthier would consider since he considers that each individual initial endowment has not be been initially acquired by him by taking advantage of another co-operator (p. 201).

There are thus two possibilities of fair bargaining range, with different levels of distributional justice: a weak one requesting to remove prices due to unfair practices according to our principles of justice; and a strong one requesting to remove artificially inflated prices due to the lack of competition from the outcome of the first one. Clearly, the second one is a much more demanding one in term of social justice.

The second step is the most crucial one since it will determine the exact determination of the range. Gauthier's contribution is here less innovative and much more questionable. In Gauthier's model, the second step is that each or one of the parties offers a concession by withdrawing part of his claim. The persons' claims are also limited by the person's contribution to the co-operative surplus. Gauthier focuses on the relative concessions[34] and presents the outcome in term of relative concession of each actor. Zeuten's principle then states that the person with a minimum relative concession must concede. Application of Zeuten's principle would mean a move to equalize the relative concessions. Gauthier clarifies (p. 136) that the relative concession is a proportion of two utility-differences or intervals[35].

He takes the example of two people, Jane and Brian, whose non-cooperative utilities are, respectively, ½ and 3/8. The co-operative surplus that they can claim from the

[34] The relative concession is "the proportion its absolute magnitude bears to the absolute magnitude of a complete concession" (Gauthier, 1985, p. 136).

[35] The relative magnitude of the concession is [$(u^{\#}-u)/(u^{\#}-u^{*})$] where $u^{\#}$ is the utility afforded from the claim, u is the utility got in the outcome and u* is the initial utility (Gauthier, 1985, p. 136)

bargain is similar since the sum of their utilities, if they co-operate, is one. Cooperation outcome will then give them a similar share of the additional utility at stake, 1/16. Jane will end up with 9/16 and Brian with 7/16. Basically, the same rationale applied to the microcredit case will see the lender claiming 60% and the borrower 20%, so that it will tend to an interest rate of 40%.
Nevertheless, this makes a very implausible assumption: that the lender and the borrower get similar utilities in the transaction. Assuming a decreasing utility scale, the lender may well get less utility from a marginal share of the surplus because his higher position on his utility scale. Hence, a small amount of the surplus may provide a very high additional utility to the poor and a small one for the lender. If the utilities conceded by the lenders and the borrowers have to be equalized, the lender is likely to get a majority of the surplus. A poor borrower would be disadvantaged vis-à-vis the richer one because of his low initial utility level that would give him a very high utility with a marginal share of the surplus.

We will therefore suggest another principle for the distribution of the fair bargaining surplus, the second step of the procedure. In a distributive bargain such as in a conflict, most of us would take into account the absolute circumstances of people when evaluating to what extent to assign priority to the worse off (Tungodden, 2003). The very poor should thus get a priority in the distribution of the fair bargaining range. This prioritarian approach that would supplement the bargaining procedure and provides the ethical component is defined by Parfit (1995) as *"Benefiting people matters more the worse off these people are"*.
Therefore, instead of basing the concessions on the utilities of both agents, our prioritarian approach assesses every additional margin of the lender above the fair reservation price. Similarly to the formation of the fair reservation price, all additional margins above this price will be assessed with the help of the impartial observers.

During the bargaining process, a lender may well argue for some relative concession of the clients so that it can reach more clients, such as in Accion's (2004) definition. This concession will however be analyzed at the light of the clients' capacity.

Any margin due to unjustified elements may be challenged. In the microcredit case, fairness could then require that the managers would efficiently manage their

institution, with the current state of the knowledge of technology and know-how, so that interest rates are not inflated by ineffective management. Even if we recognize that taken literally, the requirement may rapidly turn on to be impracticable because of its complexity, it may be used as a sort of proviso for extreme cases.

Finally, these concessions may not only be financial but also organizational. A borrower may for instance request that the terms of the loans are changed. Similarly, she may suggest another loan methodology in order to maximize her capability or well-being rather than only the price of the transaction. It is indeed not the inequality of access to credit, or the cost of the loan in itself that is the most valuable but its impact on some more profound inequalities of matters such as well-being, happiness or capabilities. As powerfully argued by Sen (1999, p. 201), women's participation in credit programs not only result in new income generation but can also provide some social benefits. Empirical evidences suggest that some features of the credit programmes can enhance these social progresses and the borrowers' capabilities. For instance, the decision-making process shifts in favor of the woman when financial services are combined with social group intermediation (Holvoet, 2005).
On a development perspective, the clients' interest may then not always be in the maximization of its share of the fair bargaining range but in the good maximization of the additional capability she gets from the loan. The compromise should be found as fair by all parties even if their agreement is not based on the same reasons[36].

9. Conclusion

After some heated debates a few centuries ago, fair prices are again at the centre of much attention, as with the fair trade or fair wage (Pull, 2006) concepts or the microcredit movement.
Many different interpretations of what fair interest rates in small credits would be have been offered. We have seen that, if these interpretations are often rightly intended, most of them face strong challenges in their application. Gauthier (1985)'s contractarian approach to imperfect markets provides a relevant basis for the question.

[36] On the reason of the agreement on the compromise, see for instance Habermas (1996, pp. 106-108).

In the case of credit to the poor, the institutions are often morally-oriented and thus likely to accept to enter a bargain.

We present a contractarian approach of interest rate based on the fair bargaining range between the borrowers' and lenders' reservation prices. We argue that the lender will first claim the borrower's reservation price or a "living interest rate" that will give back a satisfactory amount to the borrower. In an imperfect market, the borrower is likely to claim the lender's reservation price or a price as-if markets were more developed or competition existed.

Gauthier's procedure of concessions, based on the actors' utilities, would easily lead to an increase of inequality. We, therefore, argue for a prioritarian procedure, starting from the lender's reservation price and demanding the evaluation of all additional margins charged by the institution.

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