Political Stakeholder Theory: The State, Legitimacy, and the Ethics of Microfinance in Emerging Economies

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ABSTRACT: How does the state influence stakeholder legitimacy? And how does this process affect an industry's ethical challenges? Stakeholder theory adopts a forward-looking perspective and seeks to understand how managers can address stakeholders' claims to improve the firm's ability to create value. Yet, existing work does not adequately address the role of the state in defining the stakeholder universe nor the implications this may have for subsequent ethical challenges managers face. This article develops a political stakeholder theory (political ST) by weaving together the political economy, stakeholder theory, and legitimacy literatures. Political ST shows how state policies influence stakeholder legitimacy and, in turn, affect an industry's ethical challenges. This article integrates the concept of agonism to address the perennial tension between markets and states and its implications for firms and their managers. Political ST is then applied to the case of microfinance, followed by a discussion of the contributions of this approach.

KEY WORDS: business ethics, political stakeholder theory, agonism, state, legitimacy, microfinance

THE STATE, IN THE TRADITIONAL STAKEHOLDER LITERATURE, is treated as one of many stakeholders. Stakeholder theory adopts a forward-looking perspective and seeks to understand how managers can prioritize and address stakeholders' claims in an effort to improve the firm's ability to create value (Freeman, 1984). Yet, we know that states have powers and capacities that other stakeholders do not. The state can set the organizational field in which an industry or firm develops. States can influence both the legitimacy of specific stakeholders and the possible set of transactions between them. This process has implications for the ethical issues an industry confronts.

This article develops a political stakeholder theory (political ST) and seeks to fill this important theoretical lacuna. Political ST theorizes the state as a unique stakeholder that brings to bear, by definition, power that is unattainable by other stakeholders. Political ST furthers our understanding of the ethical challenges industries face by linking stakeholder legitimacy, conceptualized as a characteristic of salience (Mitchel, Agle, & Wood, 1997), to state policy.[1] Drawing from work in political theory, political ST employs the concept of agonism (Honig, 1993; Moffe, 2000) to recognize the inherent tension between markets and states and discuss the related implications for firms and their managers. Instead of lamenting the

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contestation embodied by different types of organizational fields, or searching for a universal model, an agonistic lens acknowledges the ongoing discord. This discussion informs the literature on stakeholder illegitimacy as agonism recognizes that legitimacy can come from contestation.

This article makes two key theoretical contributions. First, it facilitates our understanding as to why stakeholder legitimacy, as a characteristic of salience, varies. The existing literature includes the state as a stakeholder, but does not analytically incorporate the state's ability to limit the stakeholder universe or the implications of this process for managers. Political ST helps explain why stakeholders emerge in some cases and not others by illustrating how state policies affect the universe of potential stakeholders with which a firm may engage. Democratic states have many tools at their disposal—regulation, allocation of resources, taxation, monitoring, enforcement and, when combined, the creation of new industries.[2] This analysis primarily focuses on regulation, though there is some discussion of allocation of resources as well. Political ST does not necessarily indicate that the state will always use its power or that other actors cannot influence the state. It seeks to provide a framework, however, to analyze the state's role in influencing stakeholder legitimacy, and thus, the (un)ethical practices and legitimacy of firms and the industries they populate. This approach challenges the predominant perception that the "firm's management… determines which stakeholders are *salient* and therefore will receive management attention" [emphasis original] (Mitchell, Agle, & Wood, 1997: 871) and instead points to the important role the state plays in determining stakeholder legitimacy.

Second, political ST sheds light on the shortcomings firms face and, thus, how the state, by default or by design, can incentivize (un)ethical behavior. It facilitates our ability to assess the achievements or limitations of an industry on its own terms by incorporating how the state influences the stakeholder universe within a given organizational field. "[T]he implementation of stakeholder principles depends upon government as it is the only entity that [can] speak for society as a whole and can thus change the way corporations are governed and managed" (Buchholz & Rosenthal, 2004: 149). Legitimacy, in other words, is more thoroughly understood by analyzing the state. Political ST embraces the tension between states and markets and employs the concept of agonism to make sense of the iterative process at hand. An agonistic lens recognizes that there is not a universal template in state-market relations; it embraces divergent preferences of stakeholders; and finally, recognizes the productive role contestation may play in legitimacy creation.

The utility of political ST is illustrated through its application to the case of microfinance,[3] an industry that is facing an "ethical crisis" (Hudon & Sandberg, 2013). Some observers point to the high interest rates and aggressive collection practices of microfinance institutions (MFIs) (Boatright, 2014; Hulme & Arun, 2011; Roodman, 2012). One newspaper headline pithily stated: "Small change: Billions of dollars and a Nobel Prize later, it looks like 'microlending' doesn't do much to fight poverty" (Bennett, 2009). Today's strongest critics call microfinance a poverty trap and argue that microfinance recreates conditions under which individuals remain impoverished (Bateman, 2010). Yet, other research, and countless personal narratives, suggests positive though modest effects of microfinance (Banerjee, Duflo,

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Glennerster, & Kinnan, 2010; Banerjee, Karlan & Zinman, 2015; Karlan & Zinman, 2010).[4] A false dichotomy of support or opposition for microfinance has emerged—a tendency that ignores the variation of microfinance, both in terms of the regulatory environment in which it works and the related trade-offs that managers of microfinance institutions often face.[5]

Beneath these competing narratives are basic questions about stakeholder legitimacy, and thus, salience. Why do some MFIs focus on serving poor individuals? And, why are other MFIs primarily focused on growth? Traditional stakeholder theory does not fully explain why MFIs make certain trade-offs by prioritizing some stakeholders over others and, as a result, is at risk of providing imprecise analysis and recommendations. Political ST elucidates the relationship between states, stakeholder legitimacy, and ethical challenges. Hudon and Sandberg (2013: 567) write that they "agree with the critics that further emphasis must be put on the political dimension of microfinance." This article seeks to answer their call.

Empirically, applying political stakeholder theory to the case of microfinance facilitates a greater understanding of the ethical concerns at stake. Through a political ST lens, a new typology of microfinance emerges: state-supported, bottom of the pyramid, and hybrid approaches. The case material—drawn from Brazil, India and Mexico—analyzed with political ST, enables us to move beyond the false dichotomy mentioned above and, instead, obtain a more nuanced explanation of the variation in stakeholder legitimacy across the microfinance industry. This typology provides a framework with which observers, practitioners, academics, and policymakers can better understand the variation of the microfinance industry's shortcomings.

Political ST can be used to analyze other industries or regulatory domains, as well. Scholars might employ it to analyze new industries (e.g., the "service economy," legalized marijuana), new corporate structures (e.g., benefit corporations) or industries in crisis (e.g., the financial industry and the Dodd-Frank Act; apparel and textiles post-Rana Plaza). It could also be utilized in cases in which the public or private spheres are increasingly blurred (e.g., provision of private security and military contracts) or when government agencies increase their enforcement of existing rules (e.g., the SEC and the Foreign Corrupt Practices Act). Finally, it can be used to understand industry-level variation across countries, as is the case here.

The remainder of the article is organized as follows. The next section develops political ST drawing from political economy and stakeholder literatures. It also integrates existing work on legitimacy and draws on the concept of agonism to incorporate the tension between markets and states. The third section begins to explore the case of microfinance by illustrating how regulation and ethical challenges are linked. The fourth section applies political ST to the case of microfinance, from which a new typology of microfinance emerges. The article concludes with a discussion of the contributions of this analysis and suggestions for future research.

DEVELOPING A POLITICAL STAKEHOLDER THEORY

Existing stakeholder theory falls short because it does not adequately theorize the unique and consequential role of the state. A political stakeholder theory, as

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developed here, expands the conceptual bounds of the existing stakeholder literature. This section proceeds in three parts. First, I explore existing research on stakeholders and stakeholder legitimacy and highlight the need for, and utility of, a theory that incorporates the unique role of the state. Second, I develop this theoretical approach by weaving together the literature on political economy and stakeholder theory. I argue that the state is a unique stakeholder in that it, by definition, has attributes that no other stakeholder bears. Finally, I draw from existing research to illustrate how a state's influence on stakeholder legitimacy can have important implications for the legitimacy (cognitive, pragmatic, and moral) of firms, and by extension, industries. Importantly, I end this section by discussing the work in political theory on agonism to reaffirm that legitimacy can often develop out of contestation.

A few points of clarification are in order. First, legitimacy resides at both the stakeholder and organizational level; this research follows the work of Elms and Phillips (2009) and recognizes the importance of legitimacy at each analytical level and the reciprocity between the two. While this approach does not theorize directly about the "reciprocal moral obligations between firms and stakeholders" (Elms & Phillips, 2009: 406), others have already made this contribution in the literature (Phillips, 2003a; Phillips, 2003b; Scherer & Palazzo, 2007). This article explores an explicit analysis of the interaction between states and markets; political ST illustrates that first, stakeholder legitimacy is a function of state policy and second, a firm's legitimacy can be linked to stakeholder legitimacy.

Second, one might wonder about the potential endogeneity of the relationship outlined here. While the state can determine the stakeholder universe, firms (and other stakeholders) can also influence the state and thus, the regulatory context. Indeed, regulation is often in response to unethical firm behavior. Theorizing the nature of the "co-evolutionary" process has been explored at length elsewhere (Lewin, Long, & Carroll 1999; Olsen, forthcoming; Porter, 2006) and is illustrative of the "state-in-society" literature, which departs from earlier configurations of the state and society as separate spheres. Instead, this approach embraces the mutually constitutive nature of the two concepts and emphasizes that one cannot be understood without the other (Migdal, 2001). Though the fluidity of this relationship is acknowledged throughout the article, political ST is limited to theorizing about how the state influences stakeholders at a specific point in time.

Theories of Stakeholders and Stakeholder Legitimacy

Stakeholder theory is "a theory of organizational management and ethics" (Phillips, Freeman, & Wicks, 2003). Freeman's seminal work (1984) argues that managers and firms will be better off if they consider the needs of other groups, in addition to their shareholders. Freeman outlines how a stakeholder approach—that is, considering the preferences of "any group or individual who can affect or is affected by the achievement of the organization's objectives"—will ultimately improve a firm's ability to create value (Freeman, 1984: 46). In this view, managers, NGOs, community members, public sector agencies, investors, and consumers join together to address challenges and identify complementarities between the host community

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and firm. Through this collaboration (or "harmonization" as it is later called), the firm will strengthen its corporate-community relationship, its competitive advantage, and fulfill its obligations to other members of society (Freeman, Harrison, Wicks, Parmar, & de Colle, 2010).

While the stakeholder approach has spawned numerous debates (Elms & Westermann-Behaylo, 2012), the subset of this scholarship on stakeholder salience is particularly relevant. The two broad streams of stakeholder salience research assess first, how managers can identify their stakeholders (Hill & Jones, 1992; Starik, 1994) and second, how managers can balance the varied, and sometimes conflicting, demands of their stakeholders. Mitchell, Agle, and Wood (1997) proposed a theory of stakeholder identification and salience. They argue that stakeholder salience is based on three key attributes—power, legitimacy and urgency—and recognize the dynamic nature of stakeholder salience over time (e.g., some stakeholders may gain/lose power, gain/lose legitimacy, or have more/less urgency).

Yet, this literature overwhelmingly places agency in the hands of the manager (Mitchell et al., 1997: 871), even though managers face external constraints, such as state policies. With a variety of tools—subsidies, public-private partnerships, procurement, taxation—states can determine a stakeholder's relative power, legitimacy, and urgency. Regulation varies substantially across countries and thus, has distinct implications for the subset of stakeholders that may or may not be salient or legitimate to a given firm.

Others observe this limitation of managerial agency, as well: "managers have a lesser degree of latitude to choose their own course, as external constraints often trump managerial preferences and practices" (Phillips, Berman, Elms, & Johnson-Cramer, 2011: 163–164). Tashman and Raelin (2013) note that "the scope of the existing construct of salience is too narrow" (596) and argue that perceptions of organizational and societal stakeholders codetermine the salience of the focal stakeholder to the firm.

This is not to say that external constraints, or the role of the state, are absent completely from the stakeholder literature. Instead, scholars depict the state as one of many stakeholders and operationalize the state as being on the same plane as other external stakeholders (e.g., customers, suppliers). Departing from this depiction, Freeman discusses how, if managers adopt a stakeholder approach, they will be more likely to address the public interest. In turn, the state would be less likely to place burdensome regulations into place. The state also appears in Orts' (1992) work, which suggests that state law can facilitate corporate boards to consider concerns of non-shareholders and promotes "stakeholder law." Donaldson and Preston (1995: 75–76) build on this work and cite important legal cases (*Unocal v. Mesa Petroleum Co.* 1985; *Paramount Communications, Inc. v. Time, Inc*. 1990; *CTCS Corp. v. Dynamics Corporation of America* 1987) to provide additional evidence of the trend. They conclude, however, that such decisions "reinforce that stakeholders are defined by *their* legitimate interest in the corporation, rather than simply by the corporation's interest in *them*" [emphasis original] (Donaldson & Preston, 1995: 76). While these works acknowledge the state, it is either depicted as an external threat or as playing a supporting role in encouraging firms to address stakeholders' claims.

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Such treatment of the state, however, is incomplete. Indeed, it was beyond the scope of the initial stakeholder literature to include a more systematic analysis of the role of the state. Rather, Freeman (1984) sought to highlight how "management simply must undertake an organized effort to deal with governments in a strategic fashion," in addition to other relevant stakeholders (Freeman, 1984: 17). The traditional stakeholder approach is forward looking and, as such, is primarily geared toward avoiding future, punitive regulation. Freeman states: "A situation where a solution to a stakeholder problem is imposed by a government agency or the courts must be seen as a managerial failure" (Freeman, 1984: 74). A traditional stakeholder approach ignores the fact that the state can create external constraints and act as a gatekeeper, thereby shaping the stakeholder universe and the transactions that can take place therein.

Phillips and his colleagues (2011) aptly describe how ignoring such constraints limits the utility of a stakeholder approach and its implications for business ethics:

> As social scientists, we cannot hope to explain the importance of stakeholder management as a factor affecting a firm's social or financial performance without acknowledging the external forces that condition this effect. As ethicists, we cannot reasonably hold firms accountable for mistreating stakeholders if we have no sense of the limits of their freedom to do otherwise. *Any successful attempt to produce a genuinely managerial stakeholder theory rests on our ability to weigh the relative importance of managerial choice and external constraint in firm-stakeholder relations*" [emphasis added] (Phillips et al., 2011: 164).

This article begins filling this gap. By exploring the linkages between external constraints, in this case state policy, and managerial choice, we can better understand the ethical challenges firms and industries face as a result.

The State as a Unique Stakeholder

Why is the state a unique stakeholder? How is the government different from other stakeholder groups? Some scholars focus on the exceptional powers given to state actors. The state, as classically noted by Weber (1922, Ch. I: sec. 17), has the only legitimate use of force. The state has powers of compulsion not given to other economic organizations (Migdal, Kohli, & Shue, 1994; Skocpol 1979). We know, of course, that some transactions with the state are not voluntary, but instead are required by law and often manifested through state bureaucracy (Evans, Rueschemeyer, & Skocpol 1985; Herbst 1989). This section explores the political economy literature and outlines structural, institutional, and developmental approaches that seek to facilitate our understanding of state-market interactions.

Early scholarship on the state utilizes structural explanations to explore the mechanisms through which political and social institutions (i.e., government and politics) create and shape markets. Polanyi (1944) is oft cited for describing how the formation of the modern state goes hand in hand with the development of modern market economies. He conceptualized economic and social problems as inherently linked. Polanyi argued that states promote a competitive capitalistic economy and,

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subsequently, expand their reach so as to address the harsh effects of the economic system. For Polanyi, the state cannot be analyzed separately, but is intimately combined with the market in what he called the "market society."

Others departed from Polanyi's melding of the state and market and, instead, focused on institutional explanations (e.g., North's [1991] "rules of the game") and gave primacy to enforceable rules (Levi, 1989). Institutions influence the emergence of central political and economic actors, the distribution of power among those actors, their interests, and ultimately, their strategies within the marketplace. In this vein, some scholars focus on specific state policies or characteristics that led to economic growth (or lack thereof). Gerschenkron (1962), for example, focused on state support (primarily financing) for entrepreneurial elites. He argued that developing countries needed to promote technological advancements and entrepreneurship to compete with other, more industrialized economies. In this way, the state could assume some of the risk-taking and become actively involved in organizing and directing financial markets.

Another set of political economy scholarship was inspired by impressive development in Southeast Asia in the 1980s and early 1990s, which led scholars to focus on the "developmental state." This literature highlights the symbiotic relationship between the state and, in these cases, nascent industrial groups. Explaining South Korea's late industrialization, as Amsden (1992) argues, requires the state to go beyond Gerschenkron's (1962) "state as investment banker" or Hirschman's (1958) "disequilibrating investments." The state, instead, must provide protection and impose performance standards. Similarly, Wade (1990) illustrates that, in the case of Taiwan, state policies do not just change the behavior of existing actors, they also help *create* the societal actors without whom industrial development would be impossible.

The political economy literature highlights the ways in which states are unique because, by definition, specific powers are attributed to state actors alone. Whether a structural, institutional or developmental depiction of the state, the political economy of development literature portrays the state as a gatekeeper—directly or indirectly shaping the organizational field. As the state defines the universe of possible stakeholders, by extension, it also determines the possible transactions that are likely to occur amongst them.

The approach described below begins to fill this theoretical lacuna and assesses how state policies create external constraints and shape the stakeholder universe. This process, in turn, affects the ethical challenges of firms and the legitimacy issues of an industry, in general (see Figure 1). The literature on legitimacy, explored below, elucidates the ethical extension of political stakeholder theory and, thus, its utility.

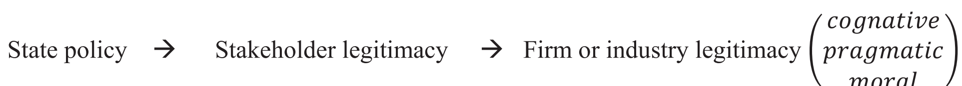

Figure 1: A Depiction of the Argument.

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Regulation and Stakeholder Legitimacy

While the previous section sought to illustrate the unique nature of the state as a stakeholder, this section outlines the relevant implications for stakeholder legitimacy, as one component of stakeholder salience. This section bridges external constraints (state policy) and managerial choice through stakeholder legitimacy.

Scholarship on legitimacy draws heavily from Suchman's (1995) typology: cognitive, pragmatic, and moral. Cognitive legitimacy is a "taken-for-granted" approach. In this case, "institutions not only render disorder manageable, they actually transform it into a set of intersubjective 'givens' that submerge the possibility of dissent" (Suchman, 1995: 583). DiMaggio and Powell (1983) discuss this in terms of coercive isomorphism, which can happen through political influence. The authors write, "the expansion of the central state, the centralization of capital, and the coordination of philanthropy all support the homogenization of organizational models through direct authority relationships" (DiMaggio & Powell, 1983: 151). Pragmatic legitimacy, alternatively, is an "exchange legitimacy" that "rests on the self-interested calculations of an organization's most immediate audiences" (Suchman, 1995: 578). This type of legitimacy "shades into a somewhat generalized and culturalized variant of more conventional, materialistic power-dependence relations" (Suchman, 1995: 578). Finally, moral legitimacy, reflects a logic that "rests not on judgments about whether a given activity benefits the evaluator, but rather on judgments about whether the activity is the 'right thing to do'" (Suchman, 1995: 579). In this scenario, "organizations might strive to achieve legitimacy by cocreating acceptable norms of behavior" (Basu & Palazzo, 2008: 127).

Others have noted the linkage between organizational fields and stakeholder theory. Elms and Phillips (2009) highlight how an "industry's moral legitimacy depends on responsible behavior by both [the firm] *and* their stakeholders" [emphasis original] (Phillips, 2009: 404). They build on Basu and Palazzo's (2008) work and link firm/stakeholder relationships to cognitive, pragmatic, and moral legitimacy.

This discussion, however, extends the stakeholder legitimacy literature by linking it to specific conceptions of the state, as outlined above. A state, as described by Polanyi (1944), that aims to engage in the market to offset the social ills of the market itself may, at times, take control of an industry and substantially restrict the participation of non-state actors. Utility companies, for example, are controlled heavily by the state (if not entirely state-run) due to the need to provide public goods to the general population. In this scenario, the state dominates the industry and substantially reduces the universe of stakeholders. Cognitive legitimacy, as coercive isomorphism, highlights the potential dominance of the state in affecting, and at times, reducing innovation or growth of an industry. In such a context, managers are likely to align their behavior with stakeholder concerns so as to obtain cognitive legitimacy (Elms & Phillips, 2009: 407–408).

Alternatively, a state seeking to create a framework that helps an industry grow, following an institutional approach (Levi, 1989; North, 1991), is likely to allow select stakeholders to engage. States may adopt policies that promote growth or investment that complement national interest—clean energy or defense-related technologies,

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for example. The state's role, in this model, is to encourage (through regulation and, possibly, subsidies) a targeted subset of actors to engage in the market. The pragmatic legitimacy lens is identified by an "exchange" or "utility" approach, in general, and may be identified by the formation of an industry in which a limited group of stakeholders gains from the existing regulatory framework. Industries characterized by pragmatic legitimacy include firms that persuade stakeholders of their usefulness (Elms & Phillips, 2009: 407–408).

Finally, a developmental state would not only be capable of masterminding economic development, but could do so by monitoring and protecting the industry. In this scenario, many stakeholders would be allowed to participate in a given industry. Moral legitimacy is characterized by a reciprocal relationship between firms and their stakeholders (Elms & Phillips, 2009: 407–408). A multitude of stakeholders, however, may mean increased contention and needed negotiation. Moral legitimacy can be created through this process.

Political ST elucidates the role of the state in affecting the variation in legitimacy observed across industries (see Figure 2). Understanding how firm/stakeholder relationships are structured, thus, has important implications for managers' discretion.

An Agonistic Perspective

The relationship between the state and stakeholder legitimacy is discussed above as distinct categories, but these are simply ideal types. An important tenet of political ST is recognizing that the tension and balance between state and market actors will ebb and flow over time. This approach, thus, requires an agonistic lens, which draws from political philosophy. Honig (1993) writes that to "affirm the perpetuity of the contest is not to celebrate a world without points of stabilisation; it is to affirm the reality of perpetual contest, even within an ordered setting, and to identify the affirmative dimension of contestation" (15). While agonism is generally applied to democratic politics, it can also provide insights for our understanding of markets and market politics.

An agonistic perspective, applied here, makes three propositions. First, instead of lamenting the inherent tensions between states and markets, or searching for a universal template, it embraces the tension and conflicts inherent in each ideal type. Indeed, DiMaggio and Powell warned against the trend of isomorphism, generally: "To the extent that pluralism is a guiding value in public policy deliberations, we need to discover new forms of intersectional coordination that will encourage diversification rather than hastening homogenization" (1983: 158).

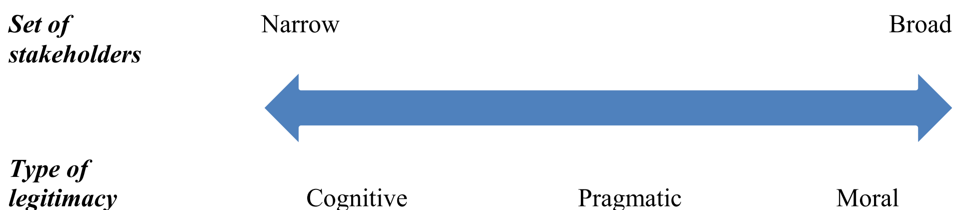

Figure 2: Spectrum of Stakeholders and Legitimacy.

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Second, an agonistic perspective acknowledges that even with the establishment of industry norms or legitimate organizational fields, preferences may change. Divergent stakeholder interests may never converge around the appropriate balance, for example, between a company's return to its shareholders and its stakeholders. "Awareness of the fact that difference allows us to constitute unity and totality while simultaneously providing essential limits is an agonistic approach" (Mouffe, 2000: 757). Distinguishing agonism from deliberative democracy, which posits that consensus may be achieved through deliberation, Mouffe continues: "Such an approach, therefore, must be much more receptive…to the multiplicity of voices that a pluralist society encompasses, and to the complexity of the power structure that this network of differences implies" (Mouffe, 2000: 757).

Finally, an agonistic lens suggests that legitimacy can come from contestation. In an organizational field with many stakeholders, the task "is not to eliminate passions nor to relegate them to the private sphere in order to render rational consensus possible, but to mobilise those passions toward the promotion of democratic designs. Far from jeopardizing democracy, agonistic confrontation is in fact its very condition of existence" (Mouffe, 2000: 755–756). Contestation, in other words, need not be avoided. Instead, it is an important component of the cocreation that facilitates moral legitimacy. Agonism embraces the idea that a reciprocal relationship between firms and their stakeholders may be antagonistic, at times, but that it can facilitate legitimacy creation.

In sum, political stakeholder theory makes three contributions. First, it illustrates that the state is a unique stakeholder and can influence the universe of possible stakeholders. Second, this discussion suggests the need for a more nuanced approach to understand the link between state policies and the stakeholders within an organizational field. Incorporating this linkage into the analysis better informs our understanding of legitimacy. Finally, political ST recognizes that, at times, consensus may represent a suboptimal outcome—instead, legitimacy can be harnessed through contestation. Political ST integrates state policy, as an external constraint, into stakeholder theory so as to better understand the limitations to managerial discretion and the ethical challenges that may develop as a result.

THE CASE OF MICROFINANCE

The remainder of the article uses political ST to add insight to the ethical challenges in the microfinance industry. Before the theory is directly applied, however, I first provide some context and discuss how the regulatory framework shapes the contours of the industry. The subsequent section illustrates that through the application of political ST, a new typology of microfinance emerges. The typology facilitates a more nuanced understanding of microfinance and, thus, moves beyond the superficial dichotomy of support for, or opposition to, the industry.

Regulating Microfinance and Associated Trade-Offs

Exploring the ethics of microfinance, Hudon and Sandberg (2013: 562) write that the "three most fundamental ethical questions concerning microfinance [are]: (1) Should it

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be done at all (what is known about the impact of microfinance)? (2) How should it be done (do MFIs exploit poor clients)? And (3) Who should do it (what are the characteristics of an ideal microfinance provider)?"

The trade-offs discussed in this section seek to contribute to these lines of inquiry. It moves the conversation beyond how the sector should look and, instead, provide greater clarity around how state policy influences the contours and ethics of the microfinance industry (Cull, Demiguç–Kunt, & Morduch, 2011; Olsen, forthcoming; Tchakoute-Tchuigoua, 2010). This variation prompts the following questions: (1) Who *is likely* to do it (rather than who should do it)? And (2) How *is* it done (rather than how should it be done)? These questions, of course, have important implications for Hudon and Sandberg's first question as to whether microfinance should be done at all.

Two primary pieces of regulation dominate the policymaking discussions around microfinance. The first informs how MFIs access capital. MFIs are interested in offering savings services, due to its low cost and stability—individuals tend to deposit their savings and leave them there (Ledgerwood, 1998).[6] MFIs also rely on state funding, and in some scenarios, an increasingly large pool of private equity.[7] The availability and cost of capital has implications for who has access to microfinance and, relatedly, the cost to the borrower. The second piece of regulation determines whether the industry is required to comply with interest rate limits. Again, interest rates also influence how much MFIs charge their borrowers and also impacts the type of borrowers MFIs target (Christen & Rosenberg, 2000; Helms & Reille, 2004). These trade-offs are depicted in Figure 3. Regulation influences an MFI's profitability and the trade-offs associated with breadth (access to services) and depth (reaching the poorest of the poor).

Who is Likely to Do It?

Historically, the protagonists of microfinance included state development institutions, international organizations, and socially oriented NGOs.[8] Such efforts

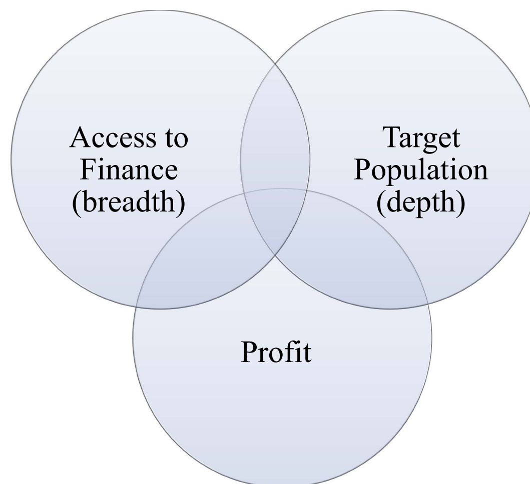

Figure 3: Trade-offs between Profit, Breadth and Depth.

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promoted an ethic of poverty alleviation by combining microfinance tools with supplementary services to lift individuals out of poverty (Rhyne, 2001). These early efforts prioritized depth (reaching the poorest of the poor) over profitability and breadth (providing greater access through economies of scale). As the microfinance "experiment" gained traction, observers were surprised by its success as it challenged conventional wisdom: thanks to high repayment rates and the power of social collateral, the microfinance model proved to be profitable (Chu, 2007; Morduch, 2000). Investors and policymakers, however, expressed increased interest in, and concern about, expanding these services (Copestake, 2002).

This transformation, or "commercialization," of microfinance led to a far greater focus on financial sustainability (Armendáriz & Morduch, 2010). It was accompanied, and perhaps spurred on by, three other shifts. First, states began to regulate the sector, in part because of increasing concerns about the existence of fraudulent organizations and unregulated lending (Olsen, forthcoming; Roodman, 2012). Second, some NGOs grew tired of their dependence upon philanthropic funding. The whim of international funding trends and the politics of state financing meant that there were often insufficient funds to scale up microfinance services to meet growing demand. Third, as the profitability promise of microfinance spread, banks, equity investors, and other formal financial institutions began investing in, and providing, microfinance.[9] Thus, the type of microfinance provider—who is likely to do it and how they navigate trade-offs—is a function of the external constraints in the industry.

How is it Done?

The tension between breadth and depth, or the "microfinance schism" (Morduch, 2000), is related to regulatory decisions around interest rates and accepting deposits. Interest rates, in particular, are often perceived as usurious. Kneiding and Rosenberg (2008) estimate the global interest yield is about 35 percent, but recognize great variation across countries. In Mexico, the co-founders of Compartamos were heavily criticized for charging interest rates over 100 percent while successfully launching their own IPO in 2007 (Rhyne & Guimon, 2007; Rosenberg, Gonzalez, & Narain, 2009). Some prominent figures within the sector, including Muhammad Yunus of the Grameen Bank in Bangladesh, argue that microfinance was intended to be "an opportunity to help people get out of poverty in a business way, but not as an opportunity to make money out of poor people" (MacFarquhar, 2010). Yet, those defending high microfinance interest rates explain that the provision of microfinance loans is more costly than larger loans provided by commercial banks (for further discussion see Armendáriz & Morduch, 2010; Boatright, 2014; Roodman, 2012). Lenders must often travel to remote locations and impoverished individuals use smaller loans, which in turn, tighten the margins for MFIs (Armendáriz & Morduch, 2010).

Interest rate ceilings may bring the cost of microfinance down, but it comes at a price (Hermes & Lensink, 2011). Limiting interest rates can create the adverse effect of encouraging MFIs to service more clients, but with a focus on those that are not as poor. MFIs may be incentivized to improve margins and lower operating expenses.

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Larger loans facilitate MFIs' ability to meet donors' and investors' profitability expectations (Ghosh & van Tassel, 2008). A greater focus on profitability is often referred to as "mission drift" (Mersland & Strøm, 2010).

Others, however, point to research that challenges the cure-all depiction of microfinance (Banerjee et al., 2015) and suggest that a greater focus should be placed on savings—both as a stable, inexpensive source of capital and as an important service for the world's poor. Nearly two decades ago, in one of the paramount studies in this field, Rutherford (1999: v) wrote in *The Poor and Their Money*: "[p]oor people can save and want to save, and when they do not save it is because of lack of opportunity rather than lack of capacity." Scholars have assessed the effectiveness of savings as a development tool and largely find widespread support for Rutherford's intuition. Dupas and Robinson (2010), for example, find that access to savings positively affects business investment in general and, specifically for women, increases business investment and general expenditures. The effectiveness of savings has been corroborated in other studies, as well (Abraham, Kast & Pomeranz, 2011; Brune, Gine, Goldberg, & Yang, 2011; Prina, 2013).

Not only are savings an effective tool for the poor, they are also an important source of capital for MFIs. In order to accept deposits, however, MFIs must be regulated; many MFIs are not legally allowed to provide this service. Roodman notes: "The microfinance industry contributes most to development when it links to its host economy in many ways, by not just making loans, but also taking savings from customers and some capital from local investors" (2012: 13). Those MFIs that are not allowed to accept deposits must rely heavily on other sources of funding—primarily state financing or private equity, as we will see below.

The transformation of the microfinance landscape has created unique ethical challenges. While this discussion is admittedly abridged, the purpose is to highlight the trade-offs that inform the key ethical debates in the sector, foreshadow the importance of regulation, and add nuance and complexity to recent trends that, at first blush, seem clearly iniquitous. It is this nuance, often overlooked, that demands a better framework with which to understand how regulation influences MFI practices by affecting stakeholder legitimacy.

A TYPOLOGY OF MICROFINANCE

Employing political ST requires a discussion of the role of regulation, its impact on stakeholder legitimacy, and ultimately the ethical challenges microfinance firms face. As outlined below, a new typology of microfinance emerges through the political ST lens (see Table 1). This typology, in turn, allows us to move beyond a superficial discussion about microfinance and, instead, understand the foundation of today's ethical concerns and how they should be addressed. As noted earlier, these are ideal types; a state may—and, indeed, is expected to—change over time.

State-Supported Model

In the state-supported approach, the regulatory framework gives primacy to the state by capping interest rates (and thus discouraging private investment). Nor does the

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Table 1: Political Stakeholder Theory Applied: Typology of Microfinance

	State-supported	Bottom of the pyramid	Hybrid
State Policy	Interest rate ceiling or de facto interest rate ceiling	No interest rate ceiling	No interest rate ceiling
	No deposit-taking	No deposit-taking	Deposit-taking
Financing	State	Private equity	Variety (customers' savings, state, private equity, philanthropic)
Set of Stakeholders	Narrow	Moderate	Broad
Type of Legitimacy	Cognitive legitimacy (coercive isomorphism)	Pragmatic legitimacy (transactional)	Moral legitimacy (reciprocal, agonistic)
Ethical Challenges	Limit growth or innovation	Excessive focus on profit	Establish balance between states and markets

state allow MFIs to accept savings. In this typology, the state ultimately restricts the engagement of other stakeholders. The state is the primary financier; managers adhere to state preferences and seek to maintain cognitive legitimacy via institutional isomorphism.

The state may engage in microfinance, in part, to uphold its responsibility to provide necessary services to its citizens and offset the social ills of a modern market economy, as Polanyi (1944) described. And, the state is well positioned to do so. It can make use of state-based infrastructure created for social service programs to support microfinance endeavors. This can facilitate the distribution of microfinance in untapped urban or rural markets. The regulatory framework for this model of microfinance prohibits MFIs from collecting deposits from the public and places a ceiling on interest rates for microfinance loans.

State-supported microfinance endorses a philosophy of helping the poorest segments of society (depth). Regulation, in this ideal type, constrains stakeholders that are legitimate in other models explained below. Rather than observing a predominance of NGOs or MFIs supported by philanthropic organizations or private capital, the state either provides the bulk of the funding for MFIs or may become a direct service provider. In countries with a state-supported model of microfinance, we would expect to see a proportionally smaller sector with subsidized state financing for both state- and non-state MFIs.

Managers working within a state-supported approach have minimal latitude. They are restricted by interest rates, but will not seek external funding due to the inability to access savings. Moreover, private equity cannot compete with subsidized funding from the state. A borrower in a community with a state-supported approach to microfinance may find it difficult to access microfinance, since growth is often limited. It may be challenging to access larger loans in this scenario, as well. Alternatively, many of the MFIs, due to subsidized funding, are willing to serve the poorest of the poor.

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Bottom of the Pyramid Model

In the bottom of the pyramid (BOP) approach, the regulatory framework places no limits on interest rates nor does it allow MFIs to accept savings. These policies provide incentives for private equity and thus validate their legitimacy as a stakeholder. In this typology, the regulatory framework allows a narrow set of stakeholders to engage in the sector. The state can provide some finance, but since savings are not allowed, private equity—over individual depositors—has greater legitimacy. Managers, in this context, achieve pragmatic legitimacy as they seek to justify the transactional, and largely profit-driven, nature of their work.

The BOP model advocates for a greater focus on scaling services (breadth) through the provision of financial services by private institutions. The regulatory framework for this ideal type allows MFIs to accept deposits and does not require institutions to comply with interest rate ceilings. With these incentives in place, a market-oriented regulatory environment encourages competition and thus, private investors emerge as a salient stakeholder for MFIs. In countries with a BOP model of microfinance, we would expect to see a proportionally larger sector comprised of MFIs that are profitable and growing quickly. MFIs in this model would reach a greater number of borrowers (breadth), but would largely forgo serving the poorest members (depth).

According to the BOP model, the growth of the MFI sector is driven by profits. Private, for-profit MFIs provide the bulk of microfinance at market rates. In doing so, MFIs seek out private capital to ensure a constant stream of financing which, in turn, allows MFIs to offer more loans and adopt efficient practices. With increased legitimacy for private investors, this ideal type suggests that competition within the sector is also beneficial. The sector is likely to become financially sustainable, as MFIs will compete to attract commercial investment and become independent from philanthropic support or state subsidies. In this model, we would expect to see large, private, and efficient MFIs. This competitive environment should also facilitate borrowers' relatively easy access to finance, given the increased competition within the sector. The logic of this model suggests it has the potential for greater long-term financial inclusion for the poor, given the emphasis on financial sustainability and the institutionalization of new financial institutions.

Managers working within a BOP approach, however, will be under pressure to pursue profit over all else and seek to expand their services quickly. MFI managers may employ loan officers that are not from the community and are thus unable to assess the quality of potential borrowers to meet investors' promised returns. Loan officers may feel pressure to disburse as many loans as possible and lend to clients that are over indebted; aggressive collection practices may ensue. Profit-oriented incentives also incentivize MFIs to provide slightly larger loans to less poor clients, thus forgoing depth for breadth.

Hybrid Model

Finally, the hybrid policy framework places no limits on interest rates, but does allow MFIs to accept savings. In so doing, this regulatory framework allows for the

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legitimacy of a varied set of stakeholders. MFIs can seek funding from individuals who save, from private financiers, and at times can also obtain financing from the state. This model has a greater number of stakeholders across the organizational field, and, as a result, contestation and negotiation may be a notable feature of this model.

As the name suggests, this approach combines components of the previous models. The hybrid regulatory framework allows MFIs to access capital from a number of different sources. The state, in this model, continues to shape the legitimacy of stakeholders and guides the sector's development. The state may use its infrastructure to act as a first mover and illustrate the feasibility of offering microfinance to hard-to-reach, rural communities. The state may use targeted subsidies, funding MFIs that are working in designated priority areas. This ideal type suggests that while private capital may ensure the microfinance sector reaches as many individuals as possible (breadth), the state can also encourage MFIs to provide services to the poorest of the poor (depth). The microfinance sector remains competitive, but with an eye toward moderate growth.

While the state and private sector may work in harmony under the hybrid approach, we would also expect periods of negotiation and contestation. An agonistic lens recognizes the tension between firms and states. Firms may have a complicated relationship with the state, as it serves as both a regulator of all, and funder of some, MFIs. Managers may push back against state involvement, as seen in the state-supported approach, or feel pressure to lend irresponsibly in the name of growth, as seen in the BOP model. While these issues still remain, managers working within the hybrid approach have options, as they are able to engage with a variety of stakeholders and have the potential to achieve balance and, thus, moral legitimacy. Agonism recognizes that contestation is part of the process and that moral legitimacy may arise from it.

MICROFINANCE IN EMERGING ECONOMIES EXAMINED

The following section outlines empirical examples of the models explained above. Qualitatively comparing empirical cases of microfinance accomplishes four things: First, this section demonstrates the empirical relevance of political stakeholder theory by illustrating how the state can determine other stakeholders' legitimacy in practice. Second, these cases highlight the multiple pathways through which a microfinance sector can develop, which third, adds richness to the conflicting narratives (and false dichotomy) around support for—or opposition towards—microfinance. Finally, political ST illustrates how state policy influences the stakeholder universe and legitimacy. It integrates an agonistic perspective by recognizing that legitimacy can come through contestation.

Data Collection and Methodology

The case studies below draw from original fieldwork I conducted in Brazil, India, and Mexico. I gathered the data for the Brazilian and Mexican cases in 2008–2009 and data for the Indian case in 2012. In all, I completed over 110 informal interviews using a snowball sampling technique. In each country, I interviewed government

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regulators, politicians, industry experts, international advocates, microfinance lenders, and microfinance borrowers. In addition, I also analyzed additional qualitative data sources, including government documents, legislative records, and journalistic accounts. Interviews were triangulated with the archival data to ensure the coherence of the record shared here.

I am employing a classic extended case method, which facilitates theory building (Achen & Snidel, 1989; Burawoy, 1991: 6). I draw on my own fieldwork and the case of microfinance to illustrate the application of a new theory. The empirical cases are not an exact match with the ideal types explained above because the typology is theoretically driven. This is to be expected. The state is a dynamic actor and its influence on stakeholder legitimacy will ebb and flow over time. Below, I explicitly note deviations from the ideal type, in recognition that a country's microfinance sector could be categorized differently at other moments in time.

State-supported Model: The Brazilian Case

Brazil represents the state-supported approach to microfinance. Historically, the state served as the first-mover and initiated early microfinance efforts in Brazil. Today, the state still dominates the sector and has limited the role of private equity or NGO-based efforts to promote microfinance. The state—by design or by default—has crowded out the private investment in microfinance. Thus, the growth of the sector has been stunted and, though MFIs have access to subsidized financing, the strength and longevity of Brazilian microfinance is in question as it is subject to political will (Barone, et al. 2002; Franco, 2002: 10–11; Kumar 2005).

Given the relatively small size of the microfinance sector in Brazil today, many are surprised to discover that Brazil is home to the earliest microfinance effort in Latin America, which began a few years prior to the Grameen Bank (Meagher, Campos, Christen, Druschel, Gallardo, & Martowijoyo, 2006: 15; Roodman, 2012: 74). In 1972, the Brazilian state, partnering with the World Bank and other prominent international organizations, created the region's first microfinance organization, UNO (União Nordestina de Assistência a Pequenas Organizações). UNO eventually closed its doors as it was unable to become financially sustainable (Barone, Lima, Dantas, & Rezende, 2002). This, and the onset of a military dictatorship (1964–1985), caused microfinance to take a back seat until the country returned to democratic rule and the economy stabilized. Former President Cardoso (1995–2003) placed microfinance squarely on the agenda by first, providing funding for state-owned institutions to provide loans directly to borrowers as well as to other MFIs, and second, creating a state-supported regulatory environment for microfinance.

During Cardoso's tenure, the state passed microfinance regulation in 1999, which created two new types of non-banking financial institutions; both were meant to facilitate NGOs' transformation into formal MFIs. First, the state created the Civil Society Organizations of Public Interest (OSCIP, Organizações da Sociedade Civil de Interesse Público), which simply legalized NGOs' participation in the sector. OSCIPs, unlike NGOs, have the opportunity to receive government funding through "Terms of Partnership" agreements. In practice, few OSCIPs were created, since these

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organizations were non-profit, prohibited from borrowing money from commercial creditors, and could not accept deposits from the public. The second piece of regulation created another type of MFI, the Society of Credit to the Microentrepreneur (SCM, Sociedade de Crédito ao Microempreendedor). SCMs are intended to be for-profit institutions that can engage in microlending, which in practice, means that they are subject to the same reporting and tax requirements as commercial banks. These requirements, however, are not offset by the ability to accept deposits. Kumar (2005) points out that such strict requirements serve as clear disincentives for NGOs or OSCIPs considering converting into an SCM. SCMs, like OSCIPs, also had to comply with interest rate limits.

One regulatory change, however, shows that Brazil has deviated from the ideal type described above. In 2001, the state removed the interest rate limit for OSCIPs and SCMs—which appears a substantial de jure victory for the microfinance sector. In practice, however, its effect is marginal, as Brazil is still considered to have a de facto interest rate limit (Helms, 2006: 83; Meagher et al., 2006). SCMs and OSCIPs still rely on funding from the state—including SEBRAE (Serviço Brasileiro de Apoio às Micro e Pequenas Empresas) and BNDES (O Banco Nacional do Desenvolvimento)—which requires MFIs to comply with interest rate ceilings. The overwhelming provision of state-subsidized funding means that nearly all institutions quote their rate to be within one percent of (but usually just under) the state's subsidized rate (Meagher et al., 2006; Olsen, forthcoming). When asked why MFIs continue to rely on the state as the primary source of funding, one interviewee simply explained, "They have deep pockets."[10]

The regulatory framework and state financial support for the microfinance sector has limited other would-be stakeholders. Despite the potential market in Brazil, private equity is largely uninterested in investing there. In addition, MFIs are not allowed to accept savings from individuals and thus, the state limits the organizational field of stakeholders for MFIs. According to the BNDES, it supplied between 50 to 80 percent of subsidized funding for most of the MFIs with which it worked (Kumar, 2005: 94).[11]

The Brazilian microfinance industry has obtained cognitive legitimacy, via coercive isomorphism. MFIs adhere to state preferences, as they face a narrow subset of stakeholders with whom to engage. Managers in the state-supported approach are limited by substantial external constraints. For microfinance borrowers, the Brazilian microfinance market may be achieving greater depth (reaching the poorest of the poor with government subsidies), but does not have great breadth. Finally, while microfinance loans may be less expensive in Brazil, it is due to state subsidies of a relatively small market, not the competitiveness of a growing industry. One study concluded, "[t]he story of microfinance in Brazil has mostly been one of unfulfilled promise" (Meagher et al., 2006: 15).

Bottom of the Pyramid Model: The Indian Case

Indian microfinance is representative of the bottom of the pyramid approach. Though there is regional variation, microfinance is generally very competitive, has experienced remarkable growth, and is marked by the formation of large, highly

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professional MFIs. While borrowers can access finance with ease, this model also falls short in some crucial ways. The highly competitive nature of the BOP approach, in combination with the introduction of private capital, has led to over indebtedness, usurious interest rates, and aggressive collection practices in some cases. Under the BOP model, MFIs also have incentives to avoid lending to the poorest of the poor.

Home to nearly one third of the world's population living in poverty, microfinance initiatives in India have received widespread support with the hope, like elsewhere, that access to finance would alleviate poverty. Early microfinance began in Gujarat through an urban cooperative, called Self-Employed Women's Association (SEWA). While these efforts initially relied on philanthropic funding, in the early 1970s apex financial institutions, such as the Small Industries Development Bank of India (SIDBI), Friends of Women's World Bank (FWWB), and Rashtriya Mahila Kosh (ROMK) began to fund these efforts. In the 1980s SHGs (self help groups), informal bodies that provide clients savings and credit services, were established throughout India (Ghate, 2007). Often, NGOs established SHGs alongside other services offered to India's poor. Government agencies, especially in rural India, established SHGs as well (Ghate, 2007).

The state was active in India's early microfinance initiatives, and in particular, through its innovative role in transforming the sector. Specifically, the state encouraged formal partnerships between informal savings and loan groups and the commercial banking sector, laying the groundwork for a bottom of the pyramid approach. In the early 1990s, NABARD, a state development bank, created the SHG-Bank Linkage Program (SBLP) to further their mission of promoting equitable rural prosperity through credit and other initiatives. Once SHGs save regularly for a minimum of six months and follow record-keeping guidelines, they are eligible to become 'linked' to a local bank branch under the SBLP. This linkage allows the SHGs to deposit savings in the bank and, according to accepted ratios, borrow funds from the bank to support additional microentrepreneurial activity. This program has continued to grow throughout India. In 2001, approximately ten years after India's first experiments with the SBLP, SHGs received nearly 264,000 new bank loans (Ghate, 2007). This number increased nearly fifteen-fold by 2009, with over 4.2 million new bank loans provided to SHGs (Reddy & Malik, 2011: 2).

As a result, India saw remarkable growth in microfinance throughout the 1990s and 2000s. Increased growth and proven profitability of the sector has also spurred on the "professionalization" or "commercialization" of the sector (Armendáriz & Morduch, 2010: 239–264). In the early 1990s, many MFIs began to transform into Non-Banking Finance Companies (NBFCs), which allowed them to attract investments through private equity.

Andhra Pradesh (AP), home to the largest and, previously, fastest growing microfinance markets in India, experienced a "microfinance bubble" in 2010–2011, highlighting the ethics of MFI practices under the BOP model.[12] This case garnered international attention, as some MFIs were reported to have charged usurious interest rates, employed questionable collection practices, and overlooked over indebtedness in an effort to increase the size (and profitability) of their lending portfolio (Mader, 2013; Kaur, 2014).

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In October 2010, the AP government shocked the microfinance sector by passing the Microfinance Institutions Regulation of Money Lending Ordinance. The legislation required that MFIs cease disbursing and collecting loans until they register with local officials (Financial Express, 2010). In addition, state officials publicly announced that borrowers did not need to repay their existing loans—a move that resulted in crippling default rates.[13] Though there had long been tension between the AP government and the microfinance sector, this decision was made after reports surfaced that poor, rural farmers had committed suicide because they were over indebted and could not repay their microfinance loans (Biswas, 2010). Subsequently, the Reserve Bank of India (RBI) placed an interest rate cap on the sector (Reuters, 2011), though it has been lifted since (Economic Times, 2014).

Due to the regulatory structure in the Indian case, private financiers of microfinance emerged as a key stakeholder for many of the largest MFIs in India.[14] While on one hand private financing improved the reach of MFIs (breadth) and the professionalization of the sector, it also led to distortions in the microfinance model and unethical practices (Srinivasan, 2011). Initially, MFI managers sought pragmatic legitimacy as for-profit institutions moved to scale their institutions. A heightened emphasis on financial returns meant that many institutions shifted their focus on achieving greater breadth (distributing as many loans as possible) at the expense of increased depth (reaching the poorest of the poor). In an unexpected announcement, Vikram Akula, the founder of SKS microfinance (which was heavily criticized for its aggressive practices) noted, "Professor Yunus was right. Bringing private capital into social enterprise was much harder than I anticipated" (Thirani, 2012).

Hybrid Model: The Mexican Case

While non-profit actors spearheaded initial microfinance efforts in Mexico, today the sector most closely reflects the hybrid approach. The hybrid approach combines components of the state-supported and bottom of the pyramid typologies; a wider variety of stakeholders are present in this model as both state and private equity are important sources of financing in the hybrid approach. Roles are sometimes hotly contested and solidify, in part, through negotiation and contestation around the regulatory environment. As illustrated here, the hybrid approach is constantly in flux, seeking to achieve a balance between the various stakeholders.

In the 1990s, Mexican MFIs worked together to determine a strategy to strengthen the sector and address the insufficient regulatory environment. In 1997, the PRI lost control of Congress and, in 2000, Mexicans elected Vicente Fox—the first non-PRI president in over 70 years—who was also a strong proponent of microfinance. The microfinance sector respected Fox's support for microfinance, generally, but was also cautious of his interest in subsidizing the industry.

In response, the sector and international supporters took a proactive approach to provide an alternative to Fox's plan, which reflected the state-supported approach as seen in the Brazilian case (Olsen, forthcoming). The Inter-American Development Bank was forthright in stating that Mexico should learn from other Latin American countries in which the presidents tried to create a "boom" in microfinance, with largely

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negative consequences (Flores, 2000). In particular, "they warned that the social bank is not the panacea to combat poverty and recommended, that if executed, the program must be well-targeted to avoid its complete failure" (Flores, 2000). The director of MicroRate, an agency that rates the financial quality of MFIs, warned that it would be "counterproductive for the government to intervene with a microcredit fund of its own," and spoke of several other countries that had experimented with state-led programs in the "euphoria for microfinance," but instead created programs which were often unsuccessful (Flores, 2000).

In 2001, the sector celebrated the passage of the Law of Community Savings and Credit (LACP, Ley de Ahorro y Crédito Popular), which constituted a turning point in Mexican microfinance. The LACP established a tiered framework that would work with and complement the heterogeneity of the sector (e.g., traditional community funds, NGOs, credit unions, urban, rural, for-profit, and non-profit MFIs). The bottom tier had relatively low entry costs, but only allowed institutions to offer a limited number of financial services. Alternatively, top tier institutions were allowed to accept deposits—not only from members, but also for the first time, from the general public.

While the LACP facilitated a legal process by which microfinance institutions could grow, it also recognized the important role for smaller and more informal institutions. The tiered nature of the LACP enabled each type of institution to do what it does best. Those in the lower tiers could remain non-profit organizations and provide microfinance legally with minimal regulatory requirements. For-profit MFIs were able to apply for a different status, which allowed them to accept deposits and access commercial finance, as well.

The deviation from the hybrid model is Banco Compartamos. Originally an NGO that began with philanthropic funding, it first offered microfinance services in 1990. Compartamos made national headlines when, in April 2007, it undertook an initial public offering (IPO) that resulted in enormous returns. "[T]he $6 million in equity investments that launched the bank in 2000…turned out to be worth $2.2 billion…though the stock price later tumbled" (Armendáriz & Morduch, 2010: 240). Its "pro-poor" mission was questioned as observers noted that, leading up to the IPO, Compartamos achieved rapid growth and a return on equity that reached over 50 percent (Rosenberg, 2007). Today, Compartamos remains an anomaly; no other Mexican MFIs have reached this kind of scale and no other Mexican MFIs have offered IPOs since.

Overall, MFI stakeholders in the hybrid model remain varied and are a reflection of the regulatory framework in place. Smaller MFIs continue to rely on state financing and seek to reach the poorest of the poor or rural populations that large MFIs are less likely to serve. The state has a variety of programs that offer rural, agricultural loans to some of the poorest individuals in Mexico (Marulanda Consultores, 2011: 7). Meanwhile, private, for-profit institutions serve low-income individuals who previously had little access to credit. Those institutions, like the bottom of the pyramid approach, do not seek to serve the poorest of the poor but have achieved greater breadth. They are able to use both the public's savings and private equity to achieve this growth.

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While MFIs have grown substantially—and at a stable pace—in Mexico, this is not to say there is consensus around the microfinance model. Regulatory modifications have occurred at a fairly regular tick since the LACP; this is to be expected. An agonistic lens allows for the recognition that moral legitimacy can be achieved through the controversy and contestation that marked the development of Mexican microfinance.

CONCLUSION

This article makes four contributions. First, it aims to advance what Phillips and colleagues (2011: 178) describe as "a version [of stakeholder theory] that details the role of stakeholders in constraining or facilitating [managerial] discretion." It does so by highlighting an important intermediary step: how the state augments or abates other stakeholders' legitimacy. Extant stakeholder theory includes discussions of the state, but the state is generally considered one of many stakeholders. This approach explores how the state limits or expands managerial discretion and illustrates the analytical utility of treating the state as a unique stakeholder.

Second, political stakeholder theory links the state, stakeholder legitimacy, and the constraints managers face to the ethical challenges of firms and the industries they populate. Regulatory environments that limit stakeholders generate an industry with cognitive legitimacy, achieved through coercive isomorphism by state centralization of resources. Those regulatory environments that allow some stakeholders to become market players facilitate pragmatic legitimacy. Cases in which the regulatory environment allows a broad set of stakeholders achieve moral legitimacy—and do so by adopting an agonistic lens and thereby accepting that legitimacy can come through contestation.

Third, the argument and evidence presented here also have important implications for business ethics scholars. The critiques of microfinance, with which the article began, are fervent. Microfinance was founded on the premise that it would help the poor. MFIs have violated the principle of protecting the vulnerable, which is "when a person or organization stands in a relevant relationship to a vulnerable party, the person or organization has a special obligation to protect the vulnerable party from harm when they have the capacity to do so" (Arnold, 2013: 137). Thus, scholars have questioned whether microfinance is meeting its obligations. This approach, however, brings clarity to microfinance outcomes and goals. A discussion around MFIs obligations can quickly become muddled, as expectations for microfinance differ. Some proponents of microfinance simply sought to provide access to finance to those who were previously "unbanked." This is no small task. Others, however, promote microfinance as a tool of personal and economic empowerment through which development as freedom (Sen, 1999) could be achieved.

This article seeks to uncover how regulation affects the development of microfinance and, thus, provide a discourse with which to more accurately discuss the ethical implications of distinct microfinance models. Moving beyond the false dichotomy that has emerged around microfinance, the application of political ST facilitates our understanding as to how MFIs within a state-supported approach struggle to expand

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access to services and innovate. MFIs, alternatively, within the BOP approach may struggle to responsibly distribute loans, as there is increased pressure to maximize profits. They may also forgo servicing the poorest of the poor, in favor of efficiencies gained with larger loans to relatively wealthier clients. Finally, MFIs operating with the hybrid approach may struggle with many of the challenges mentioned above. Within a hybrid approach, MFIs may also struggle to find consensus, given that the regulatory environment allows for greater variation of microfinance providers.

The fourth and final contribution of this article is to make sense of the contestation between markets and states through agonism. Though writing about democratic politics, Moufee (2000) states "the crucial problem is how to transform antagonism into agonism" (117). It seems the same could apply for managers; an agonistic approach requires mangers and the firms they represent to be prepared for conflict. Yet, it suggests they should embrace this process and recognize that moral legitimacy can emerge through contestation and confrontation.

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NOTES

1. In this article, qualifying stakeholder theory with "political" is in reference to the role of the state. This is distinct from, and unrelated to, Freeman's widely read article about the politics of theory building (Freeman 1994) or other canonical work that explores internal organizational conflict (e.g., March 1962).

2. Political ST, as developed here, is done so with democratic states in mind. While non-democratic states also employ the use of similar tools (e.g., regulation, resource allegation, etc.), those cases are beyond the scope of this article. Moreover, an agonistic perspective does not apply to non-democracies, as contestation is unlikely to occur freely in an environment in which political and civil rights are severely restricted.

3. Microfinance employs social capital as collateral for small loans to low-income individuals. While the initial goal of microfinance is to alleviate poverty by providing low-income individuals with access to finance, the objectives and aims of microfinance are often contested, as discussed below.

4. Banerjee et al. (2010) find that the introduction of credit in Hyderabad, India increases household borrowing and investment. In addition, the authors find that microloans help those who already owned a microenterprise to expand business.

5. The regulatory environment is defined as those rules passed by the state that determine a) the sources from which microfinance institutions can access capital, and b) whether microfinance institutions must comply with an interest rate ceiling. Each type of regulation is discussed in greater depth below.

6. Note that this analysis does not include cooperatives, which by definition accept deposits from members. MFIs, if the regulatory environment allows, accept deposits from the general public.

7. According to MIX Market (www.themix.org/mixmarket), the most comprehensive source of microfinance data to date, private equity investment increased by 80 percent between 2006 and 2011, when private investors provided 10.52 billion to for-profit MFIs; private capital to non-profits increased slightly, to around 4.44 billion during this period.

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8. It is important to note that some MFIs still exhibit characteristics described here; I refer to this approach as "historical" later in the article to highlight that this approach is no longer considered the norm.

9. Increased investment in microfinance follows broader trends about serving the BOP market, generally (see Kolk, Rivera-Santos, & Rufín, 2013; Prahalad, 2004).

10. Author's interview, February 2009.

11. Perhaps the most well-known and most internationally-recognized Brazilian MFI, CrediAmigo, was established during Cardoso's tenure. The Bank of the Northeast (BNE), a state development bank launched CrediAmigo in 1998. This organization began as a program of the BNE, but then also created an OSCIP in 2003. It is the only microfinance program in the country that is completely controlled by a state-run bank. Funds for CrediAmgio come from the BNE, which are indexed at a rate that closely tracks the SELIC, the interbank rate.

12. For a broader discussion on this topic, see Arnold and Valentin (2013).

13. Author interview, January 2012.

14. Note that the trends in Andhra Pradesh are distinct from the SHG model described above, which has continued to co-exist within the BOP model.

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