Fair Interest Rates when Lending to the Poor:
A Neo-Contractarian Approach

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Abstract: The topic of fair prices has recently been addressed in debates concerning fair trade or fair wages. This paper addresses this issue by examining fairness in terms of giving credits to the poor. It begins by analysing a few definitions of fair interest rates and then goes on to determine what a 'just' range in terms of price might be. In so doing we shall examine the major constraints and the methodology that goes into assessing the fairness of the distribution of credit. Our inquiry will base itself on bargaining theory and look at how credit should function fairly within imperfect markets. Given this approach we shall then aim to present a particular contractarian view of this credit problem. In doing so we will look to merge both the ethical and market based concerns that haunt this issue.

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1. Introduction

Debates on fair prices have a lengthy history, originating with Aristotle's famous denunciation of interest as the unnatural fruit of a barren parent. But more recently, such questions have surfaced in the fair trade movement which recently has begun lobbying for fair remunerations for workers in low-income countries.

To this end the practice of microcredits has been developed in order to offer fairer prices to small entrepreneurs within developing countries. Nevertheless, except for a very few countries where the microfinance market is competitive, microfinance institutions also charge high interest rates, sometimes similar to those charged by informal lenders. These rates are due partly to the high transaction and operating costs involved in the upkeep of these small loans. Rates often range between 20-60% per year, according to the economic environment and the ways in which the loans are repaid. To give an example, Compartamos, one of the fastest growing sustainable MFIs in Latin America, is charging an annual rate of 120% per year and that is on top of the normal fees and taxes applied to such loans (New Yorker, 2006).

While high interest rates are still discussed and challenged from within the microfinance sector more and more growing ethical concerns about such rates are originating from outside of MFIs. Civil society and the global community are engaging in these issues like they never have before. Some of this attention is simply not due to their lending practices but also results from their somewhat fragile status. But during the summer of 2006, around fifty branches of two major MFIs were closed by district authorities in the State of Andhra Pradesh (Fouillet, 2006). The authorities cracked down on the MFIs for what they considered usurious interest rates coupled with forced or unethical recovery practices (Shylendra, 2006). In light of such crack downs ethical issues and particularly debates on the interest rate levels are now widely accepted by all as a major threat to the sustainability of the entire microfinance sector.

Given the emergence of this critical and daunting issue we will look to analyze the ethical dimensions involved in lending to the poor and try to determine what fair interest rates entail. Since this is a large and complex issue we will specifically narrow our attention to those cases in which borrowers can afford interest rates which cover their lending costs. To do so we shall put to use several major theories of justice which address liberal societies (Rawls) or hypothetical perfect markets (Nozick or Hayek) that are not gender equal (Okin). This will help us put this issue into the proper ethical perspective. Alongside these theories of justice we will build our economic argument by using bargaining theory, but only insofar as it concerns incomplete or uncompetitive markets. Together these two approaches will help to balance, merge and give greater perspective to the range of issues facing microcredit lending.

The structure of the article is as follows. Since we already have introduced the major issues and concerns along with the type of methodology we will apply, our next task will be to look at some empirical evidence. Section 2 will focus on the ethical debate surrounding interest rates and consider the different actors and positions involved in the discussion of fair interest rates. In sections 3 we shall consider Gauthier's contractarian approach to justice. Section 4 explains why we could apply a bargaining and contractarian approach to microfinance imperfect markets. The last two sections will present a particular contractarian approach to solving the problem of fair interest rates and draw some conclusions.

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

First, in order to gain a good grasp on those criteria, we are going to take a short look into the history of interest rates. Specifically we will do so from the perspective of the debates that surrounded them during the emergence of the microfinance sector. We will finish by presenting some of the existing approaches used to handle the question of the fairness of microcredits.

Prior to the 70s the interest rates charged to poor entrepreneurs, particularly rural ones, for development projects were very small indeed. In the 70s and 80s debates took place on the issue of these low interest rate policies. These debates developed hand in hand with the emergence of the very costly microcredit loans we have thus far been discussing. Representative of this debate is Adams et al's (1984) seminal book *Undermining Rural Development with Cheap Credit* as well as several other works from the Ohio School scholars. These works were written in response to the existing state of affairs in which the rural poor had access to low but highly subsidized interest rates. This Ohio group argued that cheap credits would destroy the incentives to save and as a result distort the way lenders look to allocate funds (Adams et al., 1984, p. 75). The rationale was that “low interest rates on loans to rural people end, paradoxically, by restricting their access to financial services” (Von Pischke, 1983, p. 176).

Hudon (2007) suggests four criteria for determining the fairness of interest rates. These criteria help to illuminate the issue in general while letting us take a candid look into the question of fair interest rates. The first looks into what is called the deontological arguments for fair interest rates. It emphasizes the perspective of the loan recipients themselves and aims at illustrating a view that protects their interests alone. The consequence of such an argument is that it would easily put the lending institutions at risk by being one sided. The second approaches this question through the marginal impact such rates have on the client’s financial situation. The third is market-based and focuses on the restrictions that come with demand. Both the second and third approaches seek a middle ground and are based on the marginal benefit to the customer in light of the actual demands placed on the loan. These arguments, at first, take up the issue of the client’s need but ultimately seek to foster the institution’s development as well. The criteria of these middle views are dependent upon a limited set of requirements that affect both parties.

The fourth and last procedure suggests a procedural definition of fair interest rates based on fair wage literature. It looks to ignore both the clients’ and the institutions’ interests by following market guidelines or benchmarks. We might say that this last approach concretely aims to take the idea of self interest out of the equation in order to make some general objective determinations about the markets themselves. As acknowledged in the paper, each has its potential flaws which we will need to clarify. With this in mind, we now turn to review some of the poignant definitions of fair interest rates in order to formulate a critique of these positions.

These four approaches pinpoint that microfinance discussions have long been divided in two camps, the “institutional” camp and the “welfare” camp. Institutional arguments put the emphasis first and foremost on MFIs themselves and their sustainability. For an institutionalist, interest rates are justified by stressing the importance of institutional sustainability over the needs of the loan needing population. Consequently, according to the institutionalist, the poor are then able to retain some access to upright lending institutions which, in the long run, are better than informal lenders[2]. The welfare camp, on the other hand, bases their analysis of fair price and interest rates on the clients' specific need for personal development which is only available through access to credit. Interest rates, according to this view, should be structured from the perspective of helping the impoverished rather than supporting the pure sustainability of the lending institutions. We can assume fair rates would best balance both the clients' and the institutions' interests. Ideally though, even if some innovative solution could bring both of these interests together there still exists an intrinsic conflict that comes from trying to obtain the 'best' interests of both sides. This conflict is often emphasized in the economic literature in concepts such as 'moral hazard' which emphasizes the low trust or non-cooperative relationship of the agents themselves (Lapavitsas, 2003). Due to dualistic nature of the debate on fair interest rates the intrinsic conflict has no easy resolution. For example, many proponents of the institutional argument use the welfare position to justify the institutional view of interest rates. Though, the institutionalist's view of the 'welfare recipient' is quite different from that of the welfare positions own. The difference being that the institutionalist does not understand the 'welfare recipient' as the current client. Instead, the institutionalist argues for the welfare of the future client. Institutionalists claim these imaginary or ideal future clients would be harmed without access to sustainable MFIs and so they reflect the lenders highest priority. We can see the rationale behind this strategy by taking a look at Accion and the wording of its company wide pledge to provide welfare.

E. Rhyne, Vice-President of Accion, defines fair pricing as that which "allows the institution to operate as a (on)going concern, but at the same time is as low cost to the customer as possible"(Accion, 2004). Further, the Accion consumer pledge states 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, which is one of a kind in the industry, is certainly a step in the right direction. Importantly though, the pledge is voluntary in nature or comprises a sort of gentleman's agreement. As a result, the possibility exists that other institutions can

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[2] 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.

choose not to adopt it or ignore its good intentions all together. Its tenuous but right minded promise could easily be ignored or upset by other companies engaging in bad market practices. Nonetheless, a valuable question emerges in light of this possibility. To what extent do concerns about the institution's operation and sustainability come into conflict with the ideal of providing the lowest possible cost to the customer?

The general problematic lies in the definition of what the ideal state of low costs might be. The pledge, for all its good will, does not in any way directly refer to the customers' present situation. Meaning the implicit reference to provide the lowest possible cost to the customer is based first and foremost on the institutions best interest. The pledge then seems like a rehashing of the institutionalist position but in a more benevolent way. Ultimately, the pledge seems weak since it attempts to refrain institutions from imposing higher costs but only according to the institutions best interests and those of future clients. The whole pledge turns out to be paradoxical in that it seeks to reduce any additional burden on the poor from the vantage point of interests, which are ultimately not the poor' own. This concern is, however, partially addressed through the avoidance of overindebtedness[3] as well as other built in consumer protection policies, all of which are supposed to help bridge the gap.

Regardless, the institutions' operation and survival prevail as the primary objectives in Rhyne and Accion's definition of properly minded welfare relations between lender and lendee[4]. The overriding concern of Accion is that rates should first account for an institutions growth and second be fair to the customer. The institutionalist ideal appears yet again in the end goal of preserving sustainability for the future client rather than the present one. Accion's pledge of reaching more people by self-preservation once again revives the implicit contradiction inherent in institutionalist thinking. Such a view cannot help but stand fundamentally opposed to the stated pledge of providing the lowest possible costs to borrowers which are currently in need. Accordingly one should then assume that in order to operate as 'an ongoing concern', as Accion claims, requires first and foremost some sufficient hedging of the institutions own profit margins. The focus on profit margins then is thought to act as

[3] The pledge states that "members will not lend any costumer more than the customer can repay".

[4] 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.

the implicit guarantee that MFIs aim to reach more clients, but not necessarily current clients.

In light of our critiques we will next take up the main points of Gauthier's contractarian theory. By doing so we will see the value and even-handedness contractarian theory brings to the debate and definition of fair and just interest rates, from a bargaining perspective.

3. Gauthier's contractarian approach to justice

In *Morals by Agreement*, David Gauthier provides a major contribution to theories of justice concerned with non-competitive markets. Gauthier's theory is particularly useful in the microcredit cases we have been investigating. His main contribution is the idea that perfect markets are a morally free zone or a zone in which the constraints of morality have no immediate place (pp. 84-93[5]). In using the perfect market as his starting point, Gauthier claims that in them morality simply does not come into play. Nonetheless, he does directly acknowledge that the perfect market does not ever appear amongst our daily economic activities, it is an ideal. In spite of this fact, Gauthier's overriding aim is to show that markets are 'ideally' a morally free zone even if such perfect markets do not exist in everyday life. According to his theory, morality is a special case that only appears in light of market failures and not before. Even so, the idea of perfectly competitive market interaction is based on some assumptions which make its use in our debate very questionable. First, in perfect markets all products and factors of production are assumed to be privately owned. Second, circumstantial uncertainty and strategic calculations are likewise removed from consideration. Third, Gauthier also assumes the absence of any externalities that occur as "an act of production or exchange or consumption (which) affects the utility of some person who is not party or who is unwillingly party to it" (pp. 85-86). The general drift of these assumptions, i.e. the absence of externalities, makes perfectly competitive market (PCM) relatively implausible things.

In microfinance, for example, one of the main externalities or effects produced by low interest rates is the necessary change which takes place within an institutions' pricing

[5] In the rest of the paper, page numbers between brackets will refer to Gauthier (1986)

scheme. These changes can often produce unsustainable rates for institutions. Similarly, these changes also can impact prospective clients. As a result, many non-clients are not reached by MFIs since it is possible that institutions have already used their additional margin, due in part to unsustainable rates changes, to help them sustain themselves. Nevertheless, Gauthier’s contribution towards a theory of imperfect markets is still quite useful. One of its key uses is in the question of the effects of competition within the microfinance market.

In the absence of competition, institutions might charge much higher interest rates and still find some demand for their services. Institutions in such a case would benefit from a 'rent' or a return over and above the cost of what they supply. In short, this means one then “receives more than what is needed to bring her factors to the market” (p. 98). This return is due to the scarcity of 'capital' or factors that they themselves control. In these terms we are specifically talking about the factors of money and credit. According to Gauthier, this rent is due to an accidental situation and not the intrinsic nature of the factors involved. It however does depend on the contractive relations the institutions do control as well as the factors controlled or held by the renter. But what counts as justice in this case, and further what would a just resolution be?

Adopting 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).
This is Gauthier’s co-operation principle. The co-operation principle, which is influenced by Hobbes’ Leviathan (Hobbes, pp.60-62), assumes the essence of justice is an awareness that the other is a competitor. According to Hobbes' state of nature, given scarcity and mutual unconcern, each party views the other as competitors for the goods they need. While scarcity also creates a preference for dominating one's fellows, co-operation arises to avoid mutually destructive conflicts. But co-operation only comes about in light of a social contract agreed upon by all parties. Likewise, money’s scarcity in many developing countries creates unequal bargaining powers and puts the lenders in a very favorable situation allowing them to dominate their clients. If materialized, this domination would create situations of rent and impose the condition of unfair interest rates.

Gauthier's bargaining theory, like Hobbes' idea of a civil contract, enables the incorporation of the competitors concerns through the active involvement of the parties in question. The idea of a rational bargain then will ensure participation reaches an agreed and mutual outcome (Gauthier, 1986, p. 128). That said, the voluntary involvement of the actors is an essential requirement. Without it there is no way to reach the real compromise from the ideal state of competition according to Gauthier. He, therefore, considers and gives "moral" value to the necessity of voluntary agreement as the *a priori* condition of his barging theory.

4. Why apply a bargaining and contractarian approach to microfinance?

Even if one challenges Gauthier's argument that the deliberation or the agreement are in-themselves valuable, such as Elkin (2004) does, there is much yet to discuss. Elkin points out that the participation of the actors can be understood as instrumentally valuable in tackling the unequal distribution of bargaining powers. Since borrowers often lack bargaining power, because of their weak property rights and access to collateral, each party does not always have an equal chance to hold out for more acceptable terms (Satz, 2003). Given that participation can be instrumental in reaching fairness, as some empirical evidence suggests, bargaining and cooperation are both associated with the distribution of fair terms. For instance, Frey and Bohnet (1995) found that norms of fairness are more likely to come into play when the various parties have rich rather than poor interactions.

The involvement of the actors then also figures into a MFIs' sustainability. In the big picture, the sustainability of MFIs is a major goal for policy makers. Since many microfinance markets are still non-competitive, a greater range of interactions or richer interactions with clients will stoke competition. In light of this it may also have the side effect of causing some institutions to withdraw, which would then bear some heavy social costs. Therefore, even if the price of loan services is determined, with the help of an impartial observer, e.g. public institutions, it is crucial that the private owners of an MFI agree on its fairness too.

Similarly, the involvement of the clients also matters. In order to prevent the crisis that would arise from defaults and its consequent effect on the civil society, clients also need to retain a certain degree of openness to institutions. A rich interaction runs both ways and both parties are needed to sustain and supply the flow of fair credit and fair prices. That said, the fact remains that a large part of the microfinance community is still very fragile. Even if some MFIs have impressively resisted the various macro-economic crises, such as the once in Indonesia (Rosengard et al., 2001), only five to ten percent of these institutions are self-sufficient. These institutions are thus subject to instability fueled by the borrower's defaults which can cascade into a 'domino effect' of defaults. 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 which can produce the domino effect in the microfinance community and primarily does so in agrarian societies[6].

Next, we will argue that a contractarian approach to lending transactions can partly resolve the inequality present in the problem of bargaining power. First, we will briefly look at the agreement procedure at the core of contractarian theory. Conveniently enough, this issue is also at the core of the fair trade movement which we will use as our example. 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[7].” Nevertheless, if the lenders benefit from such a favorable situation what would make them want to collaborate fairly with their clients? From Gauthier's perspective the fact that the co-operators are rationally moral and are not at liberty to take advantage of their bargaining power secures each party involved against moral hazard (p. 201). But how and on what grounds can we really justify the existence of such a constraint?

Both deontological and consequentialist arguments could be used to justify the existence of fair co-operation between lenders and borrowers. From a deontological perspective, one could argue that the contractarian approach is directly justified by the differences of bargaining powers between lenders and borrowers as well as the potential social impact a lack of co-operation might entail. The difference of

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6 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

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

bargaining powers is critical to all imperfect markets, but it is even more important in non-competitive ones. This is especially true in markets where many clients are illiterate or lack a good education[8]. 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 is lacking. Hence, "a regulated price, ostensibly equal to what could have been attained by natural law economics must be determined by law." Therefore, normatively one could argue that co-operation must prevail, even if it is imposed by regulation rather than market forces.

Instead of deontological arguments though, one may argue for co-operation based on a consequentialist rationale. Three distinct consequentialist arguments are often used to legitimize the idea of a co-operational framework. These three arguments are not mutually exclusive and may even reasonably be thought to overlap and reinforce one another.

First, the lender (whether an individual or an institution) might be guided by some social concerns or ethical norms that would push him towards co-operation. 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 are open to the development of the sector without constraint, one can easily assume that MFIs could have charged much higher interest rates, closer to those of informal lenders. Theoretically, MFIs which are starting operations in a previously un-served area are similar to the first player role in an *ultimatum game*. In this game, the first player can divide a given amount of money with a second player who then can decide whether to accept player one's offer or walk away. If player two does reject player one's offer, neither get anything (Pull, 2006). In terms of application, when MFIs enter a very remote area, the only competition is often the informal lenders charging interest rates substantially higher than 10% per month.[9] MFIs could therefore rationally set their interest rate just under these rates, for instance at a 9% level.

[8] 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.

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

Nevertheless, following the logic of the ultimatum game[10], interest rates charged by MFIs are often much lower than the rates of informal lenders. Looked at in the combined terms of the ultimatum game and Pull's (2006) analysis of wages, even if these lenders are not in a direct bargaining relationship with the borrowers, some borrowers will not act as a purely rational economic agent should. This means some lenders do not aim at maximizing their profits given the lending terms. Some borrowers even act "as if co-operation" could exist with the group of borrowers themselves. Also, MFIs might hold some internalized norms of fairness and equity when offering loans for more than marginal amounts. Importantly these norms can be thought of related to the social bottom line of the microfinance sector. Microfinance then has a kind of double bottom line which includes both its social and financial performance (Copestake et al., 2005). This can be seen, for example, in the way MFIs often implicitly or explicitly co-operate with their clients in order to fix their prices.

Second, co-operation also may arise due to pressures applied by the stakeholders of the MFIs themselves. With the emergence and the publicity that often surround the development projects of MFIs, civil society is increasingly becoming acquainted with and interested in microfinance. This new found interest in microfinance is often felt by MFIs to be a potential threat to the sector.[11] Co-operation though can be seen as a positive response to those very critics who anticipate that civil society will, in the end, have to account for the price of the loan.

It is important to note that borrowers or clients of MFIs are also their stakeholders. For institutions where clients are represented on the board of directors, co-operation is likely to be encouraged. For instance, this is often fostered through the lender's interaction with its clients' representatives such that co-operation becomes the natural outcome of that relationship. Donors who look to finance these institutions also may favor co-operation as a positive method which suits their intentions. One should consider that donors usually have the dual objectives of poverty alleviation and

10 Camerer and Thaler (1995, p. 210) found that, contrary to what is assumed as "rational" behavior for player one, that player typically offers an average of about 30-40 percent of the total, with a 50-50 split being common as well. This stands opposed to the rationale that only a marginal amount should be given to player 2 who should accordingly accept a small amount of something rather than nothing.

11 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".

institutional sustainability in mind. Co-operation between the lender and the borrowers is therefore a main facilitating factor enabling MFIs to reach these potentially contentious goals.

Third, the lender might be willing to co-operate and lend to borrowers in order not to loose the potential fruits of the capital they presently hold. If no better investment alternative exists, such loans can help to ripen its capital. In this way co-operation makes good sense. This stands true even if a loan ends up bring about a potential decrease in a MFIs' profit margin.

All said, proponents of a deontological or consequentialist justification of fair rates and prices may argue that co-operation is necessary in order to fix fair rates. If we agree on a co-operative process, which methodology should we follow when doing so?

5. Methodology[12]

The problems related to imperfect markets and the emergence of high prices are ultimately related to two distinct rational approaches. Fair interest rate theories either focus on the ethical issue using the deontological approach or the importance of bargaining theory by making a more market based argument[13].

On the one hand, it is not hard to see how fair rates are an ethical or moral issue in lue of the disastrous socio-economic consequences that unfair rates create. On the other, the bargain theorists have a valid point too since rates are structured through a bargaining process. Interest rate policies, for example, using the Habermasian perspective on bargaining, fall under the idea of a bargaining alternative. Habermas (1996) defines this as negotiation between success oriented parties who are willing to cooperate. The emergence of financial institutions in impoverished or ethically charged areas ultimately depends on their willingness to enter difficult market conditions. Therefore, a middle way is needed between the two approaches that argue for a bargaining process that is also in touch with the relevant moral issues at stake.

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[12] The first part of this section is based on Hudon (2006)

[13] See Habermas (1996) for the distinction between the moral and the ethical in relation to bargaining issues. Moral issues, for instance, are represented by social policies, tax policies or the distribution of social wealth and life opportunities.

To this end we will now seek to determine a new contractarian approach to fair interest rates. The main constraint that confronts us when applying contractarian thinking is the pressing and absolute need to approach fair rates, not from the prefect market scenario, but from the everyday or imperfect situations in which rates arise. In order to do so, we will argue that the original bargaining point should eventually produce a non-cooperative outcome. Since the background conditions in these imperfect markets are not entirely fair, the outcome could easily be unfair. As we said previously, the advantage often goes to the party with the strongest bargaining power and this inequality must be ameliorated. Now, looking back to the problems pervading the international trade debate the question arises: to what extent does fairness and equity demand the current agreement not reflect past injustices? It is evident that higher tariffs for developing countries, even taking into account the "preferences" of trade partners, are really part of an unjust historical framework (Stiglitz and Charlton, 2006, p. 77). The exorbitant interest rates given by informal lenders are as unjust as the historical conditions from which they issue. So where do we go from here?

As we have already argued, in light of the second definition of fair interest rates, taking the initial situation as the reference for rate determinations is a problem. Such an approach assumes that the initial background conditions are perfectly fair while they may very well be otherwise. Often the historical and cultural conditions that inform this background can be full of elements that would violate our conceptions of justice and that, in turn, often influence interest rates. The idea of the primacy of the initial situation, however, will play another role in our approach. This is because it influences the parties' decision whether to enter into a loan or not. The initial rates for the client and the return the lender accrues will be of importance in our schema. Since we are taking the aim of fair co-operation as the main condition of this approach we need to be extra careful not to incorporate initial and potentially unfair conditions. To this end, we will side with Gauthier who states that the initial position of the bargainers must not be coercive (p. 200), have free-riders or operate through force or fraud (p 132).

The obvious first step in the right direction will be to determine what the reference point for the bargain will be. Gauthier (p .130) argues that the bargainers are primarily concerned with the distribution of gains which co-operation may bring them, i.e. the co-operative surplus. As is the case for other definitions of fair distribution, Gauthier's co-operative surplus is considered regardless of the client's capacity. The emphasis on co-operative surplus should thus be balanced with the concerns as to the clients' and institutions' capacities. This can be accomplished through their reservation prices, the price below or above which an actor refuses to enter the transaction. Given this dynamic we will seek to argue that fair interest rates should be analyzed and implemented based on what we will call the fair bargaining range. But what sort of methodology should we follow?

The evaluation of fair interest rates should begin with the bargaining range lying somewhere between the lender's and borrower's reservation prices. The institution's reservation price could, for example, be the price it requires to cover its basic costs. If the loan is used for an income-generating activity, the borrower's reservation price then will depend on their income and profit margin, The ideas is that such conditions would produce a "living interest rate", which would play a role similar to the living wage as described by Johnson (1938, p. 177).

If this were the case, fair reservation prices could then be calculated. These fair reservation prices are essentially the actors' reservation price minus, in some cases, the price given to some elements which do not fulfil our principles of justice (Hudon, 2006). An easy and practical way to analyse the fairness of a price margin is to evaluate if an institution, active in a similar environment, would need to charge 'that' amount given 'that' particular margin.

Distribution within this bargaining range or the *fair bargaining range* is the living or mutable criterion for what should be considered fair. Practically though, this range could be very difficult to establish. Impartial spectators or disinterested observers, who need not be members of the society[14], could tackle the potential conflicts of interest between lenders, borrowers and even potential future clients. They could help gather the information needed to fix the fair reservation prices and determine the fair bargaining range. Also, they could take on the role of moderator between the lender and the borrower as bargainers.

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

Even if these observers did not directly determine interest rate policy they could at the very least be useful in protecting the interests of fairness within the procedure. Given Ellingsen and Johannesson's (2005) empirical research, which suggests that impartial reasoning leads to greater moral behavior, these observers could be useful. People often are more moral in their approach when they have first reasoned through a given concern from an impartial perspective. To this end, independent observers would be instrumentally useful. Furthermore, since potential clients are not part of present negotiations, the impartial actor could represent or take their interests into account as well.

Now, turning back to the bargaining process itself, Gauthier provides us with a specific methodology we can follow. His procedure for bargaining entails two stages (p. 133). During the first stage, each party advances a claim and proposes an outcome. In our case, both parties may make claims that will vary a bit and so will be somewhat unequal to start. If the information concerning both parties fair reservation price was initially available, then a rational and fair outcome becomes a greater possibility. Given the disclosure of the reservation prices a MFI would then be able to take the borrower's actual reservation price into account and give the client a "living interest rate." A living rate would then fit hand in glove within the margins of their living wage or actual profit margin. Such an idea is in line with Locke's proviso to which Nozick and Gauthier refer. Locke's proviso aims to ensure that the situation of a person, given a good and plentiful surplus, is not worsened (Nozick, 1974, p. 175). If the borrower's reservation price is sufficient to cover the institution's costs, then there is good reason to think that a moral institution will not ask a higher rate beyond the borrower's means. Similarly, clients also could have access to knowing and understanding the institution's fair reservation price. By having access to this knowledge the borrowers become more rational well informed. Nevertheless, the limitations on any given interest rate could, according to the institution's reservation price, be challenged by the borrowers. That said, an important question arises: is it only the poor who pay the price for unjust initial background conditions and the lack of competition between financial institutions? If we understand the institution's 'fair' reservation price as something actually related to what market prices 'could' bear in a competitive market, the answer is not an automatic 'yes'. Accordingly, lending institutions also share in this kind of 'risk' or possible moral hazard due to a lack of competition. Both are brought about due to the same conditions. On the one hand, this is due to a lack of rational borrowers and on the other because of a lack of lending institutions which is essentially a lack of competition.

As of yet we still have not looked at the role coercion plays in the complex inter-relation that constitutes the kind of 'fair' competitive markets we are advocating. Looking again to Gauthier as our example, we too reject any initial bargaining positions based on coercion. He makes clear that such an initial state is akin to a slave accepting an agreement with his master while knowing full well the 'cost' resistance would entail (p. 195). Similarly, the lack of access to financial services can be seen as a kind of “economic coercion” aimed against the poor. Access to affordable credit can then be considered as a kind of right, even a human right, such as the Nobel Prize Laureate M. Yunus claims. In the absence of economic coercion, secured by the right to credit, the poor would probably not have to tolerate interest rates that are higher than what strict competition would bring. If the price of credit were determined in an ideal manner, then the poor’s claim to credit could be considered ideal and therefore something rightful or earned. This would mean determining the price of credit in terms of an 'as-if' but only as long as the 'as-if' or price is dependent on the assumption that competition actually exists. This position is more comprehensive and expands on what Gauthier himself considers in his arguments on coercion. Since Gauthier considers that each individual's initial endowment is something which has not be been acquired, through or by taking advantage of another co-operator, our new position expands the conditions of this rule of non-coercion. We are essentially expanding the position from an individual-to-individual perspective to a more systematic one (p. 201).

There are thus two possibilities for configuring a fair bargaining range, each with their own levels of distributive justice. First, there is a weak configuration based on removing prices as a whole due to initially unfair practices. Second, there is a strong configuration which seeks to remove any artificially inflated prices. The second seeks to remove artificial inflation due to the lack of competition that is implied by very the outcome of the first. That said, the second possibility is much more demanding and far reaching in terms of social justice.

The second possibility, according to Gauthier, is the most crucial one since it will be used to determine the 'fair' range of possible rates. Gauthier's contribution here is less innovative than the first and ultimately more questionable. According to Gauthier's model, the second step states that each party, or just one of the parties, has to offer a concession in the form of withdrawing part of their initial claim. The idea is that when one bargains inevitably one party has to give in order to come to an agreement. Accordingly, a party's claims are intrinsically limited by the person's contribution. In this case, the contribution is determined in terms of the co-operative surplus available. Gauthier focuses on the relative concessions[15] of each and so he seeks to present the outcome in terms of the relative concession expected of one or each of the parties. According to Zeuten's principle, the person with the minimum relative concession must concede to the one with the maximum relative concession. The application of Zeuten's principle would mean there is an implicit movement required within the very terms of bargaining as such. This principle, in light of this relativity, will then serve to equalize the relative and not absolute value of the concessions. Gauthier, in using this method also tries to clarify it by saying (p. 136) that the relative concession is, in fact, a proportion based on the two utility-differences or intervals between each relative claim[16]. If a proportion is really what is at stake in bargaining, then we should be able to reach a proportional or relatively acceptable conclusion.

Gauthier gives us the example of two people, Jane and Brian, whose non-cooperative utilities are one-half and three-eights respectively. The co-operative surplus that they claim, according to the rules of bargaining, is similar to the proportional difference. This is because the sum of their utilities, if they co-operate, totals one. The cooperative outcome in such a case gives them both a similar share of the additional utility at stake which totals one-sixteenth. Under these terms Jane will end up with a share of nine-sixteenths and Brian with seven-sixteenths. Basically, the same rationale can be applied to the case of microcredits. The result being the lender claiming 60% and the borrower 20% which in the end produces an interest rate of 40%.

Nevertheless, while everything mathematically balances out, Gauthier still makes a very implausible assumption. He assumes that the lender and borrower both get

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

[16] 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)

similar utilities in the transaction. Assuming a decreasing scale of utility, the lender may well get less utility from a marginal share of the surplus. This is because of his higher position on his utility scale and the borrower's lower one. Hence, a small amount of the surplus may provide a very high additional utility to the poor while producing a relatively small gain for the lender. The utilities conceded by the lenders and the borrowers have to be equalized or 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 which in turn would give him a disproportional share of the surplus.

Due to this inequality, we need to find another principle for the distribution of the fair bargaining surplus. In short, the second step of Gauthier's procedure needs to be revised. In a distributive bargaining situation, such as a conflict, most of us would take into account the absolute circumstances of the people involved when evaluating how we can assign priority to those who are worse off (Tungodden, 2003). Thus, the poor should get a priority in the distribution of the fair bargaining range. This prioritarian approach would supplement the bargaining procedure and provide the ethical component, as defined by Parfit (1995) where "*Benefiting people matters more the worse off these people are.*"

Therefore, instead of basing concessions on the utilities held by both agents, the prioritarian approach assesses all additional claims the lender makes on the margin. Additional claims being those claims on the margin which rise above the fair reservation price. All changes or additions to the fair reservation price as well as any margin gained above its existing level will be accounted for by impartial observers who will help assess a new fair price.

That said, we should take into account that during the bargaining process a lender may argue for some relative concession on the part of the client. This cannot be avoided and is part and parcel of the bargaining process. Lending institutions, as we mentioned earlier, are not just concerned with current clients but future ones as well. Accion's (2004) definition of its institutional concerns bears this out. Nonetheless, any concession must still be judged in the basic framework we just laid out. Specifically with the idea in mind that MFIs aim to reach more clients and this is a normal part of their initial bargaining position. But initial positions of any sort are not a guarantee of fairness. Any concession demanded by a lender will always need to be analyzed for fairness not just from the lenders initial position but from the clients' capacity as well.

Any marginal increase in share by a lender due to unjustified elements, which fly in the face of fairness, should be challenged. In the case of microcredit, fairness in such terms would require the managers of MFIs to efficiently and rationally manage their institution. Doing so will secure against interest rates becoming inflated due to ineffective leadership. Even if we recognize that, taken literally, this requirement may become impractical because of its complexity. Nonetheless it can still be used as a sort of proviso in extreme cases. In a similar manner, the effective bargaining range could also be understood as an "altruistic range" related to the social mission and responsibility of the institution. Any distribution would then be related to the level of altruism put into play by the institutions themselves. The more altruistic an institution is the more likely it is to accept larger concessions on the part of the borrower.

These concessions may not only be financial in nature but organizational as well. For instance, a borrower may request that the terms of a loan be changed. Clients may suggest restructuring a loan for many purposes including in an effort to maximize their well-being. This restructuring is not aimed at simply altering the price of the transaction for price's sake, but has a different sort of aim in mind. What ultimately underlines such restructuring or reorganization is the desired well-being of the borrower. In questions of well-being, it is not the inequality in access to credit or the cost of the loan itself that is at issue so much as the real impact these things have on profound social inequalities. As powerfully argued by Sen (1999, p. 201), women's participation in credit programs not only result in new income generation but also can provide some social benefits. Empirical evidence suggests that an important feature of credit programmes is that they can enhance social progress in the general population, as well as increase the borrowers' own socio-economic capacities. It has been found that the decision-making process of lending institutions shifts in favor of women when financial services are combined with intermediation by social groups (Holvoet, 2005).

All in all, from a developmental perspective, the clients' interests may not always be maximized within their share of the fair bargaining range. Although, the good utilization of the additional capacities a client gains from a loan can be maximized.

The basis of any good compromise should rest on this point: a loan can be considered fair by all parties even when it is not considered so for all the same reasons.

6. Conclusion

After disappearing from the realm of debate a few centuries ago, fair prices are again at the center attention, especially within the fair trade, fair wage (Pull, 2006) and microcredit movements.

We have first a few different interpretations on how fair interest rates are seen in relatively small credit markets. These interpretations, while well intended, often suffer in terms of application. Even if we don't agree with the whole of Gauthier's theory (1985) his contractarian approach to imperfect markets provides a good basis for beginning to answer this problem. In the case of fair credit and the poor, since most institutions see their lending goals in a morally-oriented way, they are just as likely to see the value in approaching rates from a bargaining perspective.

With this premise in mind we undertook a new contractarian approach to interest rates based on the fair bargaining range between the borrowers' and lenders' reservation prices. We argued that the lender must begin by claiming the borrower's reservation price in order to produce a fair "living interest rate". In this way the lender is giving back to the borrower some satisfactory amount of the existing margin of difference between the two. This is necessary because the institution primarily holds the greater share of this margin. Given imperfect market conditions, the borrower then is just as likely to understand the lender's reservation price in relation to his own. Together they can fix a living rate in terms of a price that functions on a principle of fairness. This entails an 'as-if' proposition and further an obligation that lenders lend 'as-if' markets were more developed or that competition existed. The 'as-if' is necessary in order to bolster the fairness in terms of the poor' access to credit as well as the rates. Gauthier's procedure of concessions, based on the actors' utility, could easily lead to an increase in inequality. We therefore sought to expand the contractarian position into a prioritarian procedure. The latter is based on the lender's reservation price and so prioritizes the lack of equality in the comparative difference between reservation prices and so tips the scale in the favor of the poor. This approach looks to level the playing field insofar as it demands a critical evaluation of all additional margins charged by an institution that could cause inequality and hinder fair rates.

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