To Pay or Not to Pay?

Local Institutional Differences and the Viability of Rural Credit in Nicaragua

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Abstract: Innovative credit enterprises, aiming to expand the frontier of the rural credit market, can attain financial sustainability and broadened social outreach if they embed financial operations in local institutions, such as social networks and prevailing rules. Only in this way can the “rules of the game” imposed by the credit enterprise gain the local legitimacy that is necessary to reduce transaction costs sufficiently. The nature of preexisting local institutional environments, therefore, has a profound effect on the performance of credit enterprises. Our analysis of a rural microcredit program in two neighboring villages in Nicaragua indicates that existing patron-client structures, conditioned by Sandinista agrarian reform and the harshness of agro-ecological conditions, had a negative effect on the local acceptance of strict repayment rules. This analysis suggests that the evaluation of credit enterprise performance should take into account differences in local institutional environments and that efforts should be made to fine-tune standard financial technology to more adverse institutional conditions. If not, the microfinance industry may tend to exclude more difficult and poorer rural areas.
Introduction

It is customary to frame the challenge of expanding the rural credit market frontier as primarily an issue of adopting appropriate financial technologies (Yaron, Benjamin, & Pripek, 1997). On the one hand, sound financial and business management practices are emphasized. Without such practices, it is indeed not possible to operate a sustainable financial enterprise that is capable of serving a broad social spectrum of clients without massive subsidies. On the other hand, the recommendations stress the need to implement adequate transaction-cost-reducing mechanisms. Costs relating to client selection and the specification and enforcement of financial contracts are relatively fixed per credit transaction and therefore evolve disproportionately to loan volumes. Inevitably, financial operations with poorer clients tend to entail higher transaction costs per unit of loan volume (Barham, Boucher, & Carter, 1996). To avert the danger of transaction cost rationing, a system of conditional loan renewal and a variety of recommendation and locally pooled information mechanisms, such as group credit schemes, are commonly recommended. These evidently need to be embedded in an appropriate and location-specific social interface with the local client community in order to create adequate repayment incentives and sustain the local legitimacy of the financial rules of the game.

Some versions of microcredit advocacy, such as that of the “intermediary school,” assert that the entrepreneurial success of the credit system in itself indicates the positive development impact of microcredit and other financial market-enhancing systems (Yaron, et al., in Hulme, 2000, p. 82). It is assumed that the ability to do sustainable financial business with previously excluded clients constitutes an unequivocal indicator that a previously uncovered segment of solvent demand is met.
by the extended supply of the financial system. However, the extension of a sustainable credit supply does not automatically imply that access has been extended in an optimal manner to all the relevant groups. Therefore, several recent studies argue that more refined questions need to be raised about the quality of the fit between supply and demand (Hulme, 2000; Morduch, 2000).

Transaction-cost problems in particular create tension between financial sustainability and the broadening of the social coverage of the credit supply (Rhyne, 1998; Morduch, 2000) The extended credit supply apparently tends to become concentrated on the upper-poor segments of the potential client population in urban and, to a much lesser extent, the less adverse rural areas (Hulme & Mosley, 1996). In the more adverse and poorer rural areas, the construction of an appropriate social interface between the credit system and the client community turns out to be particularly burdensome. This generates an incentive for the credit systems not to cover these problematic rural areas, especially if they give priority to the rapid attainment of strong financial sustainability, as the received “best practice” wisdom requires.

By comparing the relative success and failure of an initiating rural credit program in two neighboring rural villages in Nicaragua, this article explores some of the local institutional factors at play when a credit enterprise tries to create an appropriate social interface with rural client communities. The analysis highlights the need for an initiating microfinance system to take into account the specific “socio-cultural soil conditions,” to use a phrase coined by Klitgaard (1994). The nature of the established local institutional environment, defined for our purpose as the whole of the local social structure and its associated rules and norms, plays a vital role in the governance of financial operations. The analysis will also indicate that credit is often not the most pressing constraint on rural livelihoods and that competing access to financial resources can lead clients and communities to prefer other types of relations,
both inside and outside the local community, above their (future) relation with the credit enterprise.

The following sections analyze the institutional environment of the two villages, as well as the comparative experience and results of the credit program under study. Subsequently, we will reflect on the causes of the clear differences in performance of the credit enterprise. Finally, we will derive some conclusions about rural finance and differential local institutional environments.

The Experience of the FDL in Two Neighboring Yet Distinct Villages

Our analysis concerns the experience of the “Fondo de Desarrollo Local” (FDL) in two neighboring villages in Masaya, a rural peri-urban region in Nicaragua, some 40 km south of the capital Managua. Today, the FDL is one of the largest and definitely the most rural of all alternative credit institutions in Nicaragua, serving about 13,500 clients with a portfolio equivalent to 13 million USS (FDL, 2002). About 50% of these clients live in rural areas across the country. The FDL is one of the 25 microfinance institutions trying to fill the gap in the financial markets created by radical liberalization and the withdrawal of the state development bank BANADES (Jonakin & Enríquez, 1999). However, in this article we will not deal with its present-day success, but rather concentrate on the problems it encountered during the initial phase in the early 1990s. At that time, the FDL found itself on the steep slope of the learning curve and much of its management and financial technology was still experimental and adaptive.

The present analysis focuses on the experiences of the FDL in two villages belonging to the same region. In the first village, Los Angeles, the FDL was ultimately successful in establishing a workable social interface with the clients, so that operations expanded impressively. In the second village, San Rogelio, the FDL was unable to establish such an interface and eventually had to withdraw.
The Institutional Environment in the Two Villages

Agroecological and Economic Characteristics

The rural communities of San Rogelio and Los Angeles are situated in the northern plains of Masaya, in the Pacific region of Nicaragua. Because of its proximity to the capital and other important cities, the region has a reasonably developed road infrastructure and good access to urban markets. Thus, both villages have great economic potential.

The first village, San Rogelio, has an area of 13 sq. km and a population of 240 households, resulting in a population density of 93 habitants per sq. km. Two-thirds of the households received land during the Sandinista agrarian reform and, therefore, became members of one of the 11 established production cooperatives. In total, 640 hectares were redistributed, amounting to an average of four hectares per household. It is important to note that about a third of the present-day population immigrated during the land reform period. Historically, San Rogelio was a poorly populated area dominated by extensive cattle estates. The antecedents of both the original population and the land reform migrants are therefore predominantly rural wage laborers.

Access to San Rogelio is relatively difficult, because infrequent public transport passes along a poorly maintained sandy road. In Los Angeles, on the other hand, an all-weather tarmac road and regular public transportation services guarantee all-time access to the nearby urban markets. With 550 households living in an area of 10 sq. km, Los Angeles has a population density of 275 people per sq. km, three times higher than San Rogelio. The agrarian reform established eight production cooperatives that benefited 93 households (about 17% of the present-day population). Agrarian reform beneficiaries in Los Angeles received, on average, smaller plots of land: about 2.3 hectares per household, for a total of 216 redistributed hectares in the village (Barrios y Gómez, 1992). Furthermore, many of the agrarian reform beneficiaries were already living in the community before the reform was implemented. Immigration
prompted by the land reform was almost nonexistent. Many of
the agrarian reform beneficiaries previously owned small plots
of land and therefore had prior experience as peasant
producers.

On average, households in San Rogelio also own more land
than those of Los Angeles. However, this advantage is counter-
balanced by somewhat more adverse agroecological conditions
(less fertile soils and more irregular rainfall) and by the lack of
previous experience as independent peasant producers. This
results in a lower productivity per hectare compared with that
of Los Angeles.
At the same time, the poorer accessibility of San Rogelio implies more limited nonagricultural economic opportunities. Observation in the field indicates unequivocally that self-employment activities in Los Angeles are more diversified, including artisanal activities, services, and petty commerce besides agriculture. Although no attempt has been made to collect data on family incomes in the two communities, there are also strong indications that the average family income in San Rogelio is slightly lower than that in Los Angeles. In dynamic terms, the perception of the recent economic evolution is significantly more negative in San Rogelio, where 67% of the interviewees said their individual economic situation has evolved negatively, compared with only 24% in Los Angeles (see Table 1). At the same time, significantly more people have access to credit and development organizations in San Rogelio. So far, however, this stronger presence of development projects does not appear to have sufficed to reverse adverse economic trends.

The Incidence of the Agrarian Reform
Before exploring further institutional differences between the two communities, it is important to comment more extensively on the Sandinista agrarian reform, and in particular on the origin and evolution of the cooperative structures. After all, this agrarian reform was identified as one of the crucial determinants of the present constellation of the institutional environment of both villages.

The agrarian reform implemented by the Sandinista government in the 1980s has had a heavy, albeit unequal, impact on the agrarian structure and the institutional dimension of San Rogelio and Los Angeles. Although more than a decade has now passed since the agrarian reform, its influence in both communities remains evident. Because of the much broader incidence of agrarian reform in San Rogelio, this community exhibits a much more pronounced presence of agrarian reform
cooperative structures and the culture associated with these social structures.

As elsewhere in Nicaragua, the agrarian reform conditioned land transfers in the region upon the formation of production cooperatives with collective title and production. Very often, production cooperatives were formed by landless people, more or less accidentally grouped together by Sandinista mass organizations that tried to meet individuals' demands for land from the available estates. Because of the nature of this process, there was little space for organic and spontaneous organization processes within the cooperatives. Moreover, these cooperatives were rather vertically governed by the Sandinista state, with the local directives of the cooperatives serving as intermediaries towards the members. The members hardly possessed any autonomy with respect to production decisions, but this was compensated by the almost complete absorption of the risk by the cooperative (fixed salaries) and the state (remission of debts and free access to education and health as compensation for the artificially low production prices).

Consequently, the members enjoyed a guaranteed minimum subsistence level independent of production results. As Ruben (1997) asserts, the "cooperative institution" in this sense shows a certain resemblance to the "sharecropping institution," where the tenant and the landlord divide production risks, although the Sandinista state went much further than the average landlord in absorbing risks and guaranteeing minimum incomes. As a mechanism, this guarantee may be considered similar to the minimum survival guarantee in the "moral economy of the peasant" (Scott, 1976), but in this instance, it is provided by a paternalistic, revolutionary state and mediated by the local political leadership that manages the relations with this state.

Partly owing to the overly directive and protective governance of economic activity in the cooperatives, collective production exhibited many problems. Distorted prices and the
availability of abundant, cheap, and easily accessible finance contributed to a highly inefficient use of resources. It also provided ample opportunities for outright abuses by the leaders of the cooperatives. Such abuses and the system of standardized fixed wages caused serious incentive problems, inducing free-riding behavior on the part of cooperative members. Low identification of cooperative members with their cooperatives also resulted in a surprisingly high level of membership rotation. As a consequence of low official prices, production was often not profitable despite huge subsidies for inputs and agricultural machinery. This was, however, resolved by periodically condoning the outstanding debts.

In 1988, the abandonment of the wartime-planned economy, under which the cooperatives had been maintained in disregard of underlying profitability considerations, radically transformed their economic and management context. Distorted prices were rapidly adjusted and access to credit became severely restricted, whereas outstanding debts now had to be honored. Under these conditions, collective capital-intensive production turned out not to be viable. With the 1990 electoral defeat of the Sandinistas, government support and state control disappeared. Forced by internal problems and changing external conditions, practically all production cooperatives had, by the mid-90s, abandoned collective production in favor of land parceling into individual plots (D'Exelle and Bastiaensen, 2000; Vaessen, Cortez, & Ruben, 2000).

Although at the time of research, most production cooperatives no longer formally existed, in several communities, cooperatives' decision-making frameworks remained partially operative in order to manage the process of legalization of the insecure collective land rights into formalized individual land titles. Moreover, for many relations—especially relations with external actors—the old governance structures continued to play a decisive role as an established mechanism of collective action for which little organizational alternative had emerged.
Aspects of the Social Structure

Table 2 shows the consequences of the agrarian reform on the social structure in both villages. On the basis of survey results, we estimate that 32% of the population of San Rogelio was composed of first-generation immigrants, compared with 11% in Los Angeles. At the same time, more than half of the households identified themselves as belonging to a cooperative, while this figure was only 10% in Los Angeles. Taking these data into account, we conclude that the social structure of the San Rogelio community has clearly been more profoundly affected by the agrarian reform.

Moreover, we observe that the San Rogelio community is characterized by a significantly more explicit political allegiance than Los Angeles, with a logical preference for the Sandinista party. The Party continues to be associated with access to land and better times in terms of subsidies and protection. Not surprisingly, then, the Sandinista party obtained victories in this community in the municipal elections of 1992, 1996, and 2000. The UNAG, the peasant union with Sandinista affiliation, also occupies a relatively central position in the community. The Sandinista character of the community also explains why participation in religious activities is significantly lower, since the Catholic Church—the dominant religion in Masaya—is associated with anti-Sandinista networks.

We also observe that the population of the San Rogelio community is significantly better served by external development organizations. Local leadership in this community has a much better intermediation capacity than the leadership of Los Angeles. In San Rogelio, the external linkages with the state and, nowadays, nongovernmental development organizations are almost exclusively mediated by local Sandinista leaders. These leaders have been able to maintain their position as mediators, gained during the revolutionary agrarian reform process. Instead of acting as mediators of the Sandinista state, today they mediate the benefits of external organizations.
Table 2. Some characteristics of the social structure

<table>
<thead>
<tr>
<th></th>
<th>Los Angeles</th>
<th>San Rogelio</th>
<th>Pearson Chi-square</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of observations</td>
<td>45</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>Immigrants'</td>
<td>11%</td>
<td>32%</td>
<td>6.818 **</td>
</tr>
<tr>
<td>Cooperative membership</td>
<td>10%</td>
<td>53%</td>
<td>15.286 **</td>
</tr>
<tr>
<td>Explicit political allegiance of family head</td>
<td>38%</td>
<td>77%</td>
<td>10.487 **</td>
</tr>
<tr>
<td>Political preference for the Sandinista Party</td>
<td>19%</td>
<td>47%</td>
<td>6.291 *</td>
</tr>
<tr>
<td>Political preference for the Liberal Party</td>
<td>19%</td>
<td>17%</td>
<td>0.067</td>
</tr>
<tr>
<td>Active religious membership</td>
<td>71%</td>
<td>43%</td>
<td>5.382 *</td>
</tr>
<tr>
<td>Households attended by a development project</td>
<td>46%</td>
<td>93%</td>
<td>17.860 **</td>
</tr>
</tbody>
</table>

Source: Survey, December 1999; data refer to households.

a For this variable the number of observations are respectively 60 and 50; in cases where there were 2 decision-makers per household, both were asked about their origin.

* Significant at the 5% level
** Significant at the 1% level

toward their people, usually with implicitly similar views regarding subsidies and protection against risks.

The social structure of the Los Angeles village is more heterogeneous. Besides agrarian reform beneficiaries, it encompasses a large group of traditional peasants. The UNAG has less influence on communal life and the existent development interventions. Significantly fewer people receive benefits from development programs. Most local leaders were born in the community, and many were active before the agrarian reform.
They may be considered more traditional, historical leaders. The population is less politicized, and there is no significant preponderance of any political party in the community.

A Tentative Assessment of the Quality of Community Life

Another, more indirect way to assess local institutional differences consists in an analysis of the perceptions on the qualitative functioning of relations within the community and with outsiders. We try to measure these perceptions through subjective ratings attributed by the habitants on the basis of questions relating to six dimensions: mutual support, trust, collective action and common interest, leadership, respect for the law, and opinions about external actors.

If we calculate a total perception index’ based on these questions, we find that it is significantly more positive in the Los Angeles community. For most of the dimensions, we observe a significant difference between the two communities, in favor of Los Angeles, except for the perception of the local leadership, where no significant difference is found. In general terms, this points toward a better overall quality of the institutional environment in Los Angeles, where more people feel protected by mutual solidarity mechanisms; insiders as well as outsiders inspire more trust; the rating of the capacity for mutually beneficial collective action is better; the perception of national and local government is less negative; and both respect for and confidence in the law is higher.

The FDL in the Two Villages

The FDL started its operations in Los Angeles and San Rogelio in 1991. In the initial phase, the program underwent a number of policy changes as it struggled to find appropriate financial technologies and management systems. It started its activities with local banks administrated by the communities themselves. At the time, it was believed that interference with local dynamics on the part of the external development organization had to be minimized and gradually reduced. However, this
Table 3. Perceptions about dimensions of community life and external actors.

<table>
<thead>
<tr>
<th></th>
<th>Los Angeles</th>
<th>San Rogelio</th>
<th>Mann-Whitney U test</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of observations</td>
<td>86</td>
<td>46</td>
<td></td>
</tr>
<tr>
<td>Total index</td>
<td>0.54</td>
<td>0.44</td>
<td>2091.0 **</td>
</tr>
<tr>
<td>Mutual support</td>
<td>0.64</td>
<td>0.55</td>
<td>1575.5 *</td>
</tr>
<tr>
<td>Trust</td>
<td>0.61</td>
<td>0.51</td>
<td>1452.0 **</td>
</tr>
<tr>
<td>Collective action</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>and common interest</td>
<td>0.48</td>
<td>0.35</td>
<td>1505.0 *</td>
</tr>
<tr>
<td>Leadership</td>
<td>0.60</td>
<td>0.57</td>
<td>2925.0</td>
</tr>
<tr>
<td>External interventions</td>
<td>0.44</td>
<td>0.27</td>
<td>2427.5 **</td>
</tr>
<tr>
<td>Respect for the law</td>
<td>0.38</td>
<td>2625.0</td>
<td></td>
</tr>
</tbody>
</table>

Source: Survey, December 1999; data refer to opinions expressed by individual family members.

a. A higher index indicates a more positive perception.
b. The number of observations for these perception variables are higher than those for the variables in both previous tables; in cases where there were 2 decision-makers per household, both were asked about their perception.
c. With only three question per index, indices are not sufficiently continuous. Therefore, a non-parametric Mann-Whitney U test was used to detect significant differences between the two villages.

* Significant at the 5% level
** Significant at the 1% level

approach was abandoned, since it created persistent and unsustainable default rates.

In 1993, this self-management system was transformed into a comanagement system. The latter allowed a negotiated definition and an ex-post control of clear and objective "rules of the game" by the FDL. A crucial component of these rules was the principle of conditional renewal and expansion of the credit portfolio, both at individual and at village-bank levels.
Table 4. The FDL in San Rogelio and Los Angeles: 
Portfolio, number of clients and default rates

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>San Rogelio</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Actual portfolio</td>
<td>US$38,770</td>
<td>US$28,765</td>
<td>Operations ceased</td>
<td></td>
</tr>
<tr>
<td>Number of clients</td>
<td>166</td>
<td>n.a.</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>AR</td>
<td>108</td>
<td>n.a.</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>No-AR</td>
<td>58</td>
<td>n.a.</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Default rate</td>
<td>50%</td>
<td>63%</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Los Angeles</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Actual portfolio</td>
<td>US$4,424</td>
<td>US$41,140</td>
<td>US$97,433</td>
<td>US$156,286b</td>
</tr>
<tr>
<td>Number of clients</td>
<td>40</td>
<td>92</td>
<td>93</td>
<td>89</td>
</tr>
<tr>
<td>AR</td>
<td>25</td>
<td>50</td>
<td>48</td>
<td>37</td>
</tr>
<tr>
<td>No-AR</td>
<td>15</td>
<td>42</td>
<td>45</td>
<td>52</td>
</tr>
<tr>
<td>Default rate</td>
<td>37%</td>
<td>49%</td>
<td>19%</td>
<td>8%</td>
</tr>
</tbody>
</table>

Sources. Own calculations based on the data system of FDL and LAV; Navarro, Rodriguez & Gómez, 1993. AR = agrarian reform beneficiaries. 
 a. Default rate is calculated as arrears over expired quotas of credits. n.a. = not available. 
 b. This figure includes credits extended to 50 clients of other communities that were integrated in the Los Angeles office.

In 1992, the program canalized a portfolio of US$38,770 (see Table 4) toward the community of San Rogelio. Four-fifths of this portfolio was distributed to 68% of the total agrarian reform beneficiaries in the village. Together they represented 65% of all clients of the program in the village. In subsequent years, the program experienced serious recupera-tion problems, with default rates of around 50%. The program did not succeed in reversing this critical situation. Within the framework of the global shift from self-management to co-management, the FDL intended to reduce local participation in the decision processes, since this was identified as one of the
causes of the low recuperation rate. Effective resistance by the local leadership impeded the implementation of these policy changes. When the FDL decided in 1995 to cancel the injection of new funds, the local “bank” went bankrupt, and it was not able—nor indeed willing—to reestablish relations with the FDL by clearing its outstanding debts, as some other defaulting local “banks” did.

In the Los Angeles community the experience was quite different. As Table 4 shows, in this community the program started its activities with a similarly high percentage of agrarian reform beneficiaries (63% of the clientele). Although the initial phase was a lot less intensive, canalizing only US$4,424 (see Table 4) during the first year, recuperation rates were quite similar to those in San Rogelio. In spite of similar initial problems with the recuperation of credit, the program managed to gradually improve this situation. Several measures to improve the management of credits—such as the reduction of local decision power—could be implemented, and gradually the program augmented its portfolio to over US$ 100,000 in 1998, with a default rate of 8%. By the end of 2001, the program was able to reduce its default rate to a mere 2% (FDL, 2002).

Reflections on the Performance Differences between the Two Villages

With a view to comparing the comparative performances of the FDL and how they relate to the institutional differences between the two villages, details of the local social mechanisms that were mobilized when the FDL tried to embed its operations in the local institutional environments will be given. As indicated, these turned out to be crucial determinants of success or failure.

In San Rogelio, the FDL program established relations with six agrarian reform cooperatives. Unsurprisingly, four of the five elected members on the local credit committee were cooperative presidents. Since, during the Sandinista decade, membership of a cooperative implied an indiscriminate right of
access to credit for all members, it was unimaginable for the local committee to apply any individual selection criteria that could exclude certain problematic individuals from access. Credit was therefore distributed indiscriminately to all members of the selected agrarian reform cooperatives.

After the change of government in 1990, cooperative members saw FDL activities as a simple substitute for credit previously provided by the state rural development bank. They also preserved their perceptions about credit, including its implicit risk management function. Hence, they believed that repayment would not be due in case of adverse income shocks beyond their control. At the same time, cooperative presidents maintained their power positions, since they were almost automatically elected onto the credit committee of the program. They also viewed their new position as a continuation of their previous mediating role toward the Sandinista government. This perception was matched by the dependent clients, who considered it to be the presidents' duty and privilege to negotiate with the FDL on their behalf. Equally, they did not question the arrangement whereby the leadership administered the loan operations without accountability to them. This inherited vertical structure, with its lack of internal transparency and answerability, also resulted in an astonishing, almost absolute ignorance of the rules and the functioning of the bank by its client-members despite FDL's efforts to the contrary.

In 1993, when the village was afflicted by drought, clients expected the credit committee to negotiate a collective remission or at least a restructuring of their debts, as was the custom during the Sandinista period. The persistence of the agrarian reform culture and the presence of high production risks contributed to the persistence of this perception about credit. Moreover, the poor diversification of the local economy and the low presence of informal insurance mechanisms resulted in a high demand for risk sharing with external actors. Not surprisingly, the Sandinista mayor gained wide support during his electoral campaign when he declared that the FDL was not
entitled to claim repayment from the clients in the village. Supported by the UNAG, he even accused the program of dismantling the cooperatives in order to expropriate the land of the members. Furthermore, a newly established welfarist development program reinforced the prevailing populist logic of debt remission and subsidies.

An adequate response by the program to this situation was hampered by the fact that the members of the credit committee, who were also the traditional leaders of the cooperatives, lacked incentives to pressurize for repayment of debts by clients. They had contradictory roles to play, since they were expected both to safeguard the contractual rules of the program and to maintain their power position in the community by mediating resources towards their client networks. Moreover, as indicated, other organizations had now arrived in the community on which they could easily rely to solicit new assistance as a substitute for the FDL.

Caught in the web of patron-client relationships, both leaders and common people preferred the short-term benefits of collectively breaking relations with the FDL to create individual linkages with the FDL-system; they considered the latter to offer little security in terms of future access to additional resources. From the individual client’s perspective, this option was, however, fraught with ambiguities, not in the least because many had in fact honored their debts with the FDL. More in particular, the local directors and their close affiliates had accumulated most of the arrears. Given the conditional renewal of loans at village level, a growing realization of this situation triggered a general shift towards nonrepayment that inevitably terminated local FDL operations.

In Los Angeles the experience was different. Although the FDL program entered in a similar way, it successfully changed the credit culture. In spite of identical problems during the start-up years, many clients eventually came to recognize the importance of developing individualized credit records with their “own” local bank. Explanatory variables for this outcome
are their slightly less precarious economic situation, their higher levels of mutual support and solidarity, their larger inclination towards horizontal collective action, and the more positive perception of external interventions in the community. This situation allowed the program to improve its administration and professionalism. In 1993 an evaluation team of the central office observed various improvements in the organization of the program operations (Navarro, Rodriguez, & Gómez, 1993). A difficult learning process was initiated that resulted in a more rigorous selection of individual clients and a better application of the "rules of the game." In that same year, the program changed the administrative system, moving toward comanagement and reducing the direct local participation in management and day-to-day credit operations. In doing so, the program in Los Angeles was able to improve its performance substantially. It has continued to expand its local operations until today.

Some Tentative Conclusions about Rural Finance and Local Institutional Differences

Analysis of the experience of the FDL program in San Rogelio and Los Angeles indicates that the nature of the local institutional environment has a profound influence on the performance of rural credit programs. The analysis suggests that sustainable credit operations require active participation on the part of local leaders, but at the same time, that some distance needs to be maintained from local networks in order to impose objective "rules of the game" and avoid serving immediate factional interests. The extent to which such a balance can be reached is largely determined by the specific institutional constellation in each particular rural territory. In this particular instance, the institutional environment at village level is related to the relative incidence of Sandinista agrarian reform and its associated social networks and values, as well as to more objective factors, such as the relative levels of poverty and vulnerability.
Of course, as the problems of the self-management period in the FDL indicate, the managerial capacity and the institutional design of the governance structure of external interventions also plays an important part in explaining project performance. Deficiencies in management capacity evidently do not enhance beneficial working relations between credit programs and local clients. Nevertheless, the incidence of initial management errors was identical in the two communities and can therefore not explain the substantial difference in program performance.

Our analysis of San Rogelio indicates that the operation of sustainable credit operations can be severely hampered by the strong influence of patron-client relationships on most of its poor population. This majority is organized in social networks around cooperative and UNAG leaders, who monopolize the linkages with external organizations and are expected to protect and defend their clientele through the mediation of favors. Such patron-client social networks and their associated rules of hierarchy, loyalty, and paternalistic protection cannot easily be made compatible with the rules of a sustainable credit system, including the need to emphasize individual selection procedures and repayment under all conditions.

We do not believe that these problems are typical of Sandinista patron-client relationships, rather that they are characteristic of any type of vertical-authoritarian patronage system. In the case of San Rogelio, however, the problems associated with patron-client practices were aggravated by the previous experience with massive, subsidized, and weakly enforced Sandinista credit, mediated by the very same leadership. In such a context, clients do expect their leadership to negotiate a restructuring or a remittance of pending debts in the case of collective repayment difficulties, as may occur during a drought. However, it should be underlined that the lack of transparency and downward accountability in this institutional setup also contributes negatively to the repayment
culture, owing to the largely unsanctioned opportunism of borrowers in the circles of the "patrons." Clearly, the "Iron Law" of subsidized credit (Gonzalez-Vega, in Krahnen & Schmidt, 1994, p. 19) is at play here. Both factors help to trigger widespread default as well as effective collective action organized by the local leadership against any attempts at individual recuperation of pending debts.

This community contract choice against the safeguarding of long-term relationships with credit programs such as the FDL is also influenced by a number of additional objective factors. In particular, we ascertained that the relatively more pronounced vulnerability and poverty in San Rogelio and the higher incidence of alternative sources of external subsidies likewise play an important role. Both conspire against developing longer-term community relations with sustainable credit systems. Poverty combined with more pronounced climatological and economic vulnerability puts a positive premium on short-term defensive risk mitigation strategies such as those represented by the mediated benefits of the local patrons. The relatively abundant supply of external means from alternative sources, which we can suppose to be a function of both the poverty and the political leverage of the Sandinista leadership, completes the picture, because it allows the leadership to continue mediating short-term mitigating benefits. The option of individual relations with systems like the FDL (based on fixed-price credit contracts) apparently involves too great a risk for poor clients, despite the longer-term opportunities for access to substantial investment resources and growing independence from a contested local leadership. Developing more flexible credit products, possibly with an insurance component, could contribute to counteracting these negative tendencies from the credit programs' viewpoint.

This analysis also raises the question of endogenous institutional choice. Our study indicates that poor, vulnerable
To Pay or Not to Pay

communities might prefer defensive relationships of the “patron-client” type and could thereby become confined to an institutional path that provides short-term risk mitigation, but also involves longer-term disadvantages in terms of economic opportunities and distribution of power. In this process, there may also be an element of complicity on the part of many “welfarist” development organizations, which continue to “assist” the poor in such communities with short-term subsidies, inevitably mediated by local patrons.

For the microfinance industry, this implies that it is much more difficult to work in poor and more vulnerable rural communities. The FDL experience suggests that it is almost impossible to develop sustainable credit operations under the institutional conditions this type of community seems to engender. This, of course, raises important challenges for the poverty-reducing capacity of rural credit systems. In the present context of the industry’s almost obsessive preoccupation with the rapid achievement of financial sustainability, a tendency to concentrate on the geographical areas where institutional conditions are beneficial seems almost unavoidable. Our analysis therefore suggests that microfinance institutions should make a serious effort to search for innovative institutional designs as well as financial products that are more compatible with the needs and opportunities of the local institutional environment. A less stringent, more flexible approach toward credit-delivery to poor and vulnerable communities might be necessary in order to be able to compete successfully with the established protective, yet oppressive, patron-client networks and rules. If such innovative strategies are not given the chance to develop, the microfinance industry will almost inevitably exclude the more difficult social and geographical segments. In doing so, it will not be able to meet its ambitious, self-declared goals of poverty reduction.
References


To Pay or Not to Pay


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Appendix: Questions Used to Capture Community Life

A. Mutual support
   1. In this community, when a family faces severe problems, in most cases it cannot count on the support of other families.
   2. In this community people are ungrateful.
   3. In this community it is worthwhile helping people who face problems, as they will then help you should the need arise.

B. Trust
   4. You cannot trust anybody who is not of this community.
   5. In this community, when a person gives his word, he always honors it.
   6. The majority of the people in this community respect the property of others.

C. Collective action and common interest
   7. This community is quite divided.
   8. In case of a crisis (e.g., a drought that affects everyone), people try to discuss and cooperate to find solutions.
   9. There are groups within the community that do not want to have any relation with other groups.

D. Leadership
   10. The leaders work for the good of the community.
   11. People should respect the decisions that local leaders make.
   12. Local leaders take advantage of their position.

E. External interventions
   13. Development organizations do not fulfill their promises towards the people.
   14. The state representatives try to resolve the problems of the whole community.
   15. The local government has solved all the problems it could.

F. Respect for the law
13. When a merchant cheats someone, there is no way of getting justice.
14. State laws are more important than the rules of the local community.
15. When a patron does not respect the rights of a worker, there is no way of getting justice.

Notes

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1. This general definition corresponds to Douglas North's players and institutions/rules (North, 1990) as well as to the more popular concept of "social capital" as defined in the World Bank Social Capital Initiative (Woolcock & Narayan, 2000). For a detailed discussion of these conceptual issues, see Vaessen & Bastiaensen (1999) and Bastiaensen & Vaessen (2002).

2. For details about the historical experience of the Fondo de Desarrollo Local, see Bastiaensen (2000) and Rocha (in press).

3. The 18 largest microfinance institutions are organized in the Nicaraguan Microfinance Association (ASOMIF). These 18 institutions have increased their portfolios from US$19.7 million in 1997 to US$49.7 million in June 2001, with an increase from 18,700 to 125,200 active clients (Gutierrez, 2002). 41% of their portfolio is directed to the rural sector—a substantially higher proportion than in most other Latin American microfinance sectors. ASOMIF is very active in lobbying for legislation that will allow a further healthy expansion of its sector of sustainable microfinance enterprises.

4. For reasons of privacy, the names of the villages have been changed.

5. This policy of the Sandinista government can be explained by the combination of both a socialist bias in favor of state planning/entrepreneurship and the politico-military necessity to maintain a minimum (food) production level within the war (survival) economy.

6. From the very beginning of the agrarian reform, there was pressure from the cooperative members to allow individual production on the reformed land. Consequently, by the mid-80s there were already many cooperatives with mixed collective and individual production.
Journal of Microfinance.

7. For each dimension, three questions (see appendix) were posed and scores per dimension were constructed by summing the scores for three individual questions per dimension. The perception indices were constructed as the normalized mean of the scores per community. The total perception index is equal to the mean of the six perception indices.

8. In 1995 a new credit program was created in both communities, with long-term investment loans principally directed to former agrarian reform beneficiaries. However, the same perceptions of external assistance and credit affected the repayment incentives of the clients, resulting in similar program performance as in the case of the FDL program (see D’Exelle & Bastiaensen, 2002, for further details). This experience confirms once again our hypothesis regarding the relations between local institutional environments and the performance of microfinance programs.