

Ways Donors Can Help the Evolution of Sustainable Microfinance Organizations

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Abstract

This paper suggests ways donors can help the evolution of sustainable microfinance organizations. Sustainability is good because it helps microfinance organizations help more poor people than otherwise. Sustainability is hard because it requires balancing outreach and sustainability with prices the poor can afford yet high enough to cover the costs of the microfinance organization. Donors are like genetic engineers whose job is to speed the evolution of sturdy microfinance organizations. Technical assistance is the best way to strengthen microfinance organizations.

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1. Introduction

In a sense, donors in microfinance can be seen genetic engineers: their job is to speed the evolution of the sturdy microfinance organizations. This is worthwhile because it is believed that evolution by trial-and-error in a *laissez-faire* market would take too long. For example, donors can disseminate lessons learned by microfinance organizations as they try to strike a difficult balance between outreach and sustainability. This cross-pollination not only helps microfinance organizations to learn from others' mistakes, but it also helps to replicate the strong features of good microfinance organizations while deepening the pool from which healthy microfinance organizations can emerge.

Donors have limited comparative advantages in quickening the evolution of stout microfinance organizations. Donors are good at giving funds, measuring progress, and spreading good practice through technical assistance. It seems that healthy experimentation is better promoted by measuring progress and giving technical assistance than by simply making cash donations. Although funds are like food in that they help microfinance organizations to feed and get bigger, technical assistance is like school in that it helps microfinance organizations to learn and get better.

Donors husband microfinance by creating an environment that rewards success and punishes failure. To encourage microfinance organizations to strike a healthy balance between sustainability and outreach, donors must lubricate entry and exit (Von Pischke, 1991).

Experiments to strengthen microfinance organizations are not safe. Progress may come only after costly mistakes, if it comes at all. Experimental microfinance organizations may mutate into financial Frankensteins, well-meaning but blundering monsters doing more harm than good. Although donors work outside the market, they must try to mimic market forces so as to iron-out wrinkles and weed out experiments headed for dead-ends.

Section 2 defines *sustainability* and discusses the importance of profits. Section 3 discusses why the measurement of sustainability encourages sustainability. Section 4 discusses how different forms of help from donors impinge on sustainability. Section 5 concludes.

2. What is sustainability?

Sustainability can be defined as the ability to repeat performance through time.

A sustainable microfinance organization is permanent, but it is not constant; its organization and its structure of incentives must be flexible so that managers can adapt and adjust to keep performance healthy in a shifting environment. Sustainable microfinance organizations meet their goals now without harming their ability to meet their goals later.

Performance may be defined as fulfilling the mission of microfinance.

Microfinance is the supply of financial services to poor, unbanked people. *Outreach* is shorthand for the social worth of the output microfinance (Schreiner, 1999a). The *mission* of microfinance is to help poor people by cutting the cost of outreach. A microfinance organization helps the poor if it makes outreach cheaper than traditional banks.

Society encompasses all the people in the world. The goal of society is to maximize social welfare. *Social welfare* is social benefits less social costs. A microfinance organization is *worthwhile* from the point of view of society if its social benefits exceed its social costs. Donors get funds taken by governments from rich taxpayers in high-income countries and give them to microfinance organizations selling to the poor in low-income countries. Society may weigh benefits for the poor more than costs for the rich.

Sustainability matters because society cares about the poor both now and in the future. Unsustainable microfinance organizations might help the poor now, but they will not help the poor in the future because the microfinance organization will be gone. Unsustainable microfinance organizations might not even help the poor now (Adams *et al.*, 1984). Unsustainable microfinance organizations might be worse than no microfinance organizations at all because they may hurt exactly those they wanted to help (Krahn and Schmidt, 1994).

Sustaining performance requires profits even after accounting for all subsidies. Of course, just as infant firms need venture capital, infant microfinance organizations need subsidized resources from donors. But fledgling microfinance organizations need to be weaned quickly because donors will soon abandon them in the marketplace. Access to subsidized resources waxes and wanes as donors tire and as political moods swing. Donors are fickle, and they will withdraw. Without profits, a microfinance organization will probably shrink and die in a short time.

Even if subsidies were permanent, sustainability would still help to fulfill the goal of society. After all, the poor are plenty but the donor dollars are few. Without profits, microfinance organizations cannot attract private capital and so cannot saturate the market for microfinance (Rosenberg, 1994). Selfish investors will not start microfinance organizations from scratch unless subsidized microfinance organizations are profitable. If microfinance organizations were so profitable they attracted private

investors, then outreach would mushroom. Social benefits would skyrocket, and social costs would shrivel. Social welfare would improve.

Sustainability, profits, and repayment are linked. Losses are the symptoms of an unhealthy microfinance organization, and borrowers will stop repayment. This weakens the microfinance organization unto death.

The drive for profits is tempered by the mission to sell outreach to the poor. A microfinance organization that abandons the poor by selling big loans and big deposits is not a sustainable microfinance organization because it no longer supplies microfinance. Without the poor, a supposed microfinance organization is no different than a bank. Microfinance organizations must walk a tightrope, balancing the poor and profits (Hulme and Mosley, 1996).

3. Why the measurement of sustainability promotes sustainability

Measurement sparks good performance and casts light on bad performance (Von Pischke, 1996). The measurement of sustainability is a tool that can help donors yo build sustainability in at least five ways.

First, measurement forces the explicit definition of goals. Vague goals wither under attempts at measurement. Abstraction concepts like *sustainability* can become buzzwords unless anchored in the nuts-and-bolts of measurement (Inter-American Development Bank, 1994).

Second, measurement changes goals. Managers and donors who measure profits cannot help but worry more about profits.

Third, measurement exposes priorities. Willingness to measure sustainability shows willingness to work toward it.

Fourth, measurement helps management in very practical ways. Technical feedback helps to detect trends, to set targets, and to make benchmarks for comparisons with peers (Richardson, 1994; Koch, 1992).

Fifth, measurement proves what microfinance can do. Donors are pressured to demand sustainability from microfinance organizations. Without measurement, however, donors will be pestered by the fear that sustainability may be, in fact, impossible. Hesitant donors will expect less—and so will get less—from microfinance

organizations unless they measure performance and so know what reasonable expectations are. A few recent success stories offer the tempting vision of sustainable microfinance (Gonzalez-Vega *et al.*, 1997; Khandker, 1996; Chaves and Gonzalez-Vega, 1996; Christen *et al.*, 1995). These stories dare donors to measure progress toward sustainability.

3.1. Sustainability, worthwhileness, and cost-effectiveness analysis

Sustainability is sufficient, but not necessary, for worthwhileness. Profits are necessary, but not sufficient, for sustainability. It follows that there is not necessarily any relation between profits and worthwhileness (Figure 1).

Still, society wants donors to maximize worthwhileness. If microfinance organizations are worthwhile, then their level of worthwhileness will be maximized by sustainability. This is because the profits of sustainable microfinance organization can attract private investors who can fund more and bigger microfinance organizations than donors ever could.

Measuring worthwhileness requires benefit-cost analysis, and this naturally requires measuring both benefits and costs. A sustainable microfinance organization is known to be worthwhile even without benefit-cost analysis because social costs (at least in a financial sense) are zero. But most microfinance organizations are not yet sustainable. For these microfinance organizations, it is not enough to know that benefits

are positive because costs are also known to be positive, and costs could exceed benefits.

Measuring costs is less cutting-edge than measuring benefits. The nitty-gritty details of loan-loss provisions, tracking subsidies, and assuming opportunity costs can often seem tedious. But measuring costs matters a lot because it encourages sustainable microfinance organizations. Furthermore, measuring cost is much simpler and less expensive than measuring benefits (Adams, 1988; David and Meyer, 1983). This is true even though the cost of measuring benefits is falling (Nanda, 1999; Morduch, 1998; Pitt and Khandker, 1998; Hulme and Mosley, 1996; Bolnick and Nelson, 1990).

Measuring benefits requires a lot of good data from surveys of people before and after they gain access to microfinance and/or surveys of users and of identical non-users at a point in time. This takes a lot of time, money, and care. Complicated econometrics is needed to control for the effects of self-selection and fungibility (Moffitt, 1991; Von Pischke and Adams, 1980).

In contrast, measuring costs requires financial statements, talks with donors and accountants, and time at a desk. The math is straightforward. If opportunity costs are defined from the point of view of society and not from the point of view of the microfinance organization and if past social costs are sunk, then the measure of subsidy in the framework of the Subsidy Dependence Index of Yaron (1992a and 1992b) measures social costs in a period.

Cost-effectiveness analysis asks how high the surplus of the users of a microfinance organization would have to be to make social benefits more than social costs (Schreiner, 1999b). The analysis can span either from birth to the present or from the present to the future.

Cost-effectiveness analysis is inexpensive for three reasons. First, it is inexpensive to measure social costs in the framework of the SDI. Second, it is inexpensive to measure the average dollar-years of debt or of deposits produced by a microfinance organization. Third, the average social benefit of the average borrower or depositor is a multiple of the average debt or deposits outstanding, so the analysis need not incur the high expense of measuring benefits. Examples of cost-effectiveness analysis in the evaluation of the performance of subsidized finance include Schreiner (1997), Binswanger and Khandker (1995), and Gale (1991). If the benefit-cost rule itself were judged by a benefit-cost rule, measuring only costs without benefits would often be preferred to measuring both benefits and costs.

3.2 People must judge sustainability

A negative SDI is necessary, but not sufficient, for sustainability. Sustainability happens through time in the unknown future. One year of serving the poor with profits does not imply continued good performance any more than one year of marriage implies happily ever after.

Quantitative measures inform the qualitative assessment of sustainability by a human analyst. Computerized spreadsheets can provide inputs used in the qualitative assessment, but only a person can combine the qualitative and quantitative inputs into a subjective assessment. Forecasting future performance requires work and intelligence because it is holistic, synthetic, and idiosyncratic. Forecasts must be grounded in present and past performance, and they must be informed by the analyst's knowledge of the particular microfinance organization and of microfinance in general.

Of course, judgement is also needed for cost-effectiveness analysis. The judgement of whether the surplus needed to make a microfinance organization worthwhile is so small that actual, unmeasured surplus is likely to be more can only be subjective.

3.3 Privatness is a signal of sustainability

Profits are magnets for private investors. Private ownership helps worthwhileness because private owners press managers to produce profits. Profits are necessary for sustainability, and sustainability is sufficient for worthwhileness.

Donors, even if they own shares, are not the same as private owners. Donors do not want dividends, nor do they plan to sell their shares for a gain. In contrast, private owners care a lot about dividends and retained earnings. Unlike private owners, the people in donor organizations are not gambling with their own money, and the goals of

society may sometimes take a backseat to their personal goals. It is often safer to assume that a private investor will be selfish than it is to assume that a donor will be selfless.

Trades with private entities involve resources belonging to the two parties to the transaction. Private exchanges are repeatable and thus sustainable because the parties choosing to trade have made a personal (if often implicit) benefit-cost analysis and found that benefits exceeded costs. If an exchange is in the best interests of a private entity now, the safest assumption is similar exchanges will be in their best interests in the future.

In contrast, trades involving non-private entities such as donors are not repeatable and thus are not sustainable because they are not selfish actions. The resources traded do not belong to the parties choosing to trade. Donors dole out funds wrenched from unwilling taxpayers, not their own funds.

Privateness is also a useful signal of healthy incentives. Useful indicators are the presence of private owners and a mission statement explicitly promoting profits and sustainability. The best signal of robust incentives is diverse, private funding sources, especially from voluntary deposits (Inter-American Development Bank, 1994; Chaves and González-Vega, 1994).

4. Good ways to subsidize microfinance

Although it is often not recognized, subsidized resources are not the same as subsidies. *Subsidized resources* are what donors entrust to microfinance organizations at prices below their opportunity cost. *Subsidy* is the opportunity cost of subsidized resources, minus what a microfinance organization pays. All resources from donors are subsidized. Subsidies cannot be negative; a microfinance organization would not hassle with a donor if it could trade on the market at a better price.

For example, suppose a donor lends a microfinance organization L for a year at an interest rate of c . Let $m < c$ be the opportunity cost of a loan of like risk. The microfinance organization gains subsidized resources from the loan equal to the opportunity cost less what is paid, $L \cdot (m - c)$. This is like an injection of equity because, without the loan, expenses would be that much higher and so equity that much lower.

The subsidy from the use of the subsidized resources is not $L \cdot (m - c)$ but rather $m \cdot L \cdot (m - c)$. The debt L is eventually repaid and so is neither subsidy nor subsidized resource. Debt and debt repayments are transfers, not social costs (Gittinger, 1992).

Subsidized resources are linked to subsidies in that subsidies from the use of subsidized resources become subsidized resources. For example, suppose a microfinance organization received $m \cdot L \cdot (m - c)$ as a subsidy in a period. An unsubsidized microfinance organization would have to pay this $m \cdot L \cdot (m - c)$ in the period, and, to keep from shrinking, it would have to increase its average debt in the period by $m \cdot L \cdot (m - c) / 2$. This

extra debt would cost the unsubsidized microfinance organization $m^2 \cdot L \cdot (m-c)/2$. This is also a subsidy since it is a cost paid by an unsubsidized microfinance organization but not paid by a subsidized microfinance organization.

4.1. A typology of subsidized resources

A microfinance organization can receive subsidized resources in six ways. Three are explicit, and three are implicit (Figure 2). Explicit subsidized resources come from donor transfers. Implicit subsidized resources come from a microfinance organization not paying opportunity costs.

The first four forms of subsidized resources are non-repeatable, and the last two forms are repeatable (Figure 2). When donors leave, microfinance organizations repay only debt. Non-repeatable transfers end when a donor leaves, but repeatable transfers do not.

The first way a microfinance organization can receive subsidized resources is explicitly as a cash grant accounted for as equity. The subsidy is not the grant itself but rather the opportunity cost of the subsidized resources from the grant.

Second, a microfinance organization can receive subsidized resources explicitly as a cash grant accounted for as revenue. Grants are not revenue from operations, so all grants should be counted as injections of equity. Still, some microfinance organizations misleadingly inflate profits by counting grants as revenue. Equity changes the same in

either case. The subsidy is not the grant itself but rather the opportunity cost of the extra equity.

Third, a microfinance organization can receive subsidized resources explicitly as discounts on operating expenses from grants in-kind. Examples include technical assistance, travel, training, cars, or computers. Discounts increase equity just like grants. The subsidy is the opportunity cost of the extra equity.

Fourth, a microfinance organization can receive subsidized resources implicitly as discounts on debt. The discount is the market price of debt of like risk less the price the microfinance organization actually paid. The subsidy is not the discount but rather the unpaid opportunity cost of the use of the subsidized resources from the discount.

Fifth, a microfinance organization can receive subsidized resources implicitly as capitalized subsidies. Subsidies are like discounts on subsidized resources. Like equity injections, these subsidies become subsidized resources with an opportunity cost.

Sixth, a microfinance organization can receive subsidized resources implicitly as positive profits. Positive profits belong to owners. If positive profits are not withdrawn but left as positive retained earnings, then they have an opportunity cost just like any other form of equity. Negative profits do not have an opportunity cost. Negative profits are not claims by the microfinance organization on owners, and, from a cash-flow perspective, they do not decrease the investment owners have sunk in the microfinance organization.

4.2 Why the forms of a subsidized resource matters

All six forms of subsidized resources have the same opportunity cost. Still, in addition to the explicit/implicit and repeatable/non-repeatable distinctions, the form of subsidized resources matters in at least seven ways.

First, discounts on operating expenses can change the production technology, shifting the average-cost curve down. Technical assistance is the most important example. A donor might pay for loan officers to be trained in a certain lending method or for managers to attend talks inculcating ideas that the donor wants to promote. Good technical assistance not only shifts the average-cost curve down, but it also makes it slope down more steeply as the microfinance organization grows.

Second, grants of cash increase the funds that a microfinance organization can use as it likes. Growth slides the microfinance organization along its average-cost curve. If all is well, costs fall.

Third, buying shares for cash gives donors some control over a microfinance organization through seats on its board. Other forms of subsidized resources do not give this control. For example, the influence provided by a grant fades fast unless the donor tempts the microfinance organization by dangling more grants. Having formal owners may also help the microfinance organization to qualify for prudential regulation and supervision.

Fourth, the resources from grants in-cash can be used to lend more. If there are non-fungibilities, then grants in-kind may not lead to as much additional lending.

Grants in-cash may also dampen incentives to find market funds.

Fifth, discounts on operating expenses may pay for intangible assets. An example is technical assistance for training loan officers or for organizing management-information systems. These intangible assets are not in the accounts, but they do bear fruit over time.

Sixth, explicit transfers are more difficult politically than implicit transfers.

Seventh, microfinance organizations might spend cash that comes without strings attached more wisely than they would use resources from in-kind grants with the same worth.

4.3 Why technical assistance is preferred

If the incentives of the managers of microfinance organizations are the same as the incentives of donors, then donors should just grant microfinance organizations cash without strings attached. After all, the microfinance organization should know their own needs better than donors would. But the incentives of the managers rarely coincide with those of donors and/or society. Both want to help the poor, but managers also care about keeping their good jobs. Managers can secure their jobs at a much lower—and much easier—level of performance than what donors want to ensure worthwhileness. The opportunity cost of subsidized resources from the point of view of

managers is the rate of inflation. This is lower than the opportunity cost from the point of view of society.

In general, then, donors should try to give subsidized resources as in-kind grants of technical assistance. If donors must give cash, they should try to do so through the purchase of shares and thus through the formal transfer of ownership. This gives donors more control than do other forms of subsidized resources except technical assistance.

Technical assistance lets donors fine-tune the production technology while bestowing long-lasting, intangible assets. Technical assistance has the unique quality of letting donors target specific cogs in the present and future productive capacity of the microfinance organization. For example, paying for training to help flexibility does not have the same effect as giving the same amount of cash without strings attached.

Technical assistance can also promote sustainability in ways that cash cannot. Technical assistance can empower a microfinance organization with tools, abilities, and incentives. It aims to solve the problems that keep microfinance organizations from solving their own problems on their own.

Of course, straight cash financial assistance still has an important role to play. In particular, financial assistance can motivate joining a program that otherwise stresses technical assistance. While money rations may be the spoonful or sugar that helps the medicine of technical assistance go down, donors and microfinance organizations must guard against addiction.

5. Concluding thoughts

Feedback makes markets work. It selects strong firms and strikes down weak ones. But the feedback loop between donors and microfinance organizations is often blocked. For a time, donors can protect weak microfinance organizations from being crushed by market forces. But, like parents, they cannot protect their young for too long without causing them harm. Donors must mimic market forces if they expect their microfinance organizations to survive the inevitable move from captivity to the wild where it must fend for itself. Funds from donors should build organizations able to survive in the market without funds from donors (Rhyne and Otero, 1993).

Cooperation among donors could improve competition among microfinance organizations and thus speed evolution. In contrast, competition among donors may wreck incentives for sustainability by weakening threats to cut assistance. Competition also makes donors unwilling to push fledgling microfinance organizations that are nearing sustainability out of the nest for fear that another donor will grab it and take credit for its near-success.

In fact, just as those who already have credit are those most likely to get more credit, the microfinance organizations that need donors the least are exactly those whose umbilical cords are the toughest to cut. Cutting a good microfinance organization loose in the market takes discipline by donors (Krahn and Schmidt, 1994). Donor, examine thyself.

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Figure 1: Relationships between Profits, Sustainability, and Worthwhileness

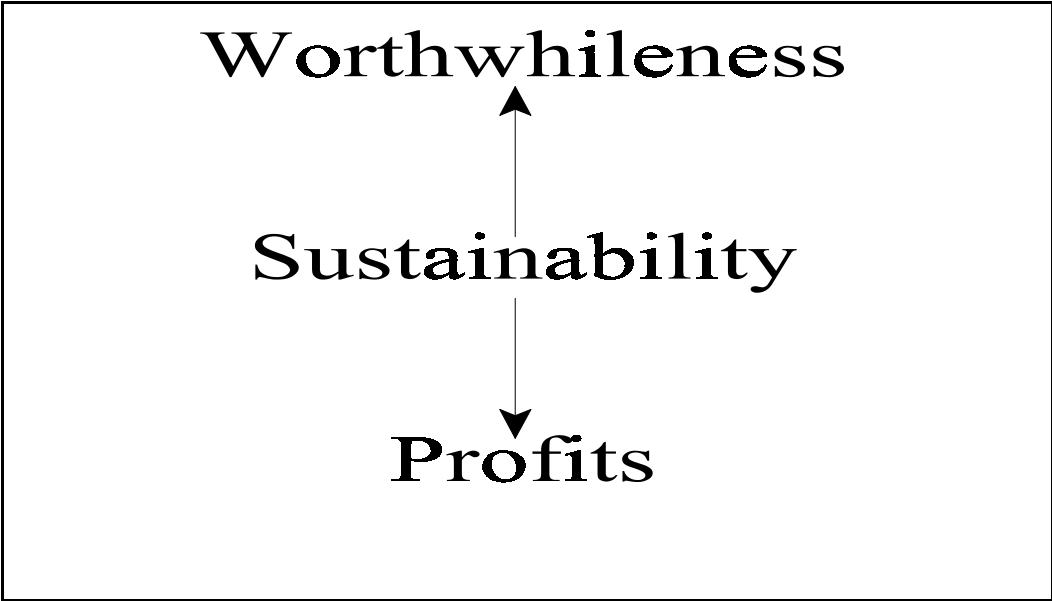


Figure 2: Ways a microfinance organization can receive subsidized resources

Form	Explicit or implicit	Repeatable or non-repeatable
1. Grants accounted for as equity	Explicit	Non-repeatable
2. Grants accounted for as revenue		
3. Discounts on operating expenses	Implicit	Repeatable
4. Discounts on debt from donors		
5. Capitalized subsidies		Non-repeatable
6. Positive profits		