BRIDGING THE GAP TO THE MICROFINANCE PROMISE: A PROPOSAL FOR A TAX-EXEMPT MICROFINANCE HYBRID ENTITY[1]

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I. INTRODUCTION

Prior to the emergence of Microfinance Institutions (MFIs),[2] poor borrowers seeking credit without collateral were limited to local moneylenders, who typically charged high interest rates in excess of 100 percent. MFIs now compete with moneylenders, but unfortunately many MFIs also charge very high interest rates.[3] It remains unclear how best to aid MFIs in

1. The phrase "Microfinance Promise" refers to economist Jonathan Morduch's seminal work on the impacts of microfinance. Jonathan Morduch, *The Microfinance Promise*, 37 J. ECON. LITERATURE 1569 (1999).

2. Microcredit, the practice of extending small loans to the poor without collateral, was the brainchild of Nobel laureate Muhammad Yunus. In 1976, while a Professor of Economics at Chittagong University, Yunus began extending group loans to poor Bangladeshi women. He later started the Grameen Bank, the first microfinance institution. MUHAMMAD YUNUS WITH ALAN JOLIS, BANKER TO THE POOR: MICRO-LENDING AND THE BATTLE AGAINST WORLD POVERTY 33, 57, 61 (PublicAffairs 1999). Today, there are over 2000 MFIs in existence, while the practice of microcredit has developed into "microfinance" – a broader term which refers to the practice of microcredit as well as other financial products, such as savings programs and insurance for the poor. BEATRIZ ARMENDÁRIZ AND JONATHAN MORDUCH, THE ECONOMICS OF MICROFINANCE 3, 14 (MIT Press 2007).

3. ARMENDÁRIZ & MORDUCH, *supra* note 2, at 17. In 2008, the average interest rate for a group of 1,084 MFIs reporting to the Microfinance Information Exchange was approximately 30 percent. The interest rate average is

lowering their rates. MFIs charge higher interest rates than commercial banks because they face higher operating costs. MFI operating costs are comparatively higher than commercial banks because the provision of numerous small loans exposes lenders to greater risk due to lack of information about borrowers, lack of collateral to secure loans, and defaults.[4] Further, MFI operating costs are also pushed upwards due to high administrative costs and the high costs of obtaining capital.[5] Most MFIs are limited in their ability to attract sufficient capital because they are formed as nonprofit entities, which generally are statutorily barred from access to equity capital due to the non-distribution constraint.[6]

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approximated from the nominal "Yield on Gross Portfolio" figure in the benchmark spreadsheet. Yield on Gross Portfolio is defined as the interest and fees on the entire loan portfolio. MICROFINANCE INFORMATION EXCHANGE, 2008 MICROFINANCE BENCHMARKS (2009), http://www.themix.org/publications/2008-mfi-benchmarks. See http://www.mixmarket.org/en/glossary for the definition of Yield on Gross Portfolio. In some cases, interest rates can be as high as 86 percent. *See, e.g.*, Richard Rosenberg, Consultative Group to Assist the Poor, *CGAP Reflections on the Compartamos Initial Public Offering: A Case Study on Microfinance Interest Rates and Profits*, FOCUS NOTE, June 2007, at 3.

4. Defaults are a minor contributor compared to other contributors to operating costs because defaults are infrequent in microfinance. San Francisco based non-profit, KIVA, for instance, estimates that industry wide 97% of micro-borrowers repay their loans. Jilian Mincer, *Microlending for Microbankers*, WALL ST. J., Mar. 20, 2008, at D2, *available at* http://online.wsj.com/article/SB120597508026550479.html.

5. Alex Counts, president and chief executive of the Grameen Foundation, claims that the difficulty of obtaining capital is a key constraint on the growth of microfinance in developing countries. *Recession Ups U.S. Demand for Microloans*, MSNBC, Feb. 18, 2009, *available at* http://www.msnbc.msn.com/id/29258701/. *See also Consultative Group to Assist the Poor,* Making Sense of Microcredit Interest Rates, DONOR BRIEF, Sept. 2002. Other major contributors are the high transaction costs associated with making loans to clients in rural areas, the risk that comes with lending to poor borrowers with no collateral or credit histories and high administrative costs. In order to monitor repayments, microbanks necessarily face the expensive practice of sending agents into rural locations, collecting repayments village by village. *Id.*

6. The non-distribution constraint does not bar nonprofit firms from making profits but simply bars the firms from distributing those earnings to people who manage or exercise any control over the firm. Profits can, however, be used to compensate employees or other persons who provide labor and services to the firm; it is only residual earnings that are barred from distribution. *See* HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 228

Demand for microfinance currently outstrips supply by $300 billion[7] and in order to reach those without access, MFIs need to expand. Current high operating costs, however, suggest that expansion will either be unlikely or very slow. To avoid this dilemma, operating costs can be lowered through cheaper access to capital that in turn would lead to lower interest rates, all else equal. One method of increasing access to capital would be to remove the capital constraints imposed by nonprofit status by converting to a for-profit form. This transition from nonprofit to for-profit should be facilitated and encouraged if MFI expansion is to come about.

As a supplemental solution to the high interest rates charged by MFIs, this Note proposes the creation of a hybrid legal entity called a microfinance limited partnership (MLP) that can bridge the gap between the capabilities of nonprofit MFIs and for-profit MFIs. MLP status is intended to apply in lesser-developed countries (LDCs) where the majority of MFIs are located.[8] However, the following discussion develops the concept of an MLP by drawing from U.S. and U.K. law, where hybrid entities have been created for social enterprise.[9] This paper seeks to explore the coupling of legal entity forms and tax-exemption in the context of microfinance. There is a dearth of academic literature on the effects of nonprofit status on MFIs. Experts have noted the problem of high interest rates, but this Note is novel in proposing solutions based on entity status and taxation.

(Harvard University Press 2000) ("All residual earnings must . . . be retained and devoted to financing the services that the organization was formed to provide.") [hereinafter HANSMANN, OWNERSHIP].

7. SAM DALEY-HARRIS, MICROCREDIT SUMMIT CAMPAIGN, STATE OF THE MICROCREDIT SUMMIT CAMPAIGN REPORT 2009 10 (2009), *available at* http://www.microcreditsummit.org/uploads/socrs/SOCR2009_English.pdf.

8. The MLP form would also work well in the United States, the U.K., and other Western nations.

9. MFIs are prevalent in numerous LDCs. Countries in Africa, Asia, Eastern Europe, Latin America, the Caribbean, and the Middle East host hundreds of MFIs. *See* MICROFINANCE INFORMATION EXCHANGE, THE MICROBANKING BULLETIN NO. 17 66-84 app. II (2008), *available at* http://www.themix.org/sites/default/files/MBB%2017%20Autumn%202008.pdf (listing hundreds of MFIs that participated in the report, located all over the world). The task of detailing the structure of a hybrid entity in so many foreign jurisdictions would unnecessarily complicate the discussion. Further, the existence of hybrid entities in both the U.S. and the U.K. already provide a useful example to build upon.

The proposed MLP will aid MFIs in expanding services by attracting new sources of equity capital, thereby decreasing operating costs and interest rates. Part I of this paper lays out the interest rate problem and the reasons why MFI operating costs require that lenders charge high interest rates. Part II describes and critiques previously proposed solutions to the interest rate problem. Part III makes the case that a for-profit firm, like the proposed hybrid entity, should be granted tax exemption applied to similar firms operating as nonprofits. Part IV compares the MLP to other hybrid entities created to accommodate the needs of social enterprise that are similar in structure to the MLP. Part V explains in greater detail a plan for a hybrid legal entity and the reasons why it will work. Part VI concludes.

II. The Interest Rate Problem With MFIs

The primary source of income to microcredit institutions is interest payments.[10] Thus, if MFIs have any interest in becoming sustainable entities that can reach more poor borrowers on a larger scale, it is necessary that MFI interest rates be set at a level that covers all costs. It is true that subsidies from charitable donations allow MFIs to charge lower interest rates, but MFIs subsidized with charitable donations are limited in their long-run capacity for growth.[11] MFIs must move toward sustainability and for-profit status because current demand for MFI loans far outstrips supply by approximately $300 billion.[12] To meet this demand, MFIs need access to capital markets, but

10. *Cf.* Consultative Group to Assist the Poor, *Why Do MFIs Charge High Interest Rates*, *available at* http://www.cgap.org/p/site/c/template.rc/1.26.1309/ (last visited May 21, 2010) (Stating that MFIs charge high interest rates to cover their costs.) Most lending institutions obtain revenues from interest payments and micro-lenders are subject to this general principle.

11. *Consultative Group to Assist the Poor, Interest Rate Ceilings and Microfinance: The Story So Far*, Occasional Paper, Sept. 2004, at 2, *available at* http://www.cgap.org/gm/document-1.9.2703/OP9.pdf [hereinafter CGAP Paper].

12. Sam Daley-Harris, *supra* note 7. Some of this demand comes from the United States. In 2008, for example, microlender ACCION had $1.45 million outstanding in loans to US-based borrowers. This volume is rising due to the recession and its tightening effect upon the credit markets. John Tozzi, *US Entrepeneurs Turn to* Microfinance, Business Week, Oct. 8, 2008, *available at* http://www.businessweek.com/smallbiz/running_small_business/archives/2008/10/microfinance.html.

investors will not put funds into unsustainable nonprofit MFIs that are legally barred from distributing profits to investors.

Opportunities exist to fill the $300 billion dollar gap in MFI access to capital. The recent emergence of MFI investment funds is an example of growing investor interest in placing capital in MFIs. Currently over one hundred MFI funds exist. Various institutions, from commercial banks to pension funds and insurance companies, have begun investing capital in MFI investment funds.[13] In fact, there is a growing class of socially conscious investors, dubbed "philanthropreneurs," who are already financially invested in microfinance and in search of new opportunities to invest.[14] In addition to investment funds, MFIs have utilized other methods of obtaining access to capital markets, including securitizing their loans[15] and issuing stock in an initial public offering (IPO).[16] Charitable contributions from individual donors, nonprofits and international financial institutions will of course continue to help supplement the demand for capital, but those resources should optimally be directed to new MFIs that are most in need of assistance.

Under current circumstances, the only way for MFIs to continue to operate and obtain capital in the nonprofit form is to charge exorbitant interest rates, rely on charity, or leverage their assets by assuming debt. Each of the aforementioned methods of obtaining capital is limited and cannot be sustained in the long term. High interest rates will exploit the poor that MFIs are intended to assist out of poverty. Charitable giving is inconsistent and subject to decline in bad markets or recessions. And banks are generally reluctant to issue large amounts of debt to nonprofit entities. Thus, when charity and

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13. Xavier Reille & Sarah Forster, Consultative Group to Assist the Poor, *Foreign Capital Investment in Microfinance*, FOCUS NOTE, Feb. 2008, at 4.

14. Stephanie Strom, *What's Wrong With For Profit*, N.Y. TIMES, Nov. 13, 2006, *available at* http://www.nytimes.com/2006/11/13/us/13strom.html.

15. *See, e.g.*, A. Counts, *Grameen Foundation USA Announces Historic $4.3 Million Securitization Deal in India,* MICROFINANCE GATEWAY, May 18, 2004, http://www.microfinancegateway.org/p/site/m/template.rc/1.26.8473/ (discussing the completion of a microfinance securitization deal between a major Indian commercial bank and an Indian MFI).

16. *See, e.g.*, Elisabeth Malkin, *Microfinance's Success Sets Off a Debate in Mexico,* N.Y. TIMES, Apr. 5 2008, at C1 (describing the controversy surrounding the decision of Compartamos, a Mexican MFI, to go public). *See generally* Rosenberg, *supra* note 3 (analyzing Compartamos' decision to go public).

debt falter, MFIs rely on interest from their loans to cover costs.

MFIs currently need to charge higher interest rates to become sustainable due to their high operating costs.[17] However, this fact does not allay concerns that charging a poor borrower a high interest rate seems contrary to the social goal of increasing the wealth of the world's poor. This contradiction has not gone unnoticed, and a number of solutions have been proposed to address the problem.

III. Previously Proposed Solutions to the MFI Interest Rate Problem

A. *Usury Laws*

In response to the MFI interest rate problem, proposals have been put forward to decrease rates. Usury laws and other methods of setting interest rate ceilings have been popular in MFI host countries. Unfortunately, interest rate ceilings set by host country governments strike at the symptom, and not the cause of the problem, because they do not address the operating costs that are the source of high interest rates. Further, the usury rates that have been set are too low to permit MFIs to cover their costs. It may be that politicians in host countries have not realized that unreasonably low ceilings have resulted in market contraction, or that MFIs scale back their operations in response to unreasonably low rates and thus reach fewer borrowers than they could if they were allowed to charge a rate that covered their costs.[18] Ceilings have also resulted in other damaging outgrowths, like a decrease in transparency, as MFIs have attempted to conceal higher interest rates in hidden fees and complicated interest rate structures.[19] Overall, the regulatory response of usury laws eliminates inordinately high and possibly exploitive interest rates, but does not address the

17. *See* Morduch, *supra* note 1, at 1588 (Stating that MFI operating costs are high and discussing the role of subsidies in attaining operational and financial sustainability.); *see also* Armendáriz & Morduch, *supra* note 2, at 28 ("High interest rates continue to worry observers today."); Marguerite Robinson, The World Bank, The Microfinance Revolution: Sustainable Finance for the Poor 29-33 (2001).

18. CGAP Paper, *supra* note 12, at 5.

19. *Id.* at 5, 6-8.

larger problem of providing greater access to credit to the poor.

B. *Consumer Protection Laws*

Other proposals to deal with MFI interest rates include consumer protection laws and fostering competition among MFIs.[20] Proponents claim that consumer protection laws will protect borrowers from abuses without the downside of interest rate ceilings by prohibiting predatory lending, discouraging objectionable collection practices, and requiring full disclosure. Types of consumer protection measures include heightened disclosure requirements of loan terms, lender practice prohibitions that limit loan size and interest rates relative to borrower income, and mechanisms for handling complaints and dispute resolution.[21] These measures all have potential, but each is also flawed. Laws requiring that MFIs disclose loan terms and complaint and dispute resolution mechanisms presume that poor borrowers have enough financial sophistication to understand the net effects of loan terms as well as high levels of literacy or access to legal services to make use of dispute resolution mechanisms. Further, lender practice prohibitions that limit loan size and interest rates relative to borrower income would require a monitoring body, such as a centralized credit agency, that is both large and sophisticated enough to track and enforce the prohibition. Thus, consumer protection laws without an adjunct financial literacy program and an efficiently run credit bureau would not yield the desired result.[22]

If applied in an LDC with institutions of appropriate quality and strong rule of law, consumer protection laws would likely have the positive effect of allowing borrowers to avoid predatory rates. But, like usury laws, consumer protection laws would address the symptom and not the cause of the problem. Though heightened disclosure requirements on loan terms, restrictions on who can borrow, and dispute resolution mechanisms may protect borrowers from predatory rates, they would not systematically reduce interest rates. At the same time,

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20. *Id.* at 10-13.

21. DAVID PORTEOUS & BRIGIT HELMS, CGAP, FOCUS NOTE NO. 27, PROTECTING MICROFINANCE BORROWERS 1, 2 fig.1 (2005).

22. *Id.* at 4-6.

MFIs operating costs would likely increase due to the administrative costs necessary for compliance with consumer protection regulations. Creating a dispute resolution mechanism and monitoring disclosure practices to comply with regulations would increase MFI operating costs and thereby increase MFI interest rates to cover those costs.

C. *Competition*

The final proposal for lowering interest rates is increasing competition between MFIs. In theory, if MFIs are forced to compete for borrowers, then interest rates will naturally decline due to market forces. Studies have shown that competitive microcredit markets have resulted in increased operational efficiency and declining interest rates.[23] There is no evidence, however, that competition leads to interest rates lower than a rate that covers operating costs. Thus, declining interest rates fostered by competition will eventually hit a floor determined by operating costs. MFIs will not lower rates beneath this floor regardless of whether they seem usurious because they will no longer be able to operate. Another problem with this proposal is that it relies on the assumption that enough MFIs exist in every location to foster competition and eventually decrease interest rates. Furthermore, unbridled competition will require an increase in host government supervision to monitor whether new MFIs are in compliance with minimum requirements.[24]

Borrowers may also suffer in a locale with a high concentration of MFIs. Ragan and Petersen argue that lenders are less willing to make concessions if they will be unable to benefit from a continued relationship with a borrower.[25] Their paper concludes that lenders who expect to share in a borrower's future revenues are more willing to charge lower interest payments in the beginning of the relationship.[26] Because the

23. *See* CGAP PAPER, *supra* note 12, at 11 (describing declining interest rates and improved operational efficiency based on research data collected by the Microfinance Information Exchange).

24. Increased supervision, however, may be as much of an obstacle in a country with strong institutions. Such a country would also be the ideal candidate for the proposed hybrid entity solution.

25. Mitchell A. Petersen & Raghuram G. Rajan, *The Effect of Credit Market Competition on Lending Relationships*, 110 Q. J. ECON. 407, 408 (1995).

26. *Id.* at 440.

presence of other MFIs lowers the probability that borrowers will remain loyal to any particular MFI, it follows that micro-lenders in competitive markets would not expect to benefit from any future growth in borrowers' micro-firms, thereby devaluing the lender-borrower relationship.

D. *An Alternative Solution*

Each of these alternatives to interest rate ceilings may result in some benefits, but none of the proposals offers a method of regulating interest rates that strikes at the problem's primary cause. Of the aforementioned proposals, fostering competition seems to be the most promising because it proposes to systematically decrease interest rates without burdening government institutions. But competition alone cannot solve the interest rate problem.

Rather than pass usury laws and set arbitrary ceilings that prevent MFIs from charging rates that will cover their costs, governments should focus on the reason why MFIs must charge high rates in the first place: to cover their operating costs. To strike at the core of the problem, governments should pass legislation that allows MFIs to transition from non-profit status into special entities (similar to recently created hybrid entities for social enterprise) with a unique status that will lower the cost of obtaining capital and thereby lower operating costs. To lower the cost of obtaining capital, the hybrid should provide the favorable tax treatment received by non-profits while avoiding the downfalls presented by the non-distribution constraint. Other benefits should include low or no taxes on profits and a lower minimum capital requirement (to the extent that an MFI takes deposits).

The theory is that if investors are permitted to invest in MFIs and receive their profits tax-free, this arrangement will encourage the kind of capital investment that MFIs are prevented from accessing due to their nonprofit status. Access to new capital will not only decrease the cost of obtaining funds, and therefore interest rates, but also result in increased efficiency.[27] A new legal entity may sound like a radical solution

27. *See* Anup Malani & Eric A. Posner, *The Case For For-Profit Charities*, 93 VA. L. REV. 2017, 2054-55 (arguing that the non-distribution constraint results in uncompetitive salaries that discourage efficient non-altruists from investing in charitable markets).

to the MFI interest rate problem, but a hybrid corporate form that acknowledges the emergence of socially responsible entrepreneurship and the limitations placed upon this kind of entrepreneurship by nonprofit status is not a groundbreaking idea; in fact, it already exists in both the U.S. and the U.K. The proposal of creating a hybrid entity aimed at reducing MFIs' cost of obtaining capital is a workable and more focused alternative than current solutions to high interest rates because, like competition, it systematically decreases interest rates. But unlike other proposed solutions, the hybrid strikes at the source of the problem by decreasing the operating costs that influence interest rates. The hybrid could, therefore, be a useful adjunct to market competition or a stand-alone solution.

IV. Granting Tax Exemption of a Charity to a For-Profit MFI

MFIs must leave the limited nonprofit form and attract investment from capital markets in order to broaden their reach and lend to the millions of poor borrowers who continue to remain without financial services.[28] MFI reliance on charitable donations and debt in a nonprofit form raises the cost of obtaining capital.[29] MFIs must move from nonprofit status to a for-profit model that attracts the kind of investors who are willing to lend capital because they can expect to profit from their investment. In addition to the benefit of attracting investor capital, another benefit to MFIs that will likely result from a for-profit organizational structure is increased ef-

28. Demand for MFI services is an estimated $300 billion. Microcredit Summit Campaign, *State of the Microcredit Summit Campaign Report 2009* 10 *available at* http://www.microcreditsummit.org/uploads/socrs/SOCR2009_English.pdf (last visited May 21, 2010).

29. Capital access theory, termed by Posner and Malani, recognizes that nonprofits have a limited ability to tap into capital markets because they cannot distribute profits to investors and that tax deductions mitigate this handicap by assisting nonprofits in obtaining capital from other sources, like donations. Malani & Posner, s*upra* note 27, at 2039. Note that agency theory suggests that capital access theory is only correct if the person receiving profits also controls the firm. *Cf.* HANSMANN, OWNERSHIP, *supra* note 6, at 240 (discussing the general slow pace at which nonprofit firms adjust their capital accumulation and output with respect to changing market conditions).

ficiency[30] and thus lower administrative costs. Further, for-profit MFIs should be entitled to the tax breaks of nonprofits, because they continue to perform the function that tax exemption is designed to encourage. Tax breaks to nonprofits are justified on the rationale that nonprofits provide public goods that governments would otherwise have to supply. Thus, because nonprofits are saving governments from spending funds on a particular good that creates social benefits, they are entitled to government subsidization. However, tax exemption, as it is currently provided to nonprofits, is not limited to nonprofits that provide public goods by the strict economic definition, but extends to all organizations that produce a desirable social benefit.[31] Because MFIs provide a desirable social benefit, it follows that both for-profit and nonprofit MFIs should be entitled to government subsidies in the form of tax exemption for the goods they produce.

Another favored rationale for nonprofit tax exemption, redistribution, also cuts in favor of granting the same treatment to for-profit MFIs. Scholars have argued that nonprofits that redistribute wealth from the rich to the poor may justifiably receive tax exemption.[32] Thus, regardless of whether the social good theory is acceptable, for-profit MFIs are entitled to

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30. *See* Malani & Posner, *supra* note 27, at 2055 ("[N]onprofit firms are less efficient than for-profit firms.").

31. A public good has two necessary features: first, it costs no more to provide to many persons as it does to provide to one, since one person's enjoyment does not interfere with the ability of others to enjoy it. Second, once the good is provided to one person there is no way to exclude others from consuming it as well. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 848 (1980) [hereinafter Hansmann, *Role*]. However, section 501(c) of the Internal Revenue Code grants tax exemption to recreational clubs, employee associations, religious organizations and organizations that foster competition in amateur sports without regard for the fact that none of the aforementioned satisfies the strictest definition of a public good, but rather perform functions that are considered socially desirable. I.R.C. §§ 501(c)(3), (7), (9) (2009).

32. *See, e.g.*, Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations From Corporate Income Taxation*, 91 YALE L. J. 54, 91 (1981) (arguing that tax exemption to a nonprofit with redistributive economic effects is justifiable, albeit only if the nonprofit risks contract failure) [hereinafter Hansmann, *Exempting Nonprofits*]. *Cf.* John K. McNulty, *Public Policy and Private Charity: A Tax Policy Perspective*, Vol. 3 VA. TAX REV. 229, 247-48 (1984) (arguing that a tax exemption for philanthropic uses of funds could help shift the tax burden as well as help achieve redistributive goals).

tax exemption by virtue of the redistributive role microfinance plays. Whether rich investors provide equity capital to MFIs or give money in the form of charitable donations, MFIs serve as a conduit for the redistribution of capital from rich to poor. From a normative perspective, the fact that the rich may derive a financial benefit from putting value into a for-profit as opposed to a nonprofit MFI should not matter, because the same positive result is achieved with respect to the poor. Redistribution is desirable, and thus MFIs should be subsidized for furthering distributive justice.[33]

A. *A Mismatch: Coupling Tax Exemption and Nonprofit Status*

In general, to qualify as a nonprofit firm an organization must bar its managers from receiving any of the firm's earnings, a limitation called the "non-distribution constraint."[34] This does not mean that nonprofits are barred from earning profits; they are simply restricted from using those profits to compensate people who control the firm.[35] In addition to the non-distribution constraint, nonprofits are also exempt from taxation.[36] Posner and Malani refer to this phenomenon of tying tax exemption to nonprofit status as "coupling."[37] In a recent article, these scholars argue against coupling and make a case for allowing tax breaks to for-profit firms that, like charities, perform services aimed at improving social welfare. They contend that rationales put forward in support of granting tax exemption to nonprofits do not make a compelling case for why the exemption should be confined only to nonprofits and

33. In certain circumstances, charitable subsidies that result in the redistribution of wealth can aid economic efficiency, and thus can be justified on that basis. Henry Hansmann, for instance, endorses redistribution as the basis for offering tax exemptions to nonprofits only if the organization exists to rectify some contract failure. *See* Hansmann, *Exempting Nonprofits, supra* note 32, at 91.

34. HANSMANN, OWNERSHIP, *supra* note 6, at 17, 18. Note that nonprofit managers are permitted fixed salaries that are independent of the nonprofit firm's profits.

35. *Id.* at 17.

36. Under U.S. law this takes the form of exemption from the federal corporate income tax. I.R.C. § 501(b), (c)(27)(A)(iii). Individual states allow for various other exemptions, such as property taxes.

37. Malani & Posner, *supra* note 27, at 2021.

not extended to for-profit firms that perform the same functions.[38]

1. *The Problem with Nonprofits*

When compared to for-profit firms, nonprofits are severely limited in two ways: (1) nonprofits have limited opportunities to raise capital;[39] and (2) nonprofits are poor vehicles for bearing risk and market volatility.[40]

Due to the non-distribution constraint, nonprofits do not have access to equity capital. Nonprofits have access to debt, donations, and their retained earnings as sources of capital, but without access to market capital these sources are inadequate.[41] All nonprofit earnings must be retained in the firm and used either to provide more social goods or remain locked in the firm until the funds can be invested in a capital asset meant to benefit the firm.[42] Thus, private investors have no incentive to place money in a nonprofit because they are barred from being issued dividends or partaking in profits produced by the nonprofit's activities.

The nonprofit form is also ill-equipped to bear the risk and volatility of the business enterprise. Access to various

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38. *See id.* Henry Hansmann has also criticized the arguments in favor of confining tax exemption to nonprofits. Hansmann cites three primary rationales: (1) the non-distribution constraint ensures that the benefit of tax subsidies go to beneficiaries of the charity and not its owners/managers, termed "subsidy incidence"; (2) nonprofits help produce public goods; and (3) nonprofits provide services of better quality than for-profit provides when the market insufficiently ensures a high quality in the for-profit context. Hansmann explains that "subsidy incidence" is an attenuated argument because even a for-profit has incentives to pass on the benefits of a subsidy to its "consumers." Public goods can be and are produced by private for-profit firms as well. Quality of service, though more compelling than other arguments, only makes sense when applied to donative nonprofits and is less applicable to commercial nonprofits that provide goods directly to individuals (as MFIs provide financial services directly to individuals or groups of lenders). Hansmann, *Exempting Nonprofits*, *supra* note 32, at 67-71.

39. *Id.* at 72.

40. HANSMANN, OWNERSHIP, *supra* note 6, at 242.

41. *See* Hansmann, *Role*, *supra* note 31, at 72-73.

42. U.S. nonprofit foundations, as per § 4944, are permitted to use some net earnings to invest in "Program Related Investments" that result in profits but that further the foundations charitable aims. IRS, Program-Related Investments, http://www.irs.gov/charities/foundations/article/0,,id=137793,00.html (last visited Apr. 14, 2010).

forms of capital, the ability to sell shares of equity in the enterprise, the freedom to choose risky investments that may provide larger returns, and the ability to diversify through public trading on the stock market are methods that investors use to spread risk in an enterprise.[43] Nonprofits are constrained from participating in all of the aforementioned methods of hedging risk and thus are poor vehicles for bearing risk and market volatility.

MFIs formed as nonprofits suffer from all the infirmities of the nonprofit form, including limitations in raising equity capital. It follows then that if the MFI sector seeks expansion and an end to high interest rates, it must increase access to capital by moving away from the nonprofit form. The MLP hybrid entity offers nonprofit MFIs a vehicle for moving from the nonprofit form and overcoming the capital-access problems and risk-bearing failures of MFI nonprofits. Because profits of an MLP will not be locked in, private equity capital should flow into the MFI sector, lowering operating costs and interest rates, and moving microfinance closer to its goal of meeting unmet demand.

Hansmann notes that for-profits *may* be able to enter an in-demand industry initially populated by nonprofit firms, "since only the for-profit firms will face no constraint on the amount of capital they can obtain, at market rates of return, for purposes of expansion."[44] However, in the case of the MFI sector, the below-market rates of return common to MFIs decrease the likelihood of for-profit entrance and expansion. Thus, an MFI hybrid entity like an MLP would be well-placed to bridge this gap by giving for-profit entrants a tax incentive to expand the MFI sector.

B. *Rationales for Coupling Also Support Tax Exemption for For-Profit Firms That Produce Social Benefits*

Academic literature has put forward a number of rationales for granting tax exemption to nonprofit firms: the absence of taxable income, subsidy incidence, public goods, quality of service, compensation for capital constraints, altruism, and redistribution. Of the aforementioned, public goods

43. HANSMANN, OWNERSHIP, *supra* note 6, at 242.
44. Hansmann, *Exempting Nonprofits, supra* note 32, at 82.

theory is the most commonly cited in academic literature. Posner and Malani examine three of the rationales that are used to support coupling. The authors describe the theories of public goods, agency theory, and altruism and conclude that none of these theories makes a compelling case for why tax exemption should be limited to nonprofits.[45] The authors do not address the redistributive theory of tax exemption for nonprofits, but other notable scholars, including Hansmann and McNulty, have cited redistribution as an important policy reason for tax exemption to nonprofits in other contexts.[46]

1. *Tax Exemption Theories: Public Goods, Agency Theory and Altruism*

The public goods justification for coupling posits that governments should subsidize nonprofits with tax breaks because they create public goods that governments would otherwise have to produce themselves. Thus, by providing charities with tax breaks, governments are in effect financing the creation of public goods.[47] Posner and Malani point out that this rationale falls short because it does not give a reason why for-profits that provide public goods should not be subsidized with tax breaks as well. A for-profit that provides services aimed at creating public goods fills the same role as a charity with regards to government. It follows then that governments should subsidize for-profits' provision of public goods as well.[48] Further, the public goods theory has limited applicability to tax-exempt entities because many nonprofits do not produce public goods but instead perform activities that are considered socially good or beneficial.[49]

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45. Malani & Posner, *supra* note 32, at 2020-21.

46. Hansmann, *Exempting Nonprofits*, *supra* note 32, at 91 (1981); McNulty, *supra* note 33, at 247.

47. Malani & Posner, *supra* note 27, at 2029.

48. It is disputed whether for-profits are actually more efficiently run than nonprofits. Posner and Malani conclude that they are. Malani & Posner, *supra* note 27, at 2055. *But see* HANSMANN, OWNERSHIP, *supra* note 6, at 245 (concluding that nonprofits are not significantly less efficient than for-profits).

49. The fact that many tax-exempt organizations do not produce public goods as strictly defined suggests that the theory is too narrow to encompass the reality of nonprofits. The theory would have wider applicability if public goods were defined more broadly to encompass all goods, activities, or services that improve social welfare.

The agency theory justification proposes that nonprofits should be given special treatment because donors lack perfect information. Donors face asymmetric information because they cannot be sure that their money is being used to provide products for the public benefit rather than being used inefficiently by people who control the firm.[50] But, the nonprofit form is in fact "a very crude consumer protection device."[51] The non-distribution constraint merely makes it more difficult for nonprofit managers to pocket profits rather than doing what is arguably more important: giving managers an incentive to create more and better public goods.[52] The theory of the nonprofit presumes that managers on a fixed salary are altruistic enough to care about the *quality* of a product when it is not tied in any way to their compensation. This presumption about the motivations and individual character of a class of individuals is likely inaccurate in many cases, because human behavior, especially when money is involved, is generally selfish before it is altruistic.[53] Thus, it seems that the theory behind nonprofit status leaves open the possibility that managers will shirk their duties and create lower-quality goods because they have no financial incentive to work harder to produce better goods.

The rationale of altruism presumes that nonprofits attract only entrepreneurs who are completely altruistic and who will work harder to produce public goods, and therefore the nonprofit form should be rewarded or encouraged. In addition to

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50. *See* HANSMANN, OWNERSHIP, *supra* note 6, at 234 (arguing that consumers of services provided by nonprofits that rely on fee-for-service are unable to evaluate the quality of that service both because the service might be too complex, and because the individual who pays may not actually be receiving the benefit of the service).

51. *Id.* at 235.

52. *See* Malani & Posner, *supra* note 27, at 2033-35 (Discussing the role of the non-distribution constraint as a solution for contract failure and concluding that the non-distribution constraint cannot guarantee that a nonprofit manager will not shirk their duties).

53. Though pessimistic, this philosophical view of the self-interested nature of man is not unfounded and has been espoused by respected thinkers. Adam Smith, for example, wrote that "it is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own self-interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages." ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 44 (Edwin Cannan ed., Univ. of Chicago Press 1977) (1776).

a general philosophical challenge that human nature may not be altruistic, this premise may also be challenged on the basis that talented social entrepreneurs with the most skill and education, who can most efficiently run a firm to provide quality public goods, are discouraged from operating nonprofits because the fixed salary of a nonprofit is not as attractive as the more lucrative incentive-based pay of a for-profit firm.[54] Thus it is possible, even likely, that talented young entrepreneurs who may be interested in founding a social good firm, like an MFI, are deterred from doing so by the constraints the nonprofit form places on compensation.

Posner and Malani conclude that coupling is unnecessary and that there is a strong case for allowing favorable tax treatment in the form of exemption from tax to for-profit charities. If the primary rational for granting tax breaks to a nonprofit is its contribution to the social welfare, and if a for-profit firm can be an equally effective, if not better, form of entity for contributing to social welfare, there is no reason why a for-profit social enterprise like an MFI should not be given the same tax breaks when it produces the same or better social benefits.

2. *Redistribution and Distributive Justice*

Regardless of whether the production of social benefits is sufficient for granting tax exemption to a for-profit, redistribution of wealth from the rich to the poor is arguably a stand-alone reason for granting tax exemption to a for-profit charity. One of the theoretical underpinnings for the progressivity of most tax systems is redistribution, under the assumption that reallocation of wealth is desirable under normative principles that remain unclear in the literature. Tax exemption for charities that reallocate to the poor is similarly desirable for its redistributive effects. The theory is that charities which aid the government in catering to the poor deserve an implicit subsidy for their role in redistributing wealth to the worse-off. There is a dearth of empirical evidence illustrating the extent to which an exemption efficiently furthers redistribution, but it appears intuitively obvious that an organization that redistributes can distribute more if it has more resources.

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54. Malani & Posner, *supra* note 27, at 2055.

By providing financial products to the world's poorest populations MFIs further redistribution in a very direct manner. Microcredit firms receive money from wealthy donors and give that money directly to the poor in developing countries.[55] Whether international redistribution should be facilitated through the tax system is debatable, but this complicated question is beyond the scope of this paper.

The role of normative principles and justice, though relevant to tax policy, is relatively unexplored in tax literature. Those who have addressed it commonly cite Rawlsian principles as a possible baseline for just tax policies.[56] Rawls' maximin principle theorizes justice only as it relates to the welfare of the least well-off in a society. Framed by this welfarist approach, to the extent MFIs redistribute wealth downwards to the least well-off, tax exemption to for-profit MFIs is acceptable as furthering distributive justice.

C. *Deductions for Investors*

Having made a case for granting tax exemption to a for-profit MFI if it improves the social welfare and redistributes wealth, the question remains whether a congruent tax deduction for those who invest or donate funds to a for-profit charity is desirable. Whether a deduction is a desirable method of incentivizing giving money to a for-profit MFI is a complicated question that may not have a clear answer.[57] However, rationales offered in favor of the charitable deduction may also

55. MFIs that give larger loans to the "poor," "lower middle," or "middle" class of Western nations, such as Accion's microcredit operations in the United States, thus would not be ideal candidates for an implicit subsidy on redistributive grounds.

56. *See, e.g.*, David E. Pozen, *Remapping the Charitable Deduction*, 39 CONN. L. REV. 531, 562 (2006) (citing Thomas Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343, 345); Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice* 43-44 (Ill. Law and Econ., Research Paper No. LE09-006) (citing Joseph Bankman & Thomas Griffith, *Social Welfare and Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905, 1949-50 (1987)).

57. Per Professor Stanley Surrey, a tax incentive is a tax deduction, credit, exclusion, exemption, deferral, or preferential rate that is meant to induce a desired activity or behavior due to the monetary benefit available. Stanley Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 706, 711 (1970).

support allowing a deduction for income donated to a for-profit charity as well. One academic in favor of the charitable deduction argued that a charitable deduction is appropriate because money donated to a charity is not taxable income.[58] Others have argued in favor of a deduction on efficiency grounds, and one academic, Boris Bittker, has famously argued in favor of the deduction on normative grounds as a reward for morally praiseworthy behavior.[59]

1. *Income Base Argument*

William Andrews argued that charitable donations should not be taxed because donations are not consumption that increases the donor's well-being. Andrews' theory that the exclusion of charitable donations was necessary for an accurate calculation of an individual's income base relied on Henry Simons' commonly accepted definition of income as the sum of an individual's consumption expenditures and the wealth the individual has accumulated over the taxable period.[60] Andrews claimed that charitable donations were not personal consumption because they went to producing public benefits and not to the donor's personal use. He noted in particular that, income given to charities that distribute "goods and services to persons . . . poorer and in lower marginal tax brackets than the donor" should not be considered income, as it is not privately consumed by the donor but consumed directly by others.[61]

Andrews' income base argument is compelling but seems more attenuated when applied to a for-profit charity. If the donor to a for-profit charity would not receive a return on their investment, then the argument holds, as the donor will have given money to increase the consumption of someone less well-off. However, if, as in the case of the proposed for-profit MFI or other existing double-bottom-line hybrids (L3Cs and CICs)[62], donors receive modest profits in return for their

58. William D. Andrews, *Personal Deduction in an Ideal Income Tax*, 86 HARV. L. REV. 309, 346 (1972).

59. Boris I. Bittker, *Charitable Contribtutions: Tax Deductions or Matching Grants?*, 28 TAX L. REV. 37, 60 (1972).

60. Andrews, *supra* note 58, at 313, 320-21.

61. *Id.* at 346.

62. *Infra* Part IV.

investment, the income base argument is an uncomfortable fit. It is arguable that people who donate to for-profit charities that give very modest or below-market returns are still giving up some portion of their income in the form of forgone revenues as they could have just as easily invested their money in corporate stocks or bonds to receive a more substantial return. But such an approach would likely present intractable problems in administration. Thus, Andrews' income base argument is a poor fit for a for-profit charity.

2. *Efficiency*

A debate has raged among American academics as to whether tax incentives are efficient. Stanley Surrey fathered this debate in 1970 when he argued that tax incentives are inferior to direct subsidies as a method of achieving social goals because they are less efficient. Surrey claimed that tax incentives were inequitable because high-income earners were the real beneficiaries of the deductions, exemptions, and credits. He also argued that it is difficult to administer social goals with tax incentives effectively because the agencies charged with implementing the tax incentives lack expertise in social policy.[63] Other scholars have challenged Surrey's position. Regarding charities and tax incentives, James Andreoni's work concludes that "a dollar spent on subsidies provides a greater stimulus to charity than a dollar of direct grants."[64] Edward Zelinsky also challenges Surrey, claiming that tax incentives are not necessarily inefficient, and that there is a lack of academic clarity on the definition of "efficiency" as applied to tax incentives.[65]

Despite this debate, tax incentives continue to persist in the U.S., the U.K., and other countries as a practical method of promoting private behavior that is considered socially good or valuable. This is especially true in the case of charitable organizations that are considered deserving of a government

63. Surrey, *supra* note 57, at 720-32.

64. James Andreoni, *Impure Altruism and Donations to Public Goods: A Theory of Warm-Glow Giving*, 100 ECON. J. 464, 470 (1990).

65. *See* Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L. REV. 973, 975 (1986) (arguing that the economic case against tax incentives is subject to important assumptions and restrictions).

subsidy because they produce social goods.[66] In his article exploring the charitable deduction and internationally targeted donations, David Pozen notes that the "deduction's political resilience and its peculiar immunity from macro-level scrutiny. . . suggest that no other policy could better broker among the competing values inherent in charitable tax policy."[67]

Another point used by the anti-tax-deduction camp is the potential for wasteful inframarginal impacts.[68] That unless a tax incentive is structured in a manner that rewards only new entrants who without the tax incentive would not have engaged in the socially useful behavior, there will be wasteful constriction of the tax base when parties are given tax breaks for behavior they would have engaged in anyway.[69] Though theoretically a tax incentive should only reward marginal external benefits, it is virtually impossible to design a tax incentive that gives this result.[70] Thus, the primary concern should be providing tax incentives to private parties that will produce the most and best social goods to society, or, simply put, give society the most "bang for its buck".[71] The problem with this school of thought however, is the assumption that deductions given to those who would have donated anyway is "waste" rather than the cost of incentivizing private support of goods or activities that improve social welfare. It is possible that the charitable deduction persists despite inefficiencies for qualitative reasons that societies find sufficiently compelling on their own to justify the cost of subsidizing charities; including the

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66. Malani & Posner, *supra* note 27, at 2018.

67. Pozen, *supra* note 56, at 590. Though observation of the tenacity of the charitable deduction is not synonymous with proof of its desirability, the long-standing nature of the deduction suggests that there may be some other reason that it is used despite any possible inefficiencies.

68. JONATHAN GRUBER, PUBLIC FINANCE AND PUBLIC POLICY 530 (2d ed. 2007) (defining "inframarginal impacts" as "the tax breaks the government gives to those whose behavior is not changed. . .").

69. *See id.*, at 530 (Explaining that the most cost-efficient tax breaks encourage behavior such as increasing charitable giving and the least cost-effective tax breaks benefit those who were already engaged in the subsidized behavior.)

70. *See* Lily L. Batchelder et al., *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 45-46 (discussing the impossibility of an optimal Pigouvian subsidy and acknowledging that practically it is best to structure a tax subsidy in a way that society gets the most "bang for its buck").

71. *Id.*

redistribution of wealth to the poor or rewarding moral behavior. Others have noted this problem with the efficiency debate and argued that the "deduction for charitable contributions . . . need not stand or fall on its efficiency."[72]

Applied in the MFI context the efficiency argument against charitable deductions is problematic for other reasons. It would be difficult to argue that a deduction to a donor in an LDC for a donation to a for-profit MFI is costly to LDCs, because research suggests that the income tax base does not play a substantial role in furthering the goals of LDC governments.[73] The role of the income tax base in LDCs suggests that the "waste" argument of the efficiency school of thought may be negligible. Further, a deduction to a donor from developed countries for investing in a for-profit MFI can be justified regardless of any inefficiencies on the ethical grounds that the donor should be rewarded for a the morally praiseworthy act of investing in poverty reduction.

3. *Rewarding the Morally Praiseworthy Donor/Investor*

Even if a deduction proves inefficient and does not serve an incentive function, "[s]omething can be said for rewarding activities which in a certain sense are selfless."[74] Borris Bittker made this argument in favor of deductions for charitable donations on qualitative grounds despite speculative efficiency-based arguments about potential "waste." Bittker argued that those who donate to charities should be rewarded for their selflessness with a deduction. An obvious challenge to this logic is that donors should not be additionally rewarded, because they have purchased a warm-glow effect and personal satisfaction with their voluntary donation. Bittker responds to this by arguing that, by discharging a moral obligation, donors are not making voluntary donations. David Pozen challenges Bittker's views on other grounds. He notes that the pleasure donors derive from giving makes donations indistinguishable

72. Bittker, *supra* note 59, at 60.

73. *See generally* Eric M. Zolt and Richard M. Bird, *Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries* 4 (UCLA Sch. of Law, Research Paper No. 05-22, 2005) (arguing that the personal income tax does not reduce inequality in developing countries, and that having an ineffective redistributive income tax imposes important costs).

74. Bittker, *supra* note 59, at 60.

from other forms of spending, that many non-deductible personal expenditures are made due to moral obligation and could be considered involuntary, and that it is unclear why selflessness should be rewarded.[75] Pozen's criticisms seem to miss that Bittker's argument at its core is about ethics. Though Bittker does not cite any ethics literature or address issues of distributive justice, the core of the argument seems to be that the selflessness of donating to charity should be rewarded because it results in the positive externality of helping those who are worse off. Notably, this argument would not apply to all charities (educational institutions and the like), but it would apply to charities that aid the poor. This would be especially true in the case of MFIs (for-profit or nonprofit) that aid the poor.

Hence, those who donate to MFIs are arguably entitled to a deduction for the morally praiseworthy act of giving money to an MFI to aid the less well-off. Donors who receive modest returns on their donation are arguably less praiseworthy, but something can be said for donating money to a for-profit MFI that will generate smaller returns than the donor could have obtained elsewhere, if it generates a return at all. In the context of MFIs, another theory in support of tax deductions to donors could be risk compensation.[76] If donors are taking the risk of losing their entire investment in the interests of aiding the poor, their praiseworthy actions should rewarded with a form of deduction as insurance.

D. *MFI Contribution to Social Welfare and Redistribution of Wealth*

Assuming that the tax incentives of the MLP will entice investors, and also assuming that a for-profit social good firm is equally entitled to tax exemption as a nonprofit, there remains the question: what social good do MFIs produce? In order to justify tax exemption, it is necessary that MFIs either improve social welfare or serve as a conduit for the redistribution of wealth.

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75. *See* Pozen, *supra* note 56, at 551.

76. *See, e.g.*, Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419 (1998).

There has been serious academic debate and divergent points of view on the issue of the actual impacts of microfinance and how they have been measured to date. Economist Jonathan Morduch claims it is a "myth . . . that microfinance has a clear record of social impacts and has been shown to be a major tool for poverty reduction and gender empowerment."[77] He qualifies this criticism by expressing his belief that "microfinance can make a real difference in the lives of those served."[78] Morduch's most recent work replicates a well-known study on the impacts of microcredit in households based on survey data collected in Bangladesh in the 1990s. The replication challenged prior studies and concluded that old data reflects that microcredit does no harm and that new experimental designs are necessary to prove causality between the presence of microcredit and increases in consumption and reduction of poverty.[79]

Statistical impact evaluations with precise controls that can account for biases which overestimate the positive effects of microfinance are challenging. Though it is true that few impact evaluations have been sufficiently detailed in their methodology to satisfy some economists, many assessments performed by reputable institutions show a positive correlation between the presence of microfinance in particular locations and increasing incomes, improved quality of life, better housing, increased school attendance, and greater access to sanitation.[80]

There are concerns that it is difficult to create a model for microfinance impact evaluation that can prove causality. In the presence of overarching factors like global or country-wide economic change, it is difficult to prove that a microfinance

77. ARMENDÁRIZ & MORDUCH, *supra* note 2, at 4.

78. *Id.* at 4.

79. Prior studies based on the same pool of survey data performed by Pitt and Khandker and Khandker in his own right had concluded that microcredit raises household consumption when lent to women and that it also helps the extremely poor more than the moderately poor. *See* David Roodman & Jonathan Morduch, *The Impact of Microcredit on the Poor in Bangladesh: Revisiting the Evidence* 39 (Ctr. for Global Dev., Working Paper No. 174, June 2009).

80. *See, e.g.*, World Bank, *10 Years of World Bank Support of Microcredit in Bangladesh*, http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:21153910~pagePK:34370~piPp:34424~theSitePK:4607,00.html (last visited Apr. 20, 2010) [hereinafter World Bank Report].

loan is the *cause* of any positive change in a borrower's circumstances. It is reasonable, however, to accept as true that microfinance loans produce positive social impacts if there is evidence that, though loans may not be the sole contributor to positive change, they are at least a contributor. Impact assessments that focus efforts on collecting data from borrowers, like those driven by organizations like Imp-Act, CGAP, and the World Bank, have shown a correlation between involvement in microfinance and positive improvements in the lives of borrowers.[81] For instance, results of an impact assessment performed by the World Bank on a sample of borrowers in Bangladesh in 2001 shows a 99 percent increase in borrowers' income, and reports that 96 percent show improved quality of life, 99 percent eat better and have more food, 99 percent are clothed better, 86 percent live in better housing, 88 percent became able to send children to school, 83 percent have better access to sanitation, and 55 percent of rural borrowers came to own land.[82] Even though evidence of this sort does not prove that microfinance produced these positive effects, the correlation suggests that microfinance may potentially be contributing to the positive developments.

Results such as these are inspiring. However, critics launch two common complaints against microcredit. The first criticism is that there are selection biases that cannot be controlled, such as borrower self-selection in many studies. And the second criticism is that some borrowers are over-indebted to MFIs. The first of these criticisms concerns situations where you might see a large number of borrowers who were already participating in entrepreneurship and had rising incomes prior to their involvement with microfinance. The skeptics' argument being simply that if these borrowers were already working to improve their circumstances, where is the proof that they would not have continued to improve in the absence of a micro-loan? This is a valid criticism to which the only response is that, without new commitment to gathering empirical evidence, there is no conclusive proof that a micro-bor-

81. *See id.*; UNCDF MICROFINANCE PROGRAMME IMPACT ASSESSMENT – ANNEX 1, *available at* http://www.uncdf.org/english/about_uncdf/uploads/org_eval/uncdf_MF_Annexes.pdf.

82. World Bank Report, *supra* note 80.

rower's circumstances would or would not continue to improve in the absence of microcredit.

The second criticism used to cut into microfinance's value as a social good is the argument that putting the poor into debt that has the *potential* to grow, as many micro-borrowers return for more loans placing them deeper and deeper into debt, may be counterproductive. Microcredit skeptics point to the potential that increasing debt will have a negative effect on borrowers' relationships with their communities. In his book *What's Wrong with Microfinance?*, Thomas Dichter warns that rural attitudes on debt are negative, debt is seen as an indicator that a borrower is not self-sufficient and is thus a burden on others.[83] Increasing consumer debt is a problem even in developed countries with strong consumer protection and usury laws backed by stiff penalties. Statistics of the negative effect of consumer debt in the United States are staggering; from 1990 to 2004 the total number of personal bankruptcies in the U.S. doubled, and the average debt burden rose from 86.2 percent to 105.1 percent.[84] If the U.S., with its numerous credit rating agencies and heavy regulation, is not able to protect its citizenry from this heavy burden, how can developing countries with no regulatory institutions set in place be able to prevent abuses and protect consumers?

However, taking a cost-benefit view, the expected benefits of microfinance should outweigh a few bankruptcies among borrowers. Undoubtedly, the over-indebtedness of some borrowers is a problem, but limiting the access of responsible borrowers because some borrowers are irresponsible is not an appropriate solution. Increased regulation, or regulation where there is none, seems the appropriate solution to micro-borrower over-indebtedness,[85] if the problem is substantial enough to warrant a solution. Without solid empirical evi-

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83. *See e.g.*, THOMAS DICHTER & MALCOLM HARPER, WHAT'S WRONG WITH MICROFINANCE? 9-16 (2007) (explaining that symbolism of debt is important in rural areas and small villages).

84. Bruce Ian Carlin & Rafael Rob, *Relationship Banking, Monetary Policy, and Consumer Credit Reform* 1 (2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1033108&download=yes.

85. *See* PORTEOUS & HELMS, *supra* note 21 at 6-7 (acknowledging the micro-consumer debt problem and proposing numerous forms of regulation in response, including MFI self-regulation and consumer education programs).

dence of a substantial number of supposed over-indebted borrowers, this criticism seems speculative. The fact remains that there is high demand for these loans regardless of the absence of regulation or the high interest rates,[86] and speculative criticisms are not sufficient reasons for creating rules that curtail microfinance.

Tools for measuring global long-run effects of microfinance in a standardized manner unfortunately are scarce. There has, however, been a promising recent effort to remedy this with a worldwide alliance of over 650 microfinance institutions, donors and investors, networks, technical assistance providers, rating agencies, academics, and researchers called the Special Performance Task Force (SPTF). The SPTF was initiated in March 2005 by CGAP, the Ford Foundation, and the Argidius Foundation[87] to create standardized social performance indicators to both measure and manage the social impact of micro-loans.[88] In 2008, the SPTF drafted a set of social performance indicators that MFIs should report on and applied them in a pilot test to determine which indicators were the most relevant and easy to obtain and verify. Member MFIs began reporting these indicators to the MIX Market in 2009[89] and will discuss the first set of performance data and indicators at an annual meeting in the summer of 2010.[90]

86. *See* SAM DALEY-HARRIS, MICROCREDIT SUMMIT CAMPAIGN, MICROCREDIT SUMMIT CAMPAIGN REPORT 10 (2009), *available at* http://www.microcreditsummit.org/SOCRs/SOCR2009_English.pdf. Some of this demand comes from the United States. For instance, microlender ACCION had $1.45 million in loan volume in the U.S. between June and August 2008, an amount that ACCION claims is rising due to the recession and unwillingness of traditional banks to extend credit. John Tozzi, *US Entrepreneurs Turn to Microfinance*, Bus. Wk., Oct. 8, 2008, *available at* http://www.businessweek.com/smallbiz/running_small_business/archives/2008/10/microfinance.html.

87. *See* Social Performance Task Force, Background, http://www.sptf.info/page/background-1 (last visited May 10, 2010).

88. Laura Foose & Amelia Greenberg, *The Double Bottom Line: Evaluating Social Performance in Microfinance*, MICROBANKING BULLETIN, Autumn 2008, at 12.

89. *Id.* at 15; *see also* Social Performance Task Force, Social Performance Indicators, http://www.sptf.info/page/social-performance-indicators.

90. *See* Performance Task Force, 2010 Annual Meeting, http://www.sptf.info/page/2010-annual-meeting (last visited Apr. 20, 2010) (sched-

Despite the lack of statistical long-run evidence of positive social impacts on a broad scale, there remains a presumption of long-run benefits particularly to female borrowers because, since the birth of microfinance, women have grown as a lending community to the point where they now comprise the majority of the poorest microcredit clients.[91] At first glance, this statistic may not say much regarding microfinance's production of social goods, but if considered in light of the fact that women as a group suffer from greater poverty than men and in some regions are subjected to severe discrimination which results in unequal wages, poor nutrition and less education, the fact that women comprise most borrowers suggests that MFIs may be getting financial products to the poorest of the poor.[92] Based on this evidence, particularly in the case of women, it seems very possible that MFIs produce a social good of value that is deserving of a government subsidy.

Regardless of the absence of conclusive proof that MFIs produce a social good the role of MFIs in redistributing wealth from the rich to the poor should be sufficient to justify subsidizing MFIs. Observers may argue against this by noting that those who borrow from MFIs are expected to repay their loans. But the reality of repayment is sufficiently mitigated by the fact that the capital MFIs reallocate from wealthy donors/investors to poor entrepreneurs can be used to create or increase their income and lift them out of poverty. Redistribution does not necessarily mean that funds are handed to the poor as free money. The role of MFIs does not fit a conception of redistribution in the old sense of giving away charity. It is a conception of reallocating wealth through social investment.[93] Further, this method of redistribution holds greater

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uling a workshop for MFI participants to discuss the latest knowledge and best practices).

91. *See* MICROCREDIT SUMMIT CAMPAIGN, EMPOWERING WOMEN WITH MICROCREDIT: 2000 MICROCREDIT SUMMIT CAMPAIGN REPORT 2 (Lise Adams et al. eds., 2000) (reporting that 75 percent of the poorest microcredit clients are female according to a 1999 survey of 1,065 microcredit institutions).

92. *See* ARMENDÁRIZ & MORDUCH, *supra* note 2, at 183-84 (citing a World Bank Report showing that women are lagging behind in many key indicators of economic development and a 1996 UNDP Human Development Report showing that 70 percent of the world's poor are women).

93. *See, e.g.*, James Midgley, *Growth, Redistribution and Welfare: Toward Social Investment*, 73 SOC. SERVICE REV. 3, 16 (1999) (arguing that the conventional view of redistribution based on altruism and social rights has lost

promise than the conventional idea of redistribution through handouts, because it is presumably better in the long term if the less well-off learn to create and increase their own incomes rather than rely on the charity of the wealthy.

E. *Tax Breaks for For-Profit MFIs*

If Posner and Malani are correct in their theories, the fact that most MFIs currently operate as nonprofits is discouraging the involvement of talented social entrepreneurs who can run MFIs more efficiently and bring the industry that much closer to sustainability.

Rationales used to make a case for special treatment of charities also support creation of a hybrid entity for MFIs. Like charities, for-profit MFIs would operate in place of government to produce social goods and government should subsidize this production with tax breaks. The hybrid entity suffix (MLP) combined with a regulator and annual disclosures would signal to investors that their money will be used for the production of social goods rather than be pocketed by managers. At the risk of promoting cynicism, altruism mistakenly presupposes that those who are best equipped to create social goods are also 100 percent altruistic.[94] Those best equipped to create social goods like financial products for the poor are a growing class of young philanthropreneurs who are seeking to do good and make a profit. Further, the idea of creating a special hybrid for-profit that performs charitable services has already taken root in both the U.S. and the U.K. and should be expanded to the MFI context to continue the trend of innovation in creating social goods.

The phenomenon of socially responsible investing in general would be encouraged by favorable tax treatment of an MFI hybrid entity. As MFI funds are growing in popularity, encouraging MFIs to switch to a for-profit form would allow MFIs greater access to capital. Nonprofit MFIs are by definition barred from access to equity capital, an unfortunate fact

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resonance, and that a new conception of redistribution based on social investments will have greater appeal).

94. *See, e.g.*, Malani & Posner, *supra* note 27, at 2042-43 (explaining that the altruist is concerned not only about how many beneficiaries her charity serves, but also about her own income).

because of the money available from venture philanthropists[95] and socially responsible equity funds. If MFIs are encouraged to become for-profits, they would no longer have to rely on the limited funds available from donations or debt and favorable tax treatment should attract a greater number of investors.

Others may argue that for-profit status should be sufficient for MFIs to gain access to previously unavailable funds without the addition of tax exemption for both the entity and investors. It may be that the forgone tax revenue to the host government is marginally greater than the social good of poverty alleviation that would be increased.[96] But any "forgone" revenue is highly speculative, and the redistributive role of MFIs, as well as the ethical behavior of donors suggests tax exemption would be good policy. It is possible that in twenty years when favorable treatment has permitted microfinance to grow to the point of sustainability an argument could be made that the tax breaks are more costly than the social good provided, but MFIs should first be given the opportunity to reach that point. Because MFIs provide a product of at least some value in terms of social benefit (particularly to women), some loss in tax revenue is an acceptable cost for promoting poverty alleviation and the redistribution of wealth to the less well-off. For-profit MFIs as well as other for-profit firms that carry on charitable activities are as deserving of the tax breaks and implicit endorsement of their governments as are nonprofit firms.[97] Further, if it is correct that coupling funnels donor funds from more efficient for-profit charities to less efficient nonprofits, then it is likely that allowing tax breaks to for-profit MFIs would encourage the survival of efficient sustainable MFIs.

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95. For instance, the Acumen Fund is a nonprofit venture capital fund that endorses the idea of "patient capital" as a method of aiding the poor. *See* Acumen Fund, About Us, http://www.acumenfund.org/about-us.html (last visited Apr. 20, 2010).

96. Lily L. Batchelder, Fred T. Goldberg & Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 44 (2006).

97. Malani & Posner, *supra* note 27, at 2065.

V. Comparison to Other Proposals

A. *Vermont's L3C*

As previously stated, the inspiration for an MFI hybrid entity came from the L3C, originating in the United States, and the CIC of the United Kingdom. The L3C, or low-profit limited liability company, was created by Robert Land, CEO of the Mary Elizabeth & Gordon B. Mannweiler Foundation. Land intended that L3Cs be a hybrid between a nonprofit organization and a for-profit corporation; in fact the "L3C" label was coined by Mr. Lang as a hybridization of an LLC.[98] In May 2008 Vermont became the first state to enact a statue that authorizes formation as an L3C.[99] The Vermont statue permits L3Cs to generate modest profits while carrying on a business that has a charitable purpose. Contrary to the proposal that MFI hybrid entities be allowed to generate tax-free profits, L3Cs are taxed on any profits but are free to invest the profits, give away profits as grants, or pay modest dividends to their investors.[100]

The intended benefit of an L3C is to fill the space in legal entity forms for businesses with social missions. The L3C is meant to encourage nonprofit foundations as well as government entities and individuals to make tax-exempt investments into L3Cs. The IRS permits nonprofits to invest in profit-making ventures that support a charitable activity in the form of a "program-related investment" ("PRI"). PRIs do not require pre-approval, however, and nonprofits could face a penalty if

98. Thomas J. Billitteri, Nonprofit Sector Research Fund, Mixing Mission And Business: Does Social Enterprise Need a New Legal Approach? 13 (2007), *available at* http://www.nonprofitresearch.org/usr_doc/New_Legal_Forms_Report_FINAL.pdf.

99. Michigan, Wyoming and the Crow Indian Nation in Montana have all followed suit by passing L3C legislation of their own. L3C legislation is also pending in Georgia, Illinois (the bill was signed in August 2009 and is expected to take effect in 2010), Montana, North Carolina, and Oregon. Sally Duros, *How to Save Newspapers*, Huffington Post, Feb. 9, 2009, http://www.huffingtonpost.com/sally-duros/how-to-save-newspapers_b_164849.html (discussing the structure of L3Cs and their growing acceptance nationwide); Ann Meyer, *New Corporate Structure Could Give Social Entrepreneurs New Funding Stream*, Chic. Trib., Aug. 10, 2009, at C19 (describing the bill's passage in Illinois).

100. *See* Community Interest Companies, About Us, http://www.cicregulator.gov.uk/aboutUs.shtml (last visited Apr. 20, 2010).

the IRS determines that a PRI does not fit the definition stated in the Internal Revenue Code ("IRC"). Because the IRS has not pre-approved/endorsed donations to L3Cs as acceptable PRIs, nonprofits seeking to donate to an L3C would need to seek permission from the IRS in the form of a "private letter ruling" to decrease the risk of facing a penalty.

The Vermont statute authorizing L3Cs uses the same language as the IRC's definition of a PRI, presumably to automatically qualify an investment in an L3C as a PRI. However, until Congress passes a law authorizing nonprofit investment in L3Cs or the IRS issues a private letter ruling that approves all investments in L3Cs, any individual or nonprofit that invests in an L3C will be taking the risk of being taxed.

B. *United Kingdom's CIC*

Like the L3C, the hybrid corporate form in the U.K. called a Community Interest Company (CIC) is a specialized limited liability company. The CIC was statutorily authorized under the Companies Act of 1985 as amended in 2004 to permit formation as a CIC. In addition to authorizing formation as a CIC, the U.K. government also put in place a regulatory framework to ensure that CICs operate as intended.[101] The Community Interest Company Regulations of 2005 contain detailed rules that govern the operation of CICs. There was also a Guidance issued in May 2005, and the U.K.'s Secretary of State for Trade and Industry[102], on authority granted in the Companies Act of 2004, appointed a Regulator to deal exclusively with issues that arise under CICs to keep the implementation of the corporate form running smoothly.[103]

CICs, like American 501(c)3s, are statutorily not permitted to engage in political activity. Other limitations on formation as a CIC include satisfaction of the "community interest

101. *See* Community Interest Companies, About Us, http://www.cicregulator.gov.uk/aboutUs.shtml (last visited Apr. 20, 2010) (describing the Companies Act of 2004 which established a 'light touch regulator' for CIC's, to "encourage the development of the CIC brand and provide guidance and assistance on matters relating to CICs").

102. Community Interest Companies, Guidance, http://www.cicregulator.gov.uk/guidance.shtml (last visited May 19, 2010).

103. *Cf.* COMMUNITY INTEREST COMPANIES, BRIEFING PACK 7-9, *available at* www.network2012.net/community/resources/cicreg_cic_briefing_pack.pdf (discussing the initial appointment and functions of the Regulator).

test," an "asset lock," and a cap on dividends. The community interest test is a prerequisite to formation as a CIC and asks whether "a reasonable person might consider that [the CIC's] activities (or proposed activities) are carried on for the benefit of the community."[104] A company formed as a CIC must continue to satisfy the community interest test throughout its life. CICs are also subject to an asset lock, which requires that any transfer of a CIC's assets either be for full consideration, made to another asset locked body (like a charity or CIC), or be otherwise made for the benefit of the community.[105] The third limitation is a two-tier dividend cap.[106] For all shares issued after April 6, 2010, the first dividend cap is a maximum per share dividend cap set at 20 percent of the paid up value of a share. The second dividend cap is an aggregate dividend cap set at 35 percent of distributable profits. CICs may also carry forward unused dividend capacity for up to 5 years.[107] CICs are also subject to disclosure requirements in the form of the Community Interest Report that requires CICs to file an annual report to be submitted along with their accounting records with the Registrar of Companies and the CIC Regulator. Expected sources of financing to CICs include grants, asset-based lending, employee share ownership schemes, and institutions that look favorably on social enterprise.[108]

C. *Tax Treatment of L3Cs and CICs*

L3Cs and CICs are subject to similar treatment regarding taxation of profits. Both hybrid entities are taxed on their profits. However, there are significant differences between the CIC and L3C. The U.K., quite notably, had the foresight to implement a regulatory framework to manage and guide the new CICs, whereas Vermont has yet to issue any regulations or

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104. *Id.* at 13.

105. *See generally id.* at 17-19.

106. *See generally id.* at 20-26.

107. Prior to April 6, 2010, the first tier of the dividend cap was set at five percentage points above the Bank of England's base lending rate. Effective April 6, 2010 the CIC Regulator set the first tier at a flat rate of twenty percent for shares issued after that date. COMMUNITY INTEREST COMPANIES, INFORMATION PACK 16, *available at* http://www.cicregulator.gov.uk/CIC leaflets/CIC%20INFORMATION%20PACK%20V00.04%20Final.pdf.

108. COMMUNITY INTEREST COMPANIES, BRIEFING PACK 33, *available at* www.network2012.net/community/resources/cicreg_cic_briefing_pack.pdf.

appoint responsibility for oversight of L3Cs to a regulator. It is also notable that the CIC has achieved success in establishing itself as a viable corporate form. As of March 2007, there have been nearly 850 incorporations as a CIC,[109] whereas comparatively fewer companies have formed as L3Cs.[110] These differences are likely accounted for by the fact that the CIC was implemented three years prior to the infant L3C and therefore has had more time to develop.

Based on the example of the L3C and CIC, it is fair to state that a hybrid entity is a viable method of motivating social entrepreneurship.[111] Thus, MFIs ready to achieve for-profit status would benefit from formation as a special entity both as a method of encouraging capital investment but also as a method of attracting the most efficient and talented social entrepreneurs. A problem presents itself in the need for appropriate oversight and regulation to be sure that MFI hybrid entities are operating as intended. Countries with weak institutions would not be ideal candidates for a hybrid entity. However, this should not be a deterrent to creating a hybrid entity, as solid institutions are a necessary prerequisite to any kind of sustainable development,[112] not only MFI development.

D. *The MLP vs. the L3C and CIC*

The MLP is based on the best aspects of the L3C and CIC. The CIC has proven popular but with unpopular limitations[113]

109. *Id.* at 3.

110. About 100 L3Cs were formed by January 2010. *See* Lydia Dishman, *L3Cs: The Hybrid Way to Do Well by Doing Good*, Fast Company Jan. 25, 2010, *available at* http://www.fastcompany.com/blog/lydia-dishman/all-your-business/l3cs-emerge-hybrid-way-do-well-doing-good (last visited May 20, 2010).

111. *Cf.* COMMUNITY INTEREST COMPANIES, BRIEFING PACK 28, *available at* www.network2012.net/community/resources/cicreg_cic_briefing_pack.pdf (explaining that it is possible to convert a CIC to charitable status).

112. *Cf.* WILLIAM EASTERLY, THE ELUSIVE QUEST FOR GROWTH 168-9, 192, 237-9, 252 (2002) (offering a number of examples of governmental and societal institutions necessary to achieve broader development goals).

113. *See* Free Valley Centre for Social Enterprise, Analysis of L3C and CIC social enterprise models 7-8 (2008), *available at* www.centreforsocialenterprise.com/f/L3C_and_CIC_social_enterprise_models_Oct_2008.doc (describing "emerging issues" with CICs, including a potentially below-market dividend cap, a restrictive interest cap, and inability to pursue grant funding).

that the MLP avoids. The CIC's 35 percent dividend cap for instance has proven low,[114] a problem avoided with the MLP by setting a substantially higher dividend cap. A high ceiling for what percentage of profits is acceptable for distribution will be less likely to discourage investors seeking an above-market profit and also serves the same purpose as the CIC's dividend cap, requiring hybrid entities to retain a minimum portion of their earnings for reinvestment into the enterprise. The MLP also avoids the mistake of both the CIC and L3C in constraining profit motive. Both existing entities force low profit distributions, the CIC in a manner that has discouraged investors and the L3C, though yet untested, in a manner that most likely will also deter investors. With its high dividend cap and favorable tax treatment the MLP will give management an incentive to maximize profits, give investors an incentive to invest, and therefore increase efficiency in providing financial services to the poor.

VI. Proposed Structure of An MFI Hybrid Entity

The proposed structure of an MFI hybrid entity is based on the L3C and CIC, and will accommodate the special needs of social entrepreneurs who run for-profit firms with social goals. The L3C is a variation of the limited liability company under U.S. law, and the CIC is a new legal entity designed to be a type of limited company under U.K. law.[115] The proposed hybrid entity is a limited liability partnership. The goal of the MLP is to keep the benefits of limited liability to managers while decentralizing management and allowing MLPs indefinite existence separate from managers. In addition, MFIs forming as the hybrid entity will have the advantage of being readily identifiable to investors if they are statutorily required to include the suffix MLP in their legal titles.

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114. *See* Paul Jump, *Consultation Opens on CIC Dividend Caps*, Third Sector Online, Apr. 3, 2009, *available at* http://www.thirdsector.co.uk/News/DailyBulletin/896128/Consultation-opens-CIC-dividend-caps/7F0DDF83E99BF02F3EEC8FEBD3CA5358/ (discussing the possibility of raising the 35 percent cap on dividends).

115. Vermont Secretary of State, Low-Profit Limited Liability Company *available at* http://www.sec.state.vt.us/corps/dobiz/llc/llc_l3c.htm (last visited May 23, 2010). CIC Regulator, About Us, *available at* http://www.cicregulator.gov.uk/aboutUs.shtml (last visited May 23, 2010).

A. *Hybrid Entity Formation as a Partnership Rather Than a Corporation*

The limited liability partnership form is preferable to formation as a corporation with shareholders and centralized management because it responds to agency costs as well as problems of free riding that tend to occur when investors feel less responsible for controlling managers.[116] The corporate form puts little control in the hands of shareholders, whose ability to control managers is based primarily in their power to vote up or down on proposals that are put forward primarily by management.[117] An MLP would put more power in the hands of members (as opposed to shareholders in a corporation) to supervise managers. The MLP form would permit the MLP founder to also perform managerial functions and reap the rewards of entrepreneurship on two fronts, with a salary and with dividends.[118] This reasoning presupposes that tighter investor control over management will produce greater social benefits. There may, however, be tradeoffs to tighter investor control if investors have opposing interests or if they are investors with greater interest in profits than advancing social welfare.

It is possible that tighter investor control would not result in the production of greater social benefits if an MLP forms with a large number of investors. It follows logically that a greater number of people will result in a greater number of diverging views. An MLP run by members who have opposing interests may be run inefficiently due to internal conflict or failure to come to a consensus on how the MLP should be run. For instance, member managers may disagree on which method the MLP should pursue in furthering the goal of extending credit to the poor.[119] The MLP could mitigate this

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116. *See* Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance,* 81 NOTRE DAME L. REV. 1431, 1466-67 (2006) (citing Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power,* 118 HARV. L. REV. 833 (2005)).

117. *See id.* at 1466-1468 (discussing the shareholder "free rider" problem and proposing solutions).

118. It is possible for a manager to achieve this with a corporation as well.

119. Members might disagree about whether the MLP should focus on lending to women, or whether it should be an equal opportunity creditor. In fact, Armendáriz and Morduch explain that "evidence from Grameen Bank—and replications elsewhere in Asia—shows that women are better

potential problem by limiting the number of members who invest. By maintaining a low number of members there would be fewer divergent groups and less chance for disagreement, but the tradeoff would be less access to capital—an untenable tradeoff considering the purpose of MLP status.

Another potential conflict will likely arise if some MLP members who invest seek to maximize value at any cost and use their influence to make managing decisions that will increase the return on members' investment at the expense of producing greater social benefits. In the case of MFIs this kind of negative pressure would likely manifest in the form of investor efforts to better secure loan repayments by asking for collateral or refusing to lend to the poorest. Though "flexible collateral" is already used by numerous MFIs,[120] MLPs would be advised to establish both institutional and contractual safeguards to protect against the risk of divisive disagreements and opportunistic behavior. An advantage of investor-owned firms, generally, is the common objective of maximizing the firm's earnings,[121] but MLP investors should have a shared goal of maximizing the social benefit to their clients.

Two methods may be implemented to ensure that MLP investors share this goal. First, statute may require that the objective of all MLPs is to maximize social welfare. Second, prior to investment, it may be required that all investors agree in writing that their primary goal is advancing social welfare and that they will not individually or as part of a group propose or support any firm decision that is contrary to producing the greatest social benefit. To encourage compliance there should be sticks for violations; for instance, investors who violate the MLP's social mission should be subject to a financial

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about repaying loans. For example . . . 15.3 percent of male borrowers were struggling in 1991 (i.e., missing some payments before the final due date), while only 1.3 percent of women were having difficulties." ARMENDÁRIZ & MORDUCH, *supra* note 2, at 183 (internal citations omitted).

120. Flexible collateral is non-traditional collateral that does not emphasize the economic or resale value of property that borrowers put up as collateral. Rather, the focus is on its personal value to borrowers and whether losing the collateral will result in some hardship to the borrower. An example would be a carpenter who puts up his tools as collateral for a micro-loan to expand his business. The tools have little resale value, but it would result in a loss of all income if the carpenter defaults and the tools are seized. *See* ARMENDÁRIZ & MORDUCH, *supra* note 2, at 1134-36.

121. *E.g.*, HANSMANN, OWNERSHIP, *supra* note 5, at 62.

penalty. MLPs should also have formal voting rules to address internal discord. Further, MLPs could also avoid investor pressure to stop lending to the poorest by including a provision in their operating agreement that prohibits moving to a class of wealthier borrowers.[122] Even though it is arguable that these safeguards may not operate as structured from a practical perspective, publicizing their existence might serve a symbolic or expressive function by signaling to the public what kind of investor should participate in MLPs; i.e. socially conscious investors looking to further a cause while making a return (meaning any return, not necessarily a return that is above market), not archetypical Wall-Street shareholders looking to maximize investment returns at any cost.

B. *What is an MLP?*

An MLP is similar to a limited liability partnership in that it provides greater flexibility than a corporate form by allowing members to also be managers and has a perpetual separate existence from its owners. The MLP should attract new sources of capital to MFIs that were previously unavailable, due either to the non-distribution constraint of the nonprofit form, the lack of special tax treatment to entice investors or the absence of a title that signaled a social good organization to the growing class of socially responsible investors.

The statute that establishes an MLP should create a special regulatory framework for guiding nonprofit MFIs through transition into MLP status and for monitoring MLP activities. A special regulator is necessary not only for oversight but also for the institutional support that developing industries need to flourish. The regulator would be a gatekeeper to prevent abuse of MLP status by requiring each entity seeking MLP status to file a statement of purpose, similar to the community interest standard of the CIC and Form 1023 statement required for 501(c)3 status in the U.S. To meet the standard for MLP status, the entity should prove a primary purpose of providing financial services to the poor in order to aid them in rising out of poverty. An MLP's statement of purpose, thus, should lay out the MLP's business plan, including the kind of microfinance-related activities that the MLP plans to engage

122. They might, for example, require that a minimum percentage of borrowers fall below a set yearly income.

in. Permitted activities would include microcredit, micro-insurance, and micro-savings, as well as any other financial product or service that is to be provided exclusively to the poor.[123] The MLP's proposed operating agreement should also be filed with the regulator before MLP status can be approved.

If the regulator is satisfied with the statement of purpose and grants MLP status, the MLP should be required to file annual reports with the regulator's office that disclose the MLP's activities for the year. MLP annual reports should include whether any members are also managers, the salaries of MLP employees and managers, whether the MLP has engaged in any asset transfers during the year, whether any dividends have been declared, what percent of total profits were given in dividends, audited financials (balance sheets, cash flow and income statements), and general information regarding activities that relate to their mission of poverty reduction. The regulator will make annual reports available as a public record. Because MLPs are in the business of producing public goods and are also benefiting from special tax treatment (discussed below), heightened transparency will be necessary to prevent abuse.

MLPs will not be subject to an asset lock like a CIC because an asset lock is too restrictive. CICs are subject to an "asset lock" provision that is mandatory. As discussed in the previous section, the asset lock prohibits managers from selling any assets below their fair market value unless they are being sold to another asset locked entity like another CIC or a charity.[124] In the case that an MLP faces a liquidity crisis, the MLP could regain stability faster if it can liquidate its assets quickly, rather than face the potential delay and restrictions of an asset lock. Thus, MLPs should be free to divest assets as they see fit, but they must acquire a majority vote of all members before doing so. Further, there will be a per share dividend cap at 15 percent over the base lending rate. There will also be an aggregate dividend cap set as the maximum amount of profits that can be distributed to investors. This means that

123. Most countries have heavy regulatory burdens on organizations that take deposits or provide insurance. Thus, to decrease costs, a special exception may be made for MLPs that engage in those activities.

124. COMMUNITY INTEREST COMPANIES, *supra* note 103, at 17-19.

any profits not distributed or used to pay salaries must be reinvested in MLP operations.[125]

C. *Tax Treatment of MLP*

The MLP entity will be exempt from *all* income and corporate taxes.[126] Investors in MLPs will be permitted to reap the fruit of their investment in the form of tax-exempt dividends that will be excluded from income (like interest received on U.S. municipal bonds).[127] MLP distributions should be subject to restrictions. Modest limitations on profits are appropriate to protect host governments' investment in MLPs. Governments may forgo substantial amounts in exchange for the production of MLP social goods, so they deserve some insurance that MLP investors will reinvest at least some of their profits back into the institution to strengthen the likelihood that it will survive long-term.

A double-layered dividend cap, similar to the double caps utilized with U.K. CICs is appropriate. The double cap will limit the amount of profits investors may reap in order to keep the arrangement of tax exemption equitable from the point of view of host governments. The first layer will be a *per share dividend cap* at a rate equal to whatever the base lending rate is to social enterprises in the country where the MLP is formed, plus 15 percent.[128] The 15 percent over the base rate is meant

125. Other limitations to dividends should also apply; dividends should only be permitted to the extent that the MLP has distributable profits. This limitation is applied to the British CIC. COMMUNITY INTEREST COMPANIES, INFORMATION AND GUIDANCE NOTES §§ 6.3, 6.3.1 (2009), *available at* http://www.cicregulator.gov.uk/guidance/Chapter%206%20-%20Feb%202010.pdf.

126. Though the MLP is not a charity, it is equally as deserving of an implicit government subsidy in the form of favorable tax treatment as a charity for reasons discussed *supra* Part III.

127. While it may seem as though investors are permitted to derive too much benefit from MLP tax treatment, many MFIs give below-market returns, if they give a return at all. Thus, investors can be viewed as making a form of charitable donation toward the redistribution of wealth MFIs engage in. *Cf.* Louis Kaplow, *A Note on Subsidizing Gifts*, 58 J. PUB. ECON. 469, 474 (1995) (discussing the optimal government subsidy for gifts, and citing the positive externality of wealth distribution as a rationale for government subsidy of both charitable and non-charitable gifts).

128. When the form was established, the CIC per share dividend cap permitted a dividend that was 5 percentage points over the Bank of England's base lending rate to social enterprises. Five percent is an overly cautious

to provide a premium that accounts for the high risk of providing a startup MLP with equity financing, as opposed to debt financing, to permit at least some recovery in the unfortunate event that the MLP is no longer able to operate. Alternatively, the MLP could set a flat cap at 20 percent, or more, of paid up value per share as CIC dividends are currently treated.[129]

For example, if an MLP is formed in the U.K. today the applicable per share dividend cap would be 21.67 percent, determined by adding 15 percent to the most recent available Bank of England lending rate to social enterprise, 6.67 percent.[130] If an MLP is formed with individual shares purchased at £5 per share, the maximum dividend per each share will be £5 x 21.67%, or £1 and 8 pence. Assuming also that the MLP has 2,000 shares for a total of £10,000 in equity financing and optimistically makes distributable profits of £24,000 in its first year of operation, a dividend paid on each share will result in an aggregate dividend of £2,160, or 9 percent of distributable profits. This would mean that a substantial 91 percent of profits, or £21,840, would remain to reinvest in the MLP and further the goal of sustainability.

The proposed second layer of the dividend cap is a yearly maximum aggregate dividend, a flat percentage applied to distributable profits for each year. The second layer aggregate dividend cap is necessary to close a potential loophole. In the case that an MLP only makes a small amount of profits in a given year but has a large number of shares outstanding, the MLP could satisfy the per share cap but ultimately pay out 100 percent of distributable profits to its numerous investors. An aggregate dividend cap responds to this loophole by requiring a minimum percentage of profits be reinvested into the MLP.

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percentage above base, because the base in England has historically been as low as 2 percent and, depending upon the success of the MLP, a 5 percent cap could result in excessive levels of profit being locked in the enterprise. *See* Community Interest Company Regulations, 2005, ch. 5, § 9 (Eng.), *available at* http://www.berr.gov.uk/files/file14631.pdf.

129. *See* Chrisanthi Giotis, *Brave Changes Will Boost Investment Into CICs*, Social Enterprise (Jan. 5, 2010), *available at* http://www.socialenterpriselive.com/section/news/policy/20100105/brave-changes-will-boost-investment-cics (last visited May 21, 2010).

130. BANK OF ENGLAND, THE FINANCING OF SOCIAL ENTERPRISES: A SPECIAL REPORT BY THE BANK OF ENGLAND 28 (2003), *available at* http://www.bankofengland.co.uk/publications/financeforsmallfirms/financing_social_enterprise_report.pdf.

To illustrate, revise the above example so that, instead of £24,000, the MLP made £10,000 in distributable profits. Adjusting the number of outstanding shares to 10,000 from 2,000 results in satisfaction of the per share cap while retaining zero profit for reinvestment into the enterprise. Thus, 10,000 shares x £1.08 per share cap equals £10, 000 aggregate distribution and no retained profits. If there were a 45 percent aggregate dividend cap in place the MLP would be maxed out at an aggregate £4,500 dividend regardless of the per share cap.

U.K. CICs have set their aggregate dividend cap at 35 percent, meaning that at a minimum two-thirds of CIC profits go back into the organization. The 35 percent cap was the result of a 2004/2005 consultation with the CIC community. Thus, it may be most prudent to permit potential MLPs as a community to determine what minimum percentage of profits should be reinvested into the enterprise. Recently, both the 35 percent aggregate cap and the CIC per share dividend cap met with disfavor in the CIC community for limiting the ability of CICs to attract investors.[131]In response, the CIC Regulator raised the per share dividend cap to 20 percent but the aggregate cap was left unchanged.[132] Nonetheless, a higher aggregate cap, possibly 45 percent or 50 percent may be more appropriate.

MLPs should also be permitted to opt out of both the per-share cap and the maximum aggregate distribution cap if they are willing to sacrifice tax exemption. This may be necessary for MLPs that have grown to a point where massive amount of profits have been made and locked into the enterprise. There should be no carryover permitted for unused dividend capac-

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131. *See* Paul Jump, *Consultation Opens on CIC Dividend Caps,* THIRD SECTOR ONLINE, Apr. 3, 2009 (predicting that after the consultation ends in June 2009 CIC Regulator Sara Burgess may raise both dividend caps due to CIC concerns that the caps and too low and limit the ability of CIC to attract investors), *available at* http://www.thirdsector.co.uk/news/rss/article/896128/Consultation-opens-CIC-dividend-caps/. Jump's prediction was only accurate with respect to the per share dividend cap.

132. *See* Chrisanthi Giotis, *Brave Changes Will Boost Investment Into CICs*, Social Enterprise (Jan. 5, 2010) *available at* http://www.socialenterpriselive.com/section/news/policy/20100105/brave-changes-will-boost-investment-cics (last visited May 21, 2010). *See also* Gareth Jones, *Regulator Raises CIC Dividend Cap to 20 Percent,* Civil Society Finance (Jan. 12, 2010) *available at* http://www.civilsociety.co.uk/finance/news/content/5838/regulator_raises_cic_dividend_cap_to_20_per_cent (last visited May 21, 2010).

ity so opportunities for dividends once lost will be reinvested in the MLP long-term unless the MLP opts out of the two-layer dividend cap and consequently its tax-exempt treatment.[133]

If the MLP form takes hold the tax exemption and special treatment of investors in MLPs will foster growth of the microfinance industry. By forgoing tax revenue from MLPs, developing countries will be giving social entrepreneurs and investors a strong financial incentive to participate in a nascent but promising industry. Simultaneously, host countries will be promoting the provision of a social good that will aid their people in lifting themselves out of poverty.

VII. CONCLUSION

The MLP provides a means to address the core of the interest rate problem. High interest rates not only harm the industry but also harm poor borrowers. Though the theory of diminishing marginal returns to capital suggests that poor borrowers can in fact "afford" to pay higher interest rates,[134] if the goal of microfinance is poverty alleviation then taking a large percentage of the profits of poor entrepreneurs seems contrary to that goal and the practice should be stopped.

On policy grounds, the MLP, a for-profit entity that improves social welfare by providing financial services to the poor and redistributing wealth, is equally as entitled to tax exemption and implicit government subsidy as a nonprofit charity. Though not without its problems, microfinance holds great potential for poverty reduction. A goal that host governments should support. Tax exemption for MLPs can further this goal by providing a method for MFIs to expand their reach to the poorest who remain without opportunities to create and grow wealth. Further, MLPs are deserving of government subsidy

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133. The choice to opt out of MLP status in order to distribute built-in profits might give investors an incentive to game the system in order to defer taxes. Investors could collude and agree not to issue any dividends throughout the life of the MLP and agree to make one large distribution of profits after opting out of MLP status. If successful, investors could collect interest revenues on their investment tax-free, effectively holding on to the time value of money for years, before paying taxes at a time of their choosing. Host countries would be well advised to close this potential loophole by imposing a penalty, such as a higher tax rate, on distributions by former MLPs that exceed a predetermined cap.

134. ARMENDÁRIZ & MORDUCH, *supra* note 2, at 5.

for their role as a conduit for redistribution of the world's wealth from the richest to poorest.[135]

The reduction of poverty is also relevant to international development goals. If it is true that development needs the support of government institutions,[136] government can provide that support by creating a legal entity like an MLP, by providing the regulatory framework needed to support it, and by subsidizing the reduction of poverty with tax exemption for both the MLP and those willing to take a risk and invest in it.

Many MFIs and related organizations are well-positioned to receive the benefits of the unique legal status that the MLP will provide, so the timing is right. MFIs established as nonprofits that have become profitable and have developed the structure to transition to for-profit status are prime candidates for organization as an MLP. Organizations like the Grameen Foundation that help funnel capital to MFIs and aid nonprofits in attaining profitability are also great candidates for tax exemption.

Thus, MFIs that are ready to transition to for-profit status should be given a financial incentive to do so with the MLP hybrid entity and leave the charitable donations to new startup MFIs who are more in need of charitable funds.

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135. The nonprofit MFI-esque micro-loan conduit Kiva is an example of how microfinance helps redistribute wealth by providing a mechanism that permits anyone to loan money directly to micro-borrowers. *See* Kiva, About Kiva, http://www.kiva.org/about (last visited Apr. 14, 2010).

136. Academics disagree on whether institutions are a prerequisite to economic development. Economist Bill Easterly advocates the necessity of institutions to economic development. EASTERLY, *supra* note 110, at 168-9, 192, 237-9, 252 (offering a number of examples of governmental and societal institutions necessary to achieve broader development goals). *Accord* DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE, 107-17 (1990); Dani Rodrik et. al., *Institutions Rule: The Primacy of Institutions Over Geography and Integration in Economic Development* (Nat'l Bureau of Econ. Research, Working Paper No. 9305, 2002), *available at* http://www.nber.org/papers/w9305. By contrast, Professor Jeffery Sachs stresses the importance of other factors like the alleviation of poverty and disease, although he does acknowledge that institutions have a role to play in development. Jeffrey D. Sachs, *Institutions Matter but Not for Everything*, FIN. & DEV., June 2003, at 38.