Accepted Manuscript

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PII: S0304-3878(15)00093-0
DOI: doi: 10.1016/j.jdeveco.2015.08.002
Reference: DEVEC 2013

To appear in: *Journal of Development Economics*

Received date: 13 March 2013
Revised date: 21 July 2015
Accepted date: 5 August 2015

Optimal (Partial) Group Liability in Microfinance Lending*

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First version: July 2009

This version: July 2015

Abstract

This paper develops a model of group borrowing that incorporates partial group liability, where borrowers are penalized if their group members default but are not held responsible for the entirety of the failed loan. The model illustrates a trade-off of group liability lending: while higher levels of group liability increase within group risk-sharing, if liability is too high, borrowers strategically default. The model predicts the existence of an optimal partial liability that maximizes transfers between group members while avoiding strategic default. Consistent with this prediction, loan officers from a large microfinance institution in southern Mexico who rarely allow one group member to repay while the other defaults achieve substantially lower default rates than loan officers for whom the practice is commonplace or for those for whom it has never occurred. Structural estimation using repayment data suggests that while a partial liability below full liability may reduce default rates, the incidence of strategic default is rare.

Keywords: microfinance, group lending, liability, strategic default, Mexico

JEL Classification: G11, G21, O12, O16

*I would like to thank Beatriz Armendariz, Dean Karlan, Maitreesh Ghatak, Tim Guinnane, Mark Rosenzweig, and Chris Udry, as well as seminar participants at Yale University, the London School of Economics, the University of Cambridge, the World Bank and three anonymous referees. I would also like to thank the staff at Grameen Trust Chiapas and Innovations for Poverty Action for their assistance with the data. This material is based upon work supported under a National Science Foundation Graduate Research Fellowship. All errors are my own.

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