

# Socially Responsible Investors and the Microentrepreneur: A Canadian Case

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**ABSTRACT.** Socially responsible investors buy financial securities with two goals: to make a market-based return, and to make companies act in a more socially responsible way. Most research on socially responsible investment deals with investing in stocks traded on major exchanges. We add the case of loaning small amounts of funds to microentrepreneurs through a discussion of a particular case. The case is that of Calmeadow which, in conjunction with the Royal Bank of Canada, set up a microlending project in rural Nova Scotia (Canada). Using Hirschman's analysis of "exit" and "voice", we show that while socially responsible investors may make market-based returns for their investments in stocks traded on major exchanges, they have no effect on corporate behaviour because their action consists of exit, and they are easily replaced by other investors. They attain their first goal but not their second. On the other hand, in the Calmeadow/Royal Bank of Canada case, we see that those who lend money to microenterprises can more easily use voice. The relative power difference between the lender and the microentrepreneur enables the lender to make the microentrepreneur act in a more socially responsible way, although only marginally. But because of the market imperfections existing in this case (the very high transactions costs associated with administering small loans), the lender concluded it could not attain a market rate of return. In this case, then, the lender attained its second goal but not its first.

## **Introduction**

Two key questions raised about socially responsible investment (SRI) are whether the investor can make a market-based return and whether she can affect firms' behaviour, making them act in a more

socially responsible way (see, for example, Haigh and Hazelton, 2004, or Rivoli, 2003). We are going to define socially responsible investment as being distinguished from other kinds of investment strategies by this twofold aim of making a market return and having an effect. This definition distinguishes socially responsible investment from ordinary investment (which shares the first goal but is indifferent to the second), from investor activism (which shares the second goal but is indifferent to the first), and from what Sparkes (2001) calls "socially directed investment" (which does not share the first goal but does share the second).

We are asking, then, whether there are conditions currently existing where the socially responsible investor can hope to realize both of her aims.

## **Two extreme cases**

To examine this question, we will look at two extreme cases. First is the case of buying a portfolio of stocks which trade on major stock exchanges. Most of the published research into socially responsible investing deals with this case. As a contrast, we will look at a particular programme in Atlantic Canada – the Calmeadow Foundation/Royal Bank of Canada microlending project in the province in Nova Scotia in the 1990s. Our two cases differ in the size of the company (to be listed on a major exchange, the company has to be large, but microenterprises are small by definition) and the type of security purchased (stocks in large companies vs. bonds of very small companies – when the Bank loans to a microentrepreneur, the IOU it receives is formally a "bond").

### **Buying stocks in large companies**

Important issues when one wants to buy a portfolio of socially responsible stocks have to do with the choice of stocks which would qualify as socially responsible, the returns these stocks yield, and whether the socially responsible investor's buying (or selling) these stocks will affect company behaviour.

To determine if a company counts as being socially responsible, generally one checks if it passes some exclusionary screens and scores high enough on some qualitative screens. There are many sources for judgments on companies: one of the most highly cited is KLD Research & Analytics, Inc., which has several benchmark ethical indices. By following the KLD ratings, investors can construct a widely diversified portfolio: the DSI (Domini 400 Social Index) contains 400 stocks, including over half of the stocks which figure in the Standard & Poor's 500 index, while the BMSI (the Broad Market Social Index) contains even more stocks – KLD Research & Analytics, Inc., reports that “As of its January, 2001 launch, the KLD BMSI comprised roughly 2200 companies that pass multiple broad-based environmental and social screens” (KLD website). Kurtz (1997) notes that although one would think that socially responsible investors would incur a cost because they cannot be fully diversified, in fact, there is no evidence in the data that they do incur any such cost. He speculates that the reason may be that so many stocks pass the screens.

The BMSI exclusionary screen rules out companies which derive revenues from gambling, from manufacturing alcohol or tobacco products, or from producing nuclear power, as well as companies which derive significant revenues from producing military weapons. Qualitative screens have to do with community relations, employee relations, workforce diversity, environment, human rights, and product quality and safety.

Once the investor chooses a portfolio of acceptable stocks, the two questions of earning a market-based return and having an effect remain. Haigh and Hazelton (2004) report that (p. 61):

Commonly, SRI fund managers make two claims. The first is that SRI funds can and will influence companies to change their operations. The second is that the financial returns of SRI funds are no differ-

ent from those of conventional investments in the short-term and are likely to be superior in the long-term.

There have been numerous studies dealing with whether the second claim (our goal #1 – earning a market return) is supported. Many of these studies have been empirical, but the theoretical issues about expected returns have also been dealt with in depth. There have been fewer studies dealing with supporting the first claim (our goal #2 – changing corporate actions), and virtually no empirical studies, although theoretical arguments have been advanced on why the mere act of buying and selling stock would affect corporate actions.

Results seem to be that socially responsible investors do earn a market return: socially responsible investment doesn't “cost”, but it also doesn't pay more than ordinary investment of the same level of systematic risk (see Kurtz, 1997). Haigh and Hazelton (2004) point out that returns on SRI funds are highly correlated with those on conventional funds, perhaps because so many stocks pass the screens (p. 65).

One major argument for why the mere buying and selling stock by socially responsible investors would affect corporate behaviour has been worked out by several researchers (Angel and Rivoli, 1997; Heinkel et al., 2001; Rivoli, 2003; Wall, 1995). When socially responsible investors buy stock in socially responsible firms and boycott the stock of other firms, the cost of capital of SRI firms will become lower than that of the other firms. But if the cost of capital were lower, then the rates of return on socially responsible stocks would be different (in risk-adjusted terms). Unfortunately for this argument, returns seem not to be different. Haigh and Hazelton (2004) attribute the failure of socially responsible investors to affect companies' action to the fact that while the amount invested in SRI funds is growing, the percentage of the total market they represent remains very small (p. 61). Sparkes and Cowton (2004) also say that the fact the socially responsible investors are acting alone, and with different notions of what is socially responsible, prevents their having an effect, although they note that if investors could coordinate (particularly if institutional investors could coordinate) they might, eventually, be able to have an effect. Haigh and Hazelton (2004) agree with the need for SRI fund

managers “to act in concert to achieve common objectives” (p. 68).

Socially responsible investors who buy portfolios of stocks which trade on major exchanges seem, then, to be having no effect: they get the same risk-related returns as other investors, and they don't affect firms' behaviour. Sparkes and Cowton (2004) say that “the problem of passive investment involving avoidance and, perhaps, more positive criteria, is that as long as it is on a small scale it is unlikely to have any impact on larger, heavily-traded companies” (p. 48). This points out that there is a problem of relative size (the investors are financially small, while the firms are very large), which is not helped by the lack of coordination among investors, nor by their silence. Hirschman uses the stock market as an example of where an “exit” strategy (as opposed to a “voice” strategy) is most likely to be used (Hirschman, 1970, p. 45), because it is easy (due to the liquidity of the market and the large number of potential buyers), and because voice is unlikely to work (due to the difference in power between the single investor and the firm). But an “exit” strategy would have little or no effect on firms. Dissatisfied shareholders simply sell their stock to someone else on the secondary market, quietly, and the firm remains uninvolved and unaware. Voicing dissatisfaction with the behaviour of the firm is no more likely to have an effect. Haigh and Hazelton (2004) note that “shareholder resolutions have been largely unsuccessful to date” (p. 67), partly because individuals, acting alone and without coordination, attempting in an *ad hoc* manner to affect the decisions of individual firms, simply are powerless against united (and wealthy) boards of directors. As Hirschman notes, voice is costly and will be avoided where exit is easy.

### Microenterprises

In this paper, we will extend the question about the ability of socially responsible investors to achieve their goals to the case of investing in microenterprises, largely in an attempt to see if changing the scale of the investment (from large to small) and changing the type of investment (from stock to loans)

will change the results. Unfortunately there has been very little (if any) research into socially responsible investment in microenterprises, where such investment is interpreted as having the two goals we mention. There are cases of socially directed investment where the investor intentionally accepts below-market rates of return (e.g., the case of the Triodos Bank – see Cowton and Thompson, 2001). But actual investigations of socially responsible investors attempting to earn market rates of return while simultaneously deliberately attempting to affect the decisions of microentrepreneurs, making them act in a more socially responsible way, are lacking.

There are many problems in dealing with microenterprises. The field is potentially vast, and not always well defined. There are problems of typology, government intervention, developing vs. developed countries' cultures, and goals of various microfinancing projects. To make our analysis more concrete, we will concentrate on a particular case of microfinancing in Atlantic Canada, an economically depressed, mainly rural area. By concentrating on this particular case, we may arrive at conclusions which are not generalizable without further research, but our conclusions may serve to point the way to the questions to ask in that research.

There is some, although not much, research on entrepreneurial ethics. Some of the questions asked are at a macro level, such as whether there is a value to society of encouraging an entrepreneurial spirit, or whether there would be a problem of wealth distribution if there were to be more entrepreneurs. Some may be at a more micro level, such as whether people with the personality type needed for entrepreneurship would act in a socially responsible way. We will abstract from all such questions. We will also abstract from the fact that some investors in microenterprises may see the investment itself as being socially responsible because it would lead to a more entrepreneurial society, or it would correct social ills due to discrimination or regional inequality. We will instead attempt to see if the investor's action of putting her money in a microenterprise will permit her to affect how the microentrepreneur will act, pushing him to act in a more socially responsible way (in the eyes of the investor) than he otherwise would have. And we will assume that the microentrepreneur, like the corporate manager, will act to

maximize the wealth of the owner of the firm (in his case, his own wealth).

### **What's different with small firms? The case of microenterprises**

Buying stock in big firms accomplishes aim #1 (market returns), but not #2 (effect on firms). Exit in an efficient market has no effect on managerial decisions.

At first it may seem that the move from the case where the socially responsible investor buys a stock portfolio, boycotting certain stocks, to one where she loans money to a microentrepreneur is merely a move from stock to bonds (in the generic sense used in academic finance) and from large to small. These moves, however, have potentially large consequences for the ability of the socially responsible investor to achieve her two aims.

Large corporations with publicly traded shares are involved in large scale, complex business activities and are often engaged in global markets, many formally regulated, and dependent on large scale formal financial institutions, all formally regulated, for their financial life.

At the opposite end of business ecology are niches involving the smallest of enterprises – conventionally known as microenterprises. These very small scale enterprises are much more numerous than large corporations. They are usually less organizationally complex consisting of own account self-employed, small family enterprises, proprietorships, partnerships or corporations with few employees (five or fewer is often used as a cutoff point – Atlantic Canada Opportunities Agency, 1991, p. xviii). Since size is often used to identify microenterprises, these firms may vary in wealth and power. Dawson et al. (2002) note that many microenterprises are run by professionals such as dentists, software engineers, etc. (in their sample 69% of the microentrepreneurs had a degree or diploma). At the other end of the wealth/power scale are the extremely marginal operations in economically depressed areas, by people with low levels of skills – operations which need support from government or NGOs in order to get started or to continue. While dentists and software engineers may find banks very willing to loan the relatively large sums they need to set up their practices, more

marginal potential microentrepreneurs find that they have difficulty accessing sources of conventional business capital – either credit or equity. We will concentrate on loans to this poorest segment of the smallest firms in the economy for our analysis of socially responsible investment in order to have the greatest contrast possible with the standard case of investment in the stocks of large firms.

The size difference and the difference in the nature of the financing bring with them important differences in market efficiency, liquidity of investment, and the nature of the relationships – particularly the power relationships – between the investor and the company in which she invests. Sparkes (1999) mentions other important differences, such as the limited sources of financing available to small businesses. These real differences change the efficacy of voice as opposed to exit, making voice more likely.

At the same time, they also bring with them a limitation on the kinds of socially responsible activities the investor can hope to influence, simply because of the smaller size of operation of the microenterprise.

### **Microlending as investing vs. microlending as a social programme**

Microlending to the extremely small scale businesses in economically depressed areas or to members of particularly disadvantaged groups tends to be a combination of economic development and welfare.<sup>1</sup> In addition, there is often a formalized business training component, where participants learn at least to make a business plan. In other cases there is an organization and training component in which participants learn to function in borrower groups, making and assessing each other's loan applications and performing various other loan administration functions for themselves.

Beginning in the developing world with experiments such as the Grameen Bank in Bangladesh in the 1980s, both government agencies and non-governmental development organizations have experimented with programmes offering very small amounts of business credit to microentrepreneurs who function outside the conventional markets for credit and investment or who are poorly served by

the conventional financial institutions in their country. Use of microcredit programmes as a tool for community economic development subsequently spread to the industrialized world including Canada (Rhyne and Otero, 1994, pp. 11–12). The motivation of such agencies and NGOs is typically social in nature as opposed to that of maximizing profit earned on their loan capital. They seek to affect the income generating potential of the microentrepreneurs to whom they lend, as well as the economic wealth of their households and their communities' economic development.

Despite their importance, we will abstract from all these questions of the non-financial aspects of microlending programmes for our analysis of the ability of socially responsible investors to realize their two aims of getting a return and having an effect. As before, we abstract from the social value of creating an entrepreneurial society. And we'll abstract from the value of empowerment of the poor, as well as from the value of helping the poor or those suffering discrimination. We'll pretend that it is possible to separate out the lending activity from all other aspects of the programmes. Servon and Doshna (2000) claim (p. 190) "that microenterprise programs spend the bulk of their resources on training and technical assistance." But we shall still limit our investigation to the questions of whether the lender to a microenterprise can get a market return, and whether she can also affect what the microentrepreneur will do, making him act in a more socially responsible way than he would have.

### **The Calmeadow Nova Scotia/Royal Bank of Canada example**

Microlending started in LDCs but has moved to North America. There are many more projects in the U.S. than in Canada, but we will look at a programme in eastern Canada. Atlantic Canada is a region with a depressed economy and with low education levels. As some authors note, microlending projects must respect the culture of the people in the region, and it is not possible to simply transfer a programme from Bangladesh to America. Similarly, Atlantic Canada is different from the U.S., particularly because of its relative lack of racial minorities, and, generally, of a diverse population, due mainly

to poor economic conditions which have persisted for well over a century and to lack of immigration. The region is very rural with no major cities: provincial populations range from less than 150,000 in Prince Edward Island to barely 1,000,000 in Nova Scotia, the largest Atlantic province by population.

The microlending project we propose to examine was run by the Royal Bank of Canada in collaboration with Calmeadow (registered as the "Calmeadow Foundation" prior to 1996 and as "Calmeadow" after 1996). The Bank is one of Canada's largest, with operations across the country. Calmeadow is headquartered in Toronto, Canada, and operates in several provinces. The project was run in many rural areas of Nova Scotia (although much of the activity in the last 3 years of the project was in the Halifax-Dartmouth area, the main urban centre of the province). Calmeadow started work in the province in 1991, but then established a stronger relation with the Royal Bank in 1994 which ran to 2000. Calmeadow was able to borrow C\$1 million from the Bank at 1% under prime, which it could then use for loans. Participants were often people who were unemployed or had bad credit histories. Unlike the U.S. case, most participants were Caucasian (76%), with smaller numbers of African Canadians (21%), and very few first nations people. Loans of up to C\$5000 were made available for both business startups and existing enterprises, starting with loans of C\$1500 and then rising with experience.<sup>2</sup> The Calmeadow Nova Scotia project initially employed the peer group lending model, as developed by the Grameen Bank in Bangladesh. In the last 3 years of the project individual lending as well as peer group lending was employed. This paper focuses strictly on the peer group lending side of the project. Borrowers were organized into groups of anywhere from 4 to 10 enterprise owner/operators and were held jointly responsible in some way for the performance of individual members. Typically, for example, delinquency or default by one member of a borrower group in making payments of interest and principal on his loan led to all members of the group being cut off from further credit. Interest rates were set at prime plus 2% or a bit higher.<sup>3</sup> In addition, clients were to establish chequing accounts at the Royal Bank for their enterprises and channel disbursements and receipts with regard to their loans and for their enterprises more generally through the

accounts. Thus the Royal Bank handled the transactions around loan disbursement and repayment and also provided the programme field staff and the borrowers' groups with information on borrower repayment and delinquency. Like many microlending projects, this project had multiple aims, and, like virtually all such projects, also had a training aspect – in this case the training in group organization and business loan application assessment required to establish the borrowers groups and have them function effectively. Calmeadow reports that “Calmeadow has provided 713 loans to 511 borrowers for a total of \$1,243,496, an average of \$1744 per borrower. Of this sum, the value of loans that have been written off is a mere \$148,000, only 11.9% of the total disbursement amount.” (Friendly and Wright, 2001)

### **The case of microlending – Goal 1: Rates of return**

Taub (1998, p. 58) says that successful microcredit programmes in Asia lend at 12 points above the going rate, but that this is still much lower than what the Asian village lender charges. Eversole (2003, p. 182) says that in Sucre (Bolivia) “... microloan interest rates ranged from 24 to 48% per year in 1997 – compared with the 18% annual rate charged by banks ...” (Eversole gives as a reason for the range, the fact that the rate is partly determined by whether the loan is in US dollars or local currency.) But Eversole (2003) also says that (p. 182): “Although microfinance organizations charged higher interest rates compared with banks, their rates were much less than what informal marketplace lenders charged – 20% interest for 40 days, or around five times as much.”

The Royal Bank, in the Calmeadow project, charged rates of two points or so above prime. This is higher than the rates offered to the bank's best clients, but lower than credit card rates or most unsecured personal loans. In fact, these rates would tempt even established small businesses. Eversole (2003) states (p. 186) that in the Bolivian case, some of the microentrepreneurs felt the microlenders charged too much – a view that was reinforced by the fact that they were aware there was one NGO involved in microlending in the area which was charging only 1% per month (or 12% per year).

Nevertheless, the microfinance organizations had no trouble finding microentrepreneurs willing to accept loans at the rates they quoted.

It's hard to tell if a rate of prime plus a few points is a market rate of interest. The loans are neither totally interest-free nor are they as usurious as credit card rates. The problem is that the loans in microlending programmes are made to people who Kibria et al. (2003, p. 57) characterize as “persons with unstable and less than stellar employment and credit histories.” Despite the very low rates of default reported by the Grameen Bank and some other microlending projects, in general, these loans would not be made at all if there had not been a programme set up.

Where a potentially valuable exchange would not be made on a market, we have a market failure. The cause of the failure in the case of microlending is that banks find that administering very small loans is just too expensive. Johnson (1998a, p. 12) notes that banks like to set \$50,000 as the minimum business loan, but starting a microenterprise often costs less than \$5000. Banks however spend the same or even more effort on small loans, particularly since the microentrepreneur often needs help even setting up a business plan. But besides the transactions costs involved in dealing with very small loans, there are many other costs in microlending programmes because of the many different activities, including training, associated with these programmes. Kibria et al. (2003) note that in the project they examine (Working Capital), the participants say the main value of the project for them was not the loan itself, but rather it was establishing a credit history, receiving business training, and developing relationships and networks (p. 42). Separating the costs of running the whole programme from the costs of managing the small loans is difficult, particularly since sometimes the training consists of teaching the microentrepreneurs how to set up a business plan and apply for a bank loan, and sometimes it pertains to organizational skills. But let's assume it is possible to separate out the elements of the microlending programme. Then the question is whether banks would lend very small amounts at prime plus 2% to very uncertain microentrepreneurs. The answer is almost certainly “No.”

The market failure is caused by the high transactions costs associated with administering small,

risky loans. One way to reduce these costs is by using a peer lending group. Originally, assignment of joint responsibility through a peer group was instituted as a risk management device. However, the peer group has become a device for offloading other credit transaction costs to the borrowers (see Johnson, 1998a, p. 15; Taub, 1998, p. 64). Instead of the bank's hiring a loan officer to review a prospective borrower's credit application, to monitor his or her subsequent credit repayment performance, and to take action to ensure repayment obligations are met, the peer groups were assigned many of these functions either in whole or in part. The labour involved in performing them was part of the costs of the loan capital to which they are given access.

The peer group members were willing to bear the costs in time and inconvenience of acting as credit administrators primarily because microcredit programme clients typically operate in capital markets that do not provide them with the investment they think they need for their enterprise – neither equity nor credit. The microcredit programme is the only investor in town extending business credit to them. Clients of the Calmeadow programme included a few on social assistance, many with poor credit histories or no credit histories, and many with limited personal assets that would serve to secure personal loans or lines of credit that could be turned to sources of credit for their enterprises (Marshall and Harold, 1994). The result was a certain amount of dependence on the microcredit programme as a source of credit unavailable elsewhere at any price. Hence, the price as a package of time and inconvenience and interest rates at a couple of points above prime was acceptable.

In setting up the programme, Calmeadow's hope was that, over time, the programme would be self-sustaining and would no longer need the subsidy provided at the beginning. But to get a market rate of return on its investment, Calmeadow needed to offload the transactions costs somewhere. Unfortunately, as it notes in its final report,

“Finally, it must be recognized that stand-alone microlending is not going to be commercially viable within the framework of a fair interest rate policy. With no offsetting revenues from other financial products, the full burden of the costs of microlend-

ing falls solely on the credit activities of the organization. The resulting gap requires ongoing subsidy, which is difficult to secure in the absence of potential financial viability.”

Typically, economists would say that market imperfections should be corrected by the government. If, however, the transactions costs can be picked up voluntarily by some other group, then the transactions, which are mutually satisfactory to the bank (if they get a market rate on the loan) and to the microentrepreneur (if the market rate they pay, plus the time and effort of administration add up to less than what they would otherwise pay) will take place. Of course, it sounds like even offloading costs in the Calmeadow Nova Scotia project didn't really cover all the costs. And even if it did, as Taub (1998) notes, some potential clients of microlending balk at all the time involved. They just want a loan, without having to sit around administering the problems of groups of strangers. Taub (1998) notes that applying the peer group lending model in the U.S. does not always work as well as in Bangladesh. If this is so, then while offloading transactions costs onto clients may satisfy the lender, it still does not give us an efficient market. Transactions which could have taken place won't, merely because of the transactions costs associated with very small loans to people with bad credit histories.

If government or foundations will pick up these costs, then loans to the poorest of microentrepreneurs could take place at market rates. This means, however, that these types of loans do not appear to be self-sustaining at the present time, solely because of a market imperfection. As Calmeadow reports on its website, its experience with Canadian microlending projects leads it “to the conclusion that stand-alone, exclusively targeted, micro-credit operations are not commercially viable in fully developed countries. The absence of a critical mass of customers or offsetting income from other services make it impossible to cover all costs within the bounds of a fair interest rate structure.” A socially responsible investor who wanted to make a market-based rate of return could not presently loan to the poorest of microentrepreneurs and expect to make a market rate, after covering her transactions costs.

### **The case of microlending – Goal 2: Having an effect**

A high proportion of microenterprises operate in the informal economy avoiding various regulations to which they might otherwise be subject. The regulations they avoid may include labour legislation concerning wages and safe working conditions, business registration, zoning restrictions with regard to commercial locations, licensing requirements of various sorts and even business tax obligations such as higher tax rates on business properties. It may even involve product/service quality standards (Versluysen, 1999, pp. 28–36). Servon and Doshna (2000, p. 194) note that: “Working in the formal economy means filing tax returns; it also may mean completing various license, certification, and inspection processes.” And they add (p. 194) that one reason for the training that is ubiquitous in microlending programmes is that the microentrepreneur has to work in the formal economy “which requires greater economic literacy than does the informal economy.”

Although Servon and Doshna (2000) claim that the informal sector in the U.S. is not as large or as important as in the developing world, the relative importance of this sector is higher in less developed areas, such as Atlantic Canada, where regulation is fairly weak and provincial governments are not always able to enforce rules. Bergbusch et al. (2000, pp. 7 and 13) note that the prevalence of the ‘underground’ economy in some of the areas where the Calmeadow Nova Scotia project operated meant significantly fewer borrowers subscribing to its peer group lending method. A significant number of microentrepreneurs preferred the advantages of operating in the informal economy and realized that participating in the project would move them into or closer to the formal economy. The small scale of a microenterprise increases the likelihood that it can be successful in operating below the radar of authorities charged with enforcing business regulation. In some jurisdictions regulatory legislation, procedures, and policies sometimes incorporate explicit exceptions for very small scale enterprises thereby anticipating the difficulties of enforcement in this sector of the business world compared to the lack of return from efforts at across-the-board regulation.

The tendency of many microenterprises in both the industrialized and the developing worlds to operate in the informal sector has been a source of concern to those involved in microenterprise development. In the developing world, working conditions of labour employed in informal enterprises have concerned the ILO and other UN agencies. In Atlantic Canada the possibility of microenterprises avoiding tax obligations and other regulation has concerned government development agencies. This concern sometimes leads microenterprise development programmes to formally adopt a secondary objective of moving very small enterprises from the informal to the formal sector of the economy. If the microenterprise development programme offers microcredit as one of its services, it has a powerful tool to influence these small enterprises to move in the direction desired. In the Calmeadow Nova Scotia programme, clients were encouraged to register their businesses provincially and those doing so increased over time as a percentage of the total number of client enterprises. Cooperative advertising and marketing efforts undertaken by the programme’s clients required them to establish recognized business identities and to register with local business associations. The programme did, in various ways, influence its microenterprise clients to operate more openly and visibly than had typically been the case previously. Therefore they were more likely to be subject to regulation they would previously have avoided.

By strongly encouraging its clients to register and to follow already existing laws and regulations, the lender in the Calmeadow case played a role analogous to that of the socially responsible investor. We should admit, however, that this is a fairly low level of social responsibility.

If one looks at the screens developed by KLD Research & Analytics, Inc., we see that it would be hard for a socially responsible investor in the smallest of microenterprises to achieve much more than to bring these enterprises into the formal economy. KLD screens out tobacco, alcohol, gambling, and companies which derive more than 2% of revenues from the production of armaments. These are not activities of microenterprises which hope to get started with less than \$5000. Taub (1998) claims that the really small microenterprises are probably limited to local services, such as hairdressing. In addition,

KLD gives a qualitative ranking on issues of community relations, employee relations, workforce diversity, environment, human rights, and product quality and safety (see the KLD website). For community relations, KLD looks at charitable giving, something that small firms which have trouble raising small sums are unlikely to be able to engage in. For employee relations, KLD looks at employee benefit programmes, but really small microenterprises often have no employees, and even where there are some employees, it is hard to institute programmes such as flextime or stock options. For workforce diversity, KLD is concerned about women and minorities in management, but small firms run by an owner-operator are either run by a woman or a minority person, or they aren't – there is nothing the microentrepreneur can do about this. Some microentrepreneurs might be able to do something about the environment, just as households can, particularly where they work in fields where toxic chemicals are used (dry cleaning, beauty shops, print shops, etc.). But environmental laws cover many of these issues, so that bringing the microentrepreneur into the formal economy, where the rules are already set, may actually do a lot. Similarly, KLD's concern with human rights, where they talk also about fair wages, might be handled just by bringing the company into compliance with provincial labour law. And, product safety is also covered by laws and regulations, so formalizing the activities of the microenterprise may help.

Eversole (2003) notes for the Bolivian case that bankers are in a position of power while the poor person getting the loan is socially disadvantaged compared to the banker. The same was true for the Calmeadow Nova Scotia project. For the lender, the loan of C\$5000 or less is a very small sum, but for the borrower it is more important. Taub (1998) notes that the importance for the borrower is probably lower in North America than in Bangladesh because of the social safety net, which, in fact, is stronger in Canada than in the U.S. Nevertheless, because of market imperfections, the microentrepreneur who is asking for the loan has few alternatives, while the bank has many. The clients of the Calmeadow Nova Scotia project typically had some education and skills, but many had "either a bad credit history or no credit history, making it difficult for them to approach traditional lenders" (Bergbusch

et al., 2000, p. 6). This means the banker/investor can exit, either by refusing future loans or by calling in this loan. The borrower has few or no alternatives.

Exit in the case of the investor is different from the case of the consumer, who, as Hirschman showed, disappointed with a decline in product quality, stops buying from one company, and starts buying a competitor's product. The consumer is on a more or less equal footing with the company. If she doesn't like what the company does, she exits. Exiting is cheap, or even costless, while voice is unlikely to work. But, for the lender, voice will work because of the imbalance of power. In the Calmeadow Nova Scotia case we see that the Bank is wealthier than the microentrepreneur, it can call in the loan when it wants (forcing the entrepreneur into bankruptcy), and, because of the market imperfection, it is the only lender.

It appears, then, that in the Calmeadow Nova Scotia case, the lender succeeded in achieving its secondary aim. It made the microentrepreneurs act in a more formalized way than they would have otherwise done, i.e., they started to obey already existing social norms, enacted as laws or government regulations. This seems like a fairly low level social objective, and it is linked to a financial objective (because of the risks of fines for firms which are constantly close to bankruptcy). But, nevertheless, the lender succeeded because of its relative power in dealing with the microentrepreneurs, who weren't, in any case, really opposed to acting in this way. And the lender succeeded because it voiced, somewhat informally, its desires.

## Conclusion

Socially responsible investors who want to make a profit (i.e., a market-based return) as well as to make a difference (affect firms' behaviour so that they act in a more socially responsible way) are attempting to attain two goals which may be contradictory.

Most research in socially responsible investment deals with buying and selling stocks of large companies which trade on major exchanges. This research has shown that the rates of return one can expect from socially responsible portfolios of stock are the same as one would expect from any portfolio

with the same market-risk characteristics. There is no cost to socially responsible investment. But socially responsible investors have no effect on firms' behaviour. Their action is really one of exit – if they don't like what a firm does, they sell its stock, quietly, on the secondary market. Silent exit is unlikely to ever have any effect.

In this paper, we attempt to look at a case on the opposite end of the spectrum, namely, investment in the smallest of small firms. This investment would ordinarily come as loans, rather than purchase of stock. Because of market inefficiencies, the loans are relatively illiquid, making exit harder. But because lenders are wealthier than the borrowers (the microentrepreneurs), they are more powerful. They can afford to exit (call in the loans), since the losses are not that important for them. But they can also use voice. The powerful are always listened to, and, in any case, what the investor is asking for is probably something the entrepreneur is willing to do. In fact, it appears that, in the Calmeadow Nova Scotia example, Calmeadow and the Bank were able to move entrepreneurs from the informal towards the formal sector of the economy. Because of the very limited range of actions of the smallest of the small, it is unrealistic to expect to accomplish much more. But gaining market rates of return seems much harder. The capital market imperfections – mainly the extremely high transactions costs of managing large numbers of extremely small loans, as well as the need to provide training – make it impossible for investors today to realize market rates of return.

## Notes

<sup>1</sup> We should note that as Taub (1998) and Johnson (1998a) point out, the very poorest of the poor may not be the main clients for microlending in North America. Taub (1998) shows that the people in the group he studies often had working spouses (pp. 66–67), but that welfare recipients found the barriers to participation (loss of benefits including medical benefits) were too high.

<sup>2</sup> The above details come from Friendly and Wright's (2001) report, which can be found at Calmeadow's website at <http://www.calmeadow.com>.

<sup>3</sup> The details on interest rates come from an interview with Gord Cunningham (2004), the field officer in charge of the Nova Scotia program from 1991 to

1997, conducted by R. Wehrell, April 19, 2004. Cunningham says that the nominal interest rate during the time he was in charge was 2 points above prime, but at different times they implemented measures to increase effective interest rates, such as a 5% of loan administration fee.

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