Using Microenterprise Programs in the Rural United States

George **Wallace**

Microenterprise programs have received a great deal of attention in the United States in recent years as the number and scope of such programs have grown. Unlike most government programs aimed at existing businesses, these programs are frequently directed at the chronically unemployed, poor single parents, and welfare recipients. In many cases, they provide access to loans and technical training for the express purpose of creating a new class of small-scale, economically self-sufficient entrepreneurs no longer dependent upon public support.

Microenterprise programs currently operate in both developed and developing countries. A firm's "micro" status depends on ownership structure, size of business in terms of employees or sales, and access to financial capital. The designation has been applied rather loosely to include firms that employ more than 10 people, with sales of over $100,000 per year and capital needs above $250,000 per year. This article focuses on smaller enterprises that are either sole proprietorships, partnerships, or family businesses. They typically have fewer than five employees and generally lack access to the commercial banking sector. Their debt capital needs can usually be met with loans under $15,000.

According to the Directory of U.S. Microenterprise Programs (1997), programs have grown from only a few in 1985 to 266 in 44 States in 1996 (fig. 1). The Directory reports that microenterprise programs in 1995 served 36,211 microbusinesses with loans and technical assistance; of these, 13,787 (or 38 percent) were startups. Loans made to individuals averaged $9,248 while those made to peer-lending groups averaged $1,597 per group member. Loan sizes varied from $1,000 to $500,000. Seventy-five percent of programs had a client base that was majority women. Microenterprise programs serve both rural and urban counties, but data on program operation, services, or benefits are not available separately for rural and urban areas. This study draws from the international experience and our knowledge of rural areas to help identify attributes of a successful microenterprise program in rural areas.

Because microenterprise programs assist people who are often new to business, it is more difficult to develop operational guidelines for eligibility and loan purposes, for example, than in financial assistance programs designed to help more established businesses. Practitioners and donors continue to learn hard lessons about the need for paying close attention to performance standards and developing more useful and reliable measures of program effectiveness. The risks are considerable with these programs. In their study of international development finance programs, Adams and Von Pischke conclude that managerial ability, product prices, asset control, and input costs are likely to be more serious constraints to business success than credit. While not all international lessons apply to microenterprise clients in the rural United States, many do. Knowledge of what has been successful internationally will help to shape more effective and efficient U.S. microenterprise programs.

Microenterprise Is a Successful Development Tool Internationally

Of relatively recent origin (the 1960's), most modern microloan programs follow the model developed by the Grameen Bank in Bangladesh. Program operation

George Wallace is a financial economist in the Food Assistance and Rural Economics Branch, Food and Rural Economics Division, ERS, USDA.

varies, depending on geographic location, clientele served, and mix of funding sources.

In the Grameen Bank model, virtually all startup capital is supplied through philanthropic funding. Basically free as long as certain targeting and loan purpose goals are met, this funding comes from international donors, such as USAID, and will typically be matched by foundations and national governments. Successful programs have applied the following rules of operation to decrease their dependence on these philanthropic sources and to attain long-term self-sustainability.

Loan Portfolios Are Managed According to Successful Business Practices. Although loan amounts vary, most international microenterprise programs concentrate on providing very small loans, averaging the equivalent of less than $100 per borrower. Many loans are for short-term operating expenses or to purchase small-scale equipment for startups. Loans are generally short-term, from a few days to as long as 1 year. Loan terms offer flexible repayment options and allow balloon payments. Repayment schedules may be as frequent as daily and usually are designed to mirror the borrower's cash flow patterns. Frequent repayments prevent borrowers from accumulating cash that might otherwise be spent on consumption rather than loan repayment. Loans are made at or above relative market interest rates, reflecting higher financial risk. Still, these rates are usually lower than those offered by informal money market lenders.

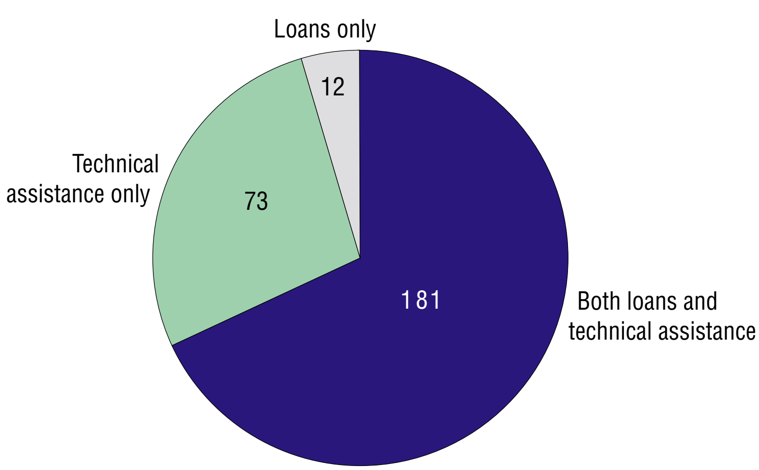
The use of market interest rates allows improved coverage of operational costs, including loan losses. In addition, successful programs avoid providing unintended "grants" in the form of subsidized lending rates that are often captured by economically viable businesses. Since it can be almost impossible to screen out these viable businesses by some method other than loan price, only a minority of the targeted population is usually reached. Incentives such as interest rebates or penalties such as additional charges on late payments are used to motivate timely repayment of loans. The penalty for poor performance is immediate, additional borrowing is prohibited, and the borrower's access to credit is eliminated. While conventional wisdom has held that low-income borrowers cannot pay market interest rates, Lapar and Graham found otherwise. They examined a sample of 400 Philippine microenterprises engaged in a variety of activities, and found that although these microenterprises are generally credit-constrained, potential return to credit is high, suggesting that these businesses can pay market rates of interest.

Obligatory Savings Increase Clients' Stake in Program's Success. Successful international programs require obligatory savings by their clients. Possibly the most important deficiency overcome by successful programs is the imbalance between sizable subsidized loan portfolios and lack of savings among the borrowing population (Yaron). Promoting better deposit and savings facilities was found to be essential for successful rural development. In addition, obligatory savings provide additional loanable funds to the microlender, a financial cushion to the borrower, and an additional equity stake in the business. Most international development experts agree that by improving savings facilities that pay market rates of interest, the rural poor have been given a more efficient way to store value. By linking borrowing and savings services, these clients have learned overall financial discipline more quickly, which has translated into higher client success rates.

Figure 1

Microenterprise programs, 1996

Most of the 266 active programs offered both loans and technical assistance



Source: C. Alexander Severens and Amy J. Kays, eds., *1996 Directory of United States Microenterprise Programs*, The Aspen Institute, 1997.

Peer Lending Reduces Loan Transaction and Administrative Costs. Peer-lending groups are comprised of a small number of individuals who agree to be jointly liable for repayment of a loan that is made to the group and then divided among the members based on the amount needed. Peer-lending groups allow the burden of screening and monitoring loan performance to be shifted to the group, effectively reducing loan transaction and administrative costs for the microlender. These groups have resulted in loan repayment rates of near 100 percent. High loan loss rates are often the principal cause of fund insolvency, illiquidity, and increased reliance on government bailouts. People in positions of leadership or authority help assess borrowers' reputations, reducing screening costs, and determine which prospective clients will make a reliable peer group. Joint liability for short-term loans allows a small, homogeneous group to reduce the "free-rider" problem that is usually inherent, for example, when lending to large cooperatives. When loans are made to cooperatives, some members can have poor financial performance but still obtain more financing because of their membership and the cooperative's general performance. Thus, the nonperformers get a free ride at the expense of the high performers. As a rule, joint liability is effective only within small like-minded groups where peer pressure can be brought to bear.

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Operating Microenterprise Programs in the United States

Microenterprise programs are most likely to be sustainable when they follow sound business practices. Successful microenterprise programs also create innovative methods of microlending that are tailored to the needs of their clientele. Microenterprise program managers face four basic obstacles.

- Geographic, demographic, and economic characteristics that work against the success of rural microenterprises.
- The need to develop efficient and relatively low-cost operational procedures for identifying the success potential of prospective clientele.
- The need to develop sound business principles for processing, monitoring, and servicing the resulting loans.
- The need to find innovative ways of leveraging philanthropic capital to achieve adequate rates of return on loan portfolios, to minimize overhead costs, and to gain credibility with investors. Only then will the programs' capital grow without constant reliance on philanthropic or State concessional funds or bailouts.

Economic differences between the United States and developing countries tend to make the implementation of microenterprise programs more difficult here. Many developing economies lack the resources to provide social safety nets. International microloan operators have suggested that the presence of safety nets in the United States impedes risk taking among the chronically unemployed and nonworking poor (Stearns). In rural areas, population density is low, which raises operating costs. Also, the United States demonstrates less cultural homogeneity than most international sites. Homogeneity of values complements the function of the peer group process. The U.S. economy is more capital-intensive, increasing the investment required for businesses of viable size. In many developing economies, a very small loan could enable a new business startup or a sizable expansion. In developing economies, financial services markets are significantly underdeveloped relative to those in the United States Thus, obligatory savings likely would not have as dramatic an impact on the success of microloan programs in the United States However, the benefits of increased financial discipline and a larger equity stake in the business would be a positive development for microloan borrowers regardless of where they are located.

Rural America is diverse, with various concentrations of population subgroups. Traditional resource-based industries are declining as sources of jobs and income, much of the local labor force is relatively low-skilled, and distance tends to hinder the economic development of many rural areas. These characteristics complicate the environment for developing uniform, lower cost microlending and training programs in some rural areas. It remains to be seen if new information technologies will be able to offset some of these negative effects.

Loanable Fund Sources

As with programs abroad, most microenterprise funds initially come from foundations and other nonprofit sources, including governments. Recently, interest has increased in microenterprise programs at all levels of government.

The Federal presence in microprograms is small at present (see "Federal Funding Opportunities for Microenterprise Programs"), but increasing. Government and nonprofit donations can be used to guarantee and thus leverage for-profit sources of investment. Commercial lender involvement in microenterprise activities, for example, helps these lenders meet the requirements of the Community Reinvestment Act. However, participation by commercial intermediaries has been slight in the absence of a reliable method of lending and loan servicing that creates a clear line between providing charity as opposed to disciplined investment in an emerging microloan market. Here again, the low population density and remoteness of some rural areas may affect access to commercial sources of credit. Many rural communities are often served by a single or a very few commercial lenders.

Targeting, Screening, and Monitoring Programs

Successful microloan borrowers usually have employable work skills and experience, but lack access to the financial or physical assets needed to start or expand a business. This client profile has been important to the success of international programs. For example, prior to microlending, Bangladesh had a large pool of prospective borrowers with undercapitalized labor skills. These individuals were selling their labor skills at near-zero wages because someone else controlled the essential elements of production and/or distribution. With access to capital, a "real" credit constraint was overcome and borrowers were able to earn positive rates of return on both their labor and the financial capital that was invested in their businesses. Business viability is further enhanced by coupling credit access with technical training to improve production methods and financial management.

No hard evidence indicates whether a similar pool of skilled but undercapitalized labor exists among the rural poor in the United States, but limited information on education and skill levels and present employment patterns among the low-income poor suggests not. Thus, programs need to identify those applicants with the aptitude to make up such a pool of undercapitalized labor. Microloan programs that also develop client skills are very expensive, and improved screening would help decrease operating costs and improve program effectiveness.

Successful Portfolio Management in Rural Microlending

How do rural microenterprise programs achieve adequate rates of return on loan portfolios and minimize overhead so that operations can gain credibility? What can be done to provide efficient and relatively low-cost operational procedures for screening, processing, monitoring, and servicing the loans of rural microenterprise programs? First, as with the international experience, loans can be priced at market interest rates to instill financial discipline in the borrower. In addition, providing a full range of financial services to this developing class of businesses would promote the viability of the loan program. Second, since rural areas are hampered by remote and diverse clientele, alternatives to the standard peer-lending model would assist in screening, loan collection, and reducing other transaction costs. Third, consolidating service delivery operations could create economies of scale and reduce the high per unit cost of technical training and education. And fourth, successful microenterprise supporters need to steer the program where it can do the most good, recognizing that credit is not always the primary constraint. Building human capital through training and developing social capital by linking clients, institutions, and the community at large may prove to be of more lasting value (Servon).

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Charging Market Interest Rates

Microlenders are beginning to realize the necessity of charging market rates of interest on loans. However, many still view below-market rates as a cornerstone of business development assistance. This policy is intended to enhance the financial situation of borrowers, and clearly gives them a cost advantage, but not without consequences (Mikesell and Wallace). The impact of these unintended consequences varies, and is described by the effects they have in the following areas.

- Subsidized loan programs can neither grow nor become self-sustaining. Typically, the low interest rates result in lenders' operating income that is below operating costs, requiring continued injections of capital from donors.
- Resource allocations are distorted. Distortions occur because other businesses may find their

Federal Funding Opportunities for Microenterprise Programs

Microenterprise projects are funded by a variety of sources, including State and local governments, foundations, and private businesses. Most Federal funding sources emphasize either business technical assistance or loan programs. The following funding descriptions are organized under loan programs, technical assistance programs, and mixed programs. For all except the Small Business Administration's Microloan Program, microlending is only one of many eligible purposes for which program funds can be used. Agencies funding loan programs generally refer to the organization receiving funds as an "intermediary" because this organization will in turn provide a loan to a business. The number of programs may give the impression that Federal involvement in microenterprise programs is sizable. However, in most cases, the dollar amount is small relative to other types of Federal business assistance.

Loan Programs

The Department of Treasury—Community Development Financial Institutions (CDFI) Fund provides capital to intermediaries as well as funds to increase the capacity of intermediaries. A one-to-one match is required for awards. The CDFI Fund does not allow its awards to be used for business technical assistance.

The Department of Agriculture, Rural Business Service—Intermediary Relending Program (IRP) provides funding to an intermediary for businesses in rural areas with populations under 25,000. Funds are available to nonprofit corporations and public agencies at 1-percent interest for up to 30 years. The intermediary can set its interest rates as long as they are lawful. Loans cannot fund tourism, recreation, or agricultural production ventures.

Technical Assistance Programs

The Department of Health and Human Services (HHS), Office of Community Service has strict rules regarding the beneficiaries' income level for program eligibility. Currently, HHS has two funding sources: the Discretionary Grants Program and the Job Opportunities for Low Income People. Grants competitively awarded by HHS can go to agencies in rural areas.

The Department of Labor, Employment and Training Office–Job Training Partnership Act Microenterprise Grant Program provides funds to enhance community-based microenterprise activities. Recently, the program has focused on the long-term unemployed and dislocated workers.

*The Department of Labo*r—Unemployment Insurance Demonstration provides funds to States to establish self-employment assistance programs as part of the unemployment compensation system, rather than for microenterprise projects per se. Funds are not available for business technical assistance. This program is similar to successful programs in Europe and the States of Washington and Massachusetts, where employment compensation is given in a lump sum to the unemployed benefits recipient to invest in self-employment activities.

Programs That Provide Both Loan and Technical Assistance

The Small Business Administration—MicroLoan Program lends funds to nonprofit intermediaries who relend the funds to microenterprises. Assistance is targeted to women, minorities, low-income individuals, and others unable to access traditional credit. Intermediaries can request up to 25 percent of their total loan request to fund technical assistance, including management and marketing. Technical assistance grants are also made available to intermediaries who provide access to other capital sources but do not lend funds themselves. There is a matching requirement of 50 percent. Rural intermediaries may participate.

The Department of Housing and Urban Development—Community Block Grants program has two types of awardees: Entitlement Communities and State Development Authorities. Rural areas may receive assistance from either program, and regulation changes specify that microenterprise lending and technical assistance programs are eligible to compete for assistance.

The Department of Health and Human Services, Office of Refugee Resettlement—Microenterprise Program provides funds to nonprofit refugee resettlement groups and local development corporations. Funds, which must be awarded to a State or nonprofit agency, can be used for training and revolving loan funds. Funding is available to both rural and urban areas.

inputs more costly and competitors lose business to the subsidized borrower.

- Interest subsidies are inflexible. The borrower's direct subsidy is the amount by which cash-flow expenses are lowered. To benefit the borrower, the subsidy needs to be large, which ultimately depresses the repayment cycle of the lender and slows the building of a capital base to relend. Borrowers are sheltered from market incentives because of the cost advantages afforded by the subsidy and therefore will be insulated from the consequences of poor management practices.
- All borrowers like low interest rates. Thus, subsidies increase the difficulty of screening applicants, raising the need for a screening method other than price. To keep repayment rates high to satisfy donors, microlenders may be tempted to make loans to "blue-chip" borrowers.

Building Program Infrastructure To Reduce Per Unit Costs

Microenterprise programs can be very expensive. It cost an estimated $1.47 per dollar loaned to make and manage a microenterprise loan in 1995 (Edgcomb and others). Furthermore, additional training averaged nearly $2,000 per client. Technical assistance and training are costly because of the heterogeneity of small enterprises. A possible solution is to identify those attributes of operating microenterprise programs and small businesses that are consistent across locations and business types. Materials preparation and training could be done regionally with funding and expertise pooled and the associated costs spread over many more clients than is the case locally. Loan cost and training expenses have to be brought more closely in line with revenue potentials of the microenterprises themselves, or these programs are not likely to be self-sustaining.

Summary and Conclusions

Based on international experiences and limited research in the United States, a successful microlending program will do the following:

- Provide access to credit at market rates of interest to a clientele that already possess in-demand labor skills but are undercapitalized.
- Link microenterprise policy with a policy to improve savings and thus asset accumulation for microenterprise clientele. In the United States, the Individual Development Account (IDA) may do this. IDA's are dedicated savings accounts that can be used only for specific purposes such as purchasing a first home, receiving education or job training, or capitalizing a small business. The Assets for Independence Act, which became law in October 1998, provides for a series of demonstration projects to determine the viability of such policy actions.
- Apply peer-lending group principles, which provide cost-effective methods of screening borrowers and maintaining high loan repayment rates. Assuming that these principles can be applied to microenterprise programs in the rural United States, problems of client readiness, creditworthiness, and scarcity of potential entrepreneurs in rural areas may still exist.
- Develop programs with fee-based systems to compensate for training services. Studies by the Aspen Institute (Edgcomb and others) suggest that program operating costs are made higher because of the large number of nonborrowing clients who receive free technical assistance.
- Develop more stable sources of funding, realistic expectations for scale of operations financed, and universal performance measures that can be applied across all microenterprise programs.
- Devise compelling "best-practices" methodology for operating microenterprise programs.
- Develop program infrastructure to support the implementation of a more market-disciplined approach to microenterprise development.

For Further Reading . . .

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