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SUBSCRIPTIONS AND SUBMISSIONS

Journal of Microfinance (ISSN 1527-4314) is published semiannually by Brigham Young University. Second-class postage paid at Provo, Utah, and at additional mailing offices. Postmaster: please send address changes to Journal of Microfinance, 790 TNRB, Marriott School, Brigham Young University, Provo, UT 84602.

Subscriptions: The subscription rate for subscribers in the United States for two issues is U.S.$30 for individuals and U.S.$60 for libraries. Back issues may be obtained from the editor. Add U.S.$6 to subscriptions outside the U.S. for postage. All claims on issues not received must be made within three months of publication if within the United States, or within six months for subscriptions outside the United States. All subscriptions are renewed automatically unless timely notice of cancellation is given. Please send all correspondence regarding subscriptions to gwoller@byu.edu or Journal of Microfinance, 790 TNRB, Marriott School, Brigham Young University, Provo, UT 84602, USA; visit us online at http://www.microjournal.com; or call (801) 378-1770.

Submissions: Journal of Microfinance is pleased to accept submissions for publication sent to the special attention of the editor. All communications dealing with articles should be sent by email to gwoller@byu.edu; or to Journal of Microfinance, 790 TNRB, Marriott School, Brigham Young University, Provo, UT 84602, USA.

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In Search of “Sound Practices” for Microfinance

by Christopher Dunford

ABSTRACT: The notion of “best practices” for all microfinance is challenged in favor of “sound practices” that are appropriate for particular organizational strategies and situations. A simple conceptual framework is offered to facilitate understanding of the current diversity of experiments with product-market pairs (e.g., group-based lending to poor women struggling to earn enough for family survival). Since the microfinance movement is still in a mode of intensive learning, we should not presume too soon what will be “best” for all product-market pairs. We can expect to discover a somewhat different set of sound practices for each distinct product-market pair.

Many microfinance practitioners are committed to sustainable institution building but refuse to be satisfied with the current notion of “best practices.” Proponents of best practices have often seemed unconcerned about impact. While they may care deeply about impact, they seldom talk about, much less measure, progress toward their ultimate development objectives. To talk of best practices without reference to impact objectives begs the question: best for what? Why are we doing all this microfinance? The only explicit concern in most of the best practices writing has been to foster financial sustainability of institutions that provide financial services to people who have a tough time getting services
from the traditional providers, like banks. Concern for the very poor, which was driving the pioneers of the microfinance movement, very often gets lost somewhere along the way.

I have found this to be an exceedingly difficult message to get across without generating a lot of misunderstanding and dismissive responses. “He’s just stuck in the old charity paradigm.” With much help from fellow travelers down this difficult road, I’ve learned a few things that may help the message be better understood.

Hans Dieter Seibel of Germany’s Cologne University (and now IFAD, the International Fund for Agricultural Development in Rome) writes that there is no such thing as “best practices” in microfinance, because the adjective “best” implies that we have found the optimal way of doing things. But this is not likely in a newly emerging field in which there is still a lot to learn. Seibel says, however, there can be “sound practices” that are appropriate for particular organizational strategies and situations.

This bears repeating: There can be practices that are sound for particular organizational strategies and situations. Given the great diversity of microfinance organizations, strategies and situations, there cannot possibly be a unitary set of best practices, only diverse sets of sound practices. This diversity is still waiting to be fully explored and articulated. The microfinance movement needs to remain for some time to come a “learning organization” or a movement of experiments in sound practices geared to the different organizational strategies and situations.

I’ve spent the past ten years trying to sort out the pieces of the current experiments in sound practices. The conceptual framework I’ve come up

Christopher Dunford is president of Freedom from Hunger. This article is taken from a presentation made to the 2nd Annual MicroEnterprise Conference “Investing in the Poor” held at Brigham Young University, Provo, Utah on March 26–27, 1999.
with is very basic, but sufficient perhaps for taking our thinking back to basics (see the figure below).
In Search of “Sound Practices” for Microfinance

There are four components of every one of these experiments: an institution, a product or service, a market or customers, and a development impact.

Private sector business is focused on the institution, whether or not it is profitable and therefore financially self-sufficient. A for-profit institution may be built around a particular market or a particular product, but as it grows, it diversifies its products and markets. It may eventually abandon the products and markets that gave the institution life in the first place. The institution is like an organism, whose behavior must focus on self-preservation through growth and change. The development impacts of this institution are incidental, perhaps minimal, perhaps enormously good, perhaps enormously bad, but mostly unintentional.

On the other hand, development programming is focused on the development impact. It defines its impact very intentionally in terms of a particular market, like a geographic area, or certain communities, or classes of families or individuals who are to benefit from the intended impact. Products are designed specifically to produce this impact. An institution is created to make and distribute these products to have this development impact on this market. The notion that the market for these products can generate revenue to sustain the institution financially is a relatively new one. Even so, the institution is supposed to remain committed to this development impact for this market, regardless of the market’s willingness and ability to pay for the product.

Microfinance started in the “development programming” mode. It created or rediscovered a new product—lending to joint-liability groups—to achieve a variety of mostly unspecified welfare impacts for the poorest of the economically active poor. Upon realizing that the very poor could and would pay handsomely for credit, almost any kind of credit, the prospect of building financially self-sufficient institutions became an active goal. This attracted those who welcomed the opportunity to show
that development programming could function as efficiently and as free of donor support as private sector business. They have created “best practices” designed to complete the transformation of microfinance into the private sector business mode. In that mode, microfinance institutions are already growing and diversifying their products and markets in pursuit of self-preservation, even when that means abandoning the product and market that gave microfinance life.

The obvious but difficult solution is to find a middle ground that allows microfinance to be both focused on the institution and on development impacts.

Here is where we have to be a learning movement, experimenting with sound practices. The focus of these experiments must be on products and markets. Products are nothing without markets; markets are defined by the products they buy. Institutions depend on product-market dyads or pairs that generate more revenue than cost. Development impacts depend on product-market pairs that generate more benefit than cost. A productive partnership will be one in which those of us oriented to institutional sustainability experiment with a variety of product-market pairs to see which ones can be profitably delivered. And those oriented to development impacts should experiment with a variety of product-market pairs to see which ones can yield specified development impacts. Donors and social investors seeking specified development impacts can provide incentives to both orientations to work in coordination, so that both are experimenting with the same set of promising product-market pairs.

Notice that this approach calls for everyone to be very clear, very explicit about their objectives. The institution-oriented people need to do careful operations research to test the profitability of different market-pairs in various institutional and economic situations. The development-oriented people need to do careful cause-and-effect research (that means
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science) to determine the impacts of the different product-market pairs in various social and economic situations. In combination, the results of this work should produce a set of sound practices for each viable product-market pair.

The abstract way I have presented this scenario may make it sound like pie-in-the-sky. But this process is already happening—it is well underway. We need to encourage rather than suppress it. Most of all, we need to be broadminded and honest, with ourselves and others, about our orientations, objectives and our appropriate roles in the bigger picture of the microfinance movement.

Already evidence has been accumulated for sound practices regarding certain product-market pairs in microfinance:

- If you seek economic growth, export growth, sector or subsector development, your credit products had better be appropriate to corporate or otherwise good-sized businesses. That means more traditional lending products, such as capital equipment and working capital loans and business lines of credit.

- If you want to lift large numbers of people out of poverty through increased farm output, nonfarm enterprise development, and resulting job creation, you had better target your credit services to well-organized, even if small, livestock and agriculture operations or nonfarm manufacturers, wholesalers, and even mom-and-pop retailers. That probably means agricultural input credits or small business loans to individual farmers and entrepreneurs.

- If you want to relieve the crushing burden of poverty through improved food and nutrition security, public health improvements, women’s empowerment, or child health and education, your credit package should be designed for family survivalists, by which I mean people doing something—anything—to earn a little income
to keep their families alive. Untargeted lending through joint liability groups seems to work well for these very poor people.

There is no inherent reason why these multiple products cannot be offered to these multiple markets by one and the same institution seeking self-preservation and yet generating development impacts. However, some product-market pairs will have higher profit margins than others, and some institutions are better structured than others to operate as going concerns with lower profit margins. Some even are very capable of tapping into reliable sources of partial subsidy for many, many years running.

Granting that microfinance practitioners know a great deal already, we nonetheless are still in a phase of intensive learning. It is too soon to make hard and fast conclusions about what will be “best.” We can make good estimations only of what will be “sound” and then see if we’re right or wrong.

References

The Application of Microcredit Technology to the UK:

Key Commercial and Policy Issues

by Rosalind Copisarow

ABSTRACT: This article addresses the following issues: who needs microcredit in the UK, what is the extent of the unmet demand across the country, what are the precise terms and conditions required by microentrepreneurs, how repayment rates of at least 95% can be expected, and how an institution making microcredits can become self-financing within six years. The article also describes the main barriers faced by microcredit institutions in the UK and offers solutions to obtaining funds from the private, public, and voluntary sectors and to operating within a legal and regulatory framework that permits microcredit institutions to serve their clients with the products that they need. Finally, the article examines the social and economic impact that can be expected from microcredit, at an individual client level, at a local community level, and at a national level.

In the UK, there are approximately 500,000 microenterprises. These are tiny businesses which have no more than five employees. Only about 3% to 4% of them, however, are able to obtain credit from all the commer-
cial, government, and voluntary sector sources combined. Microfinance provides such enterprises with access to capital for as long as they need it. It thereby acts as a financial “partner,” supporting their development into mainstream banking. This is achieved through a series of incremental loans for working capital or investment purposes.

The UK is not alone in being so underserved. Microfinance in the whole industrialized world is at present hardly existent, and certainly not in a way that is capable of making a significant impact on an affordable, long-term basis. Yet for millions of people, it is a more appropriate tool to help them become self-sufficient and move toward mainstream bankability than any other means of support currently offered. If it is to become more widely available, it needs to be provided by financially self-supporting institutions.

The worldwide microfinance industry currently comprises about 7,000 to 10,000 institutions, out of which no more than 100 to 200 are both profitable and serving tens of thousands of clients, and none of these are in any industrialized country. Out of the 300 to 500 programs currently operating in industrialized countries, Fundusz Mikro in Poland has come considerably closer to profitability and scale than any other, with 30,000 loans having been extended over the past 3 to 4 years, by 90 staff working in 33 towns and cities. Since 1999, Fundusz Mikro has been fully self-supporting. An independently commissioned study of Fundusz Mikro shows, inter-alia, that every loan increased the borrower’s income by about 20% over an average term of nine months. For example, clients who started borrowing in 1995 now have two to three times more income and assets. Also, approximately 47 new jobs were created by every 100

Rosalind Copisarow was a banker at Citicorp, Midland Montagu and JP Morgan until 1994. Since then, she has worked entirely in microcredit, establishing a Polish institution (Fundusz Mikro), founding the Microfinance Centre for Central and Eastern Europe, becoming an advisor to the World Bank and, most recently, establishing Street (UK).
clients over three to four years. With 15,000 clients having borrowed from Fundusz Mikro since 1995, this implies 7,000 new jobs have resulted from the program.

A simple recommendation for the creation of many Fundusz Mikro-style organizations across the industrialized world is not, however, the answer. This is because there is no one in whose interest it entirely falls to take up such a recommendation. The social rates of return that the industry can offer in the wealthier countries require a partnership approach to be taken by financial institutions, the government, and the voluntary sector. In addition, a whole set of legal, regulatory, and institutional organization changes must accompany these partnerships in order to make them truly effective.

If this can be achieved, the rewards will be immense: for individuals, microfinance improves psychological, social, and financial well-being; for communities, it strengthens ties of mutual support and reaches out to the most needy; and for the country as a whole, microfinance can create tens of thousands of real and permanent jobs in only a few years, increase the survival rates of microbusinesses, improve the skill base of the workforce, and support a whole segment of society into the financial mainstream.

Introduction

How many people are lucky enough to be offered US$24 million of starting capital to design and create an entirely new financial institution, especially one dedicated to a market generally considered unbankable? I will always be grateful to the Polish-American Enterprise Fund for giving me this exceptional opportunity. Not only did it push me into rethinking from first principles what banking really ought to be about, but it also allowed me to test in practice the validity of some growing
convictions that had gradually taken root in my mind over the course of my career in commercial lending.

It is now only four short years since Fundusz Mikro made its first microloan. Nevertheless, during that time we disbursed over 25,000 loans worth US$25 million and not only obtained a consistent 98% repayment rate but also built a scale of operation large enough to fully cover its running costs and become a self-sustaining institution. Although these results are hardly sufficient to draw any generic conclusions about the legitimacy of the Fundusz Mikro approach across the whole of Europe, I hope they do at least indicate the need to re-evaluate the widely held view that microfinance cannot work in the industrialized world, however successful it may be in developing countries.

I firmly believe microfinance can work in the wealthier countries but, to do so, it must be approached with quite a different attitude from that adopted by either charitable community loan funds or commercial banks. Not only do the operating companies’ attitudes need to be radically different but so also do the community’s at large. The concept of giving people a hand-up instead of a hand-out is much talked about but has yet to be widely adopted in concrete action. Also, the legal and regulatory environment, including tax and accounting issues as well as definitions of charity and business, all need urgent review and reform if the microfinance industry is to be encouraged to develop on the one hand and protected from failure on the other.

These are all issues, however, which, though difficult, can be addressed, for they may all be regarded as externalities in relation to the two central issues of (1) whether or not microenterprises in industrialized, richer countries need lesser-developed country microfinance, and (2) whether or not they have similar propensities to repay unsecured loans to the levels seen in the best microfinance institutions worldwide.
If there is indeed the demand and the repayment basis is sound, then surely we have a secure foundation for the building of an industry. In this article, I will try to address some of the underlying principles of microfinance that make it just as appropriate in the richer as the poorer countries and to show how here, too, there is every reason to expect high demand and repayment. (These are what one might term “client issues.”) Next, I will discuss some institutional design issues which are crucial to achieving, at minimum, financial sustainability. Third, I will look at the implications of these issues for the wider environment: What are the current obstacles, how might they be addressed, and what specifically can the public, private, and voluntary sectors each do to help build a healthy microfinance industry? And finally, I will address the potential rewards of microfinance, that is, the social and economic impact it has already made in Poland, as well as its likely impact in the UK. To begin, however, it is worth reflecting on why and for whom we need a microfinance industry in the industrialized world.

The Case for Microfinance in the Industrialized World

The developing country view is clear: Microfinance is a very important tool for poverty alleviation and in many countries it is needed by the majority of the citizens, because unbankability is the norm, not the exception. Nevertheless, it should be stressed that not one microfinance institution that I have ever visited in a developing country serves the absolute “poorest of the poor.” Below a certain threshold of energy, determination and morale, a person cannot make proper use of a commercial interest rate debt instrument. He or she first needs relief-type help, such as counselling, food, shelter and donations, as well as other financial instruments for risk-protection purposes.
The same is true in the industrialized world. Thanks to a welfare system, relief programs are available and appropriately provided to the needy. Relief programs are also, however, provided (in the form of soft loans and grants, income support, counselling and training), where funds permit, to people who do not qualify as “mainstream” but neither do they need to be candidates for relief. What they really need is a hand-up, but it is generally not available. In the meantime, as commercial financial institutions demutualize and merge and as globalization has created higher minimum thresholds of profitability for credit transactions to be deemed worthwhile, the community of potential bank clients who do not qualify has increased substantially over the past decade. This has stretched the public purse to the limit and has left the majority of the potential microfinance market in a no-man’s-land: too rich to qualify for relief, too poor to qualify for mainstream credit.

Some microenterprises may be able to take personal bank overdrafts or borrow on credit cards. But this practice often creates more problems than it solves because the unstructured nature of the debts is inappropriate for inexperienced borrowers and leads them frequently into default. The majority borrow from family, friends, loan sharks, or they do without. Again, this comprises unstructured, one-time assistance, and is very expensive and/or totally inadequate for the needs of a growing business. A small proportion obtain public sector- or voluntary sector-supported soft loans or grants for start-ups. These do little, however, to ensure their transition into the financial mainstream if they cannot be supplemented by further “development” capital. Many microenterprises operate in the gray market because the bureaucracy and tax regime create too high a threshold for them to cross in one step into officialdom. What these businesses need is transitional support enticing them into the formal economy.
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The microfinance market in the industrialized countries therefore encompasses start-ups, gray market activities, and fully registered small businesses that still lack the collateral for mainstream credit. This may not be as large or as poor a market as in the developing countries, but it is nevertheless substantial; it is largely hidden from measurement by appearing to be served by other means or by being outside of the formal economy; and it could well grow in the future if minimum thresholds for mainstream credit continue to rise. What microfinance offers in the industrialized countries is not so much classic poverty alleviation as a means of supporting small business survival and development, encouraging start-ups, motivating people out of welfare who have the desire and capacity to become financially independent, stimulating in an organic, unsubsidized way the creation of thousands or even millions of jobs, and reattaching to mainstream society a whole segment of unnecessarily excluded people.

Client Issues

Let us look first at what microenterprises actually need from their financial institution:

1. *Small amounts of capital* (on average US$1500 for a first-time borrower in Poland; likely to be US$4500 in the UK); this should be the amount structured by an expert to match precisely what they can afford without undue risk of default, i.e., to protect as well as to support their development.

2. *Minimal waiting time* for the loan to be approved. The fragility of the business might not survive the cashflow consequences of a one-month processing period. Also, minimal bureaucracy and time taken to complete the application process.
3. *A high probability of receiving a loan.* The reason banks do not have higher rejection rates is that people do not bother to apply for a loan if the chances of success relative to the processing time and the paperwork involved are too low. It is therefore essential to maintain high acceptance ratios in order to encourage people to apply.

4. *Reasonable interest rates.* These do not need to be below standard bank lending rates to small business clients, but they cannot be anywhere as high as money lending rates.

5. *Immediate subsequent loans* for the further development of the business, assuming timely repayment of the previous loans.

6. *Friendly, professional lending officers* who understand the client’s business, can advise where required, treat the client truthfully, efficiently, fairly, and with respect, and who are therefore, in turn, respected by the client.

7. *Clearly pre-explained terms and conditions,* including all costs, all small print in the loan agreement, all requirements, which, if met, will ensure the client’s future access to larger loans, etc.

8. *Other tailored financial services,* especially including a bank current and deposit account with lower transaction charges in reasonable proportion to the (small) average balances.

9. *No training requirements in order to obtain a loan.* Training, consulting, and mentoring services should be available for purchase by the client at reasonable cost.

10. *Opportunities to network* with other microenterprises for mutual support purposes, as well as to explore business development opportunities.

These requirements may be simply summarized as the strong likelihood of receiving quickly and at reasonable cost appropriate, uncomplicated, structured loans that can be increased upon repayment.
This list may look obvious, reasonable, and not too difficult to respond to; that is, until one examines the extent to which existing financial institutions are in fact failing to meet them. Table 1 (see p. 22) summarizes the extent of this market failure.

Banks fail on many points. As mentioned earlier, unstructured credit is fatal for inexperienced borrowers. Banks do not structure it (in the form of a business, cashflow-based loan as opposed to a personal loan or overdraft) because it is more labor-intensive, and therefore theoretically less profitable. A low probability of having the loan application accepted discourages a large proportion of the market from even applying, just as the high transaction costs on bank accounts keep a considerable potential deposit base from being brought into the financial system.

Most credit unions also fail to provide loans tailored to the businesses’ cashflows. They are also unable to support a microenterprise’s growth if the loan requirement exceeds their fairly restrictive limits. Further, with credit limits related to the deposits first made by a client, the waiting time for a first loan can be months, and the deposit requirement may exclude many potential borrowers. In addition, marginal and excluded populations may not be eligible to join a credit union.

Money-lending companies such as Provident Financial, Cattles, Scottish London, etc., score well on many points. However, their biggest problems for microenterprises are the 40% to 160% per annum interest rate that is prohibitive for businesses, and (again) consumer loans that are neither structured to the businesses’ cashflows nor likely to be big enough for their future development.

Finally, public-sector and voluntary-sector loan schemes, though well intentioned, are frequently poorly designed with unstructured loans, have a low probability of application acceptance especially for the better (i.e., less disadvantaged) clients, possess low or no chance of any further loans, sometimes require pretraining, and, worst of all, send a confusing
Table 1: Inability ("X") of the Market to Serve Microentrepreneurs’ Needs

<table>
<thead>
<tr>
<th></th>
<th>Commercial Banks</th>
<th>Credit Unions</th>
<th>Money-Lending Co's</th>
<th>Public/Voluntary Sector</th>
<th>Credit Card Companies</th>
</tr>
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<tr>
<td>Appropriate Amount</td>
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<td>—</td>
<td>—</td>
<td>—</td>
<td>X</td>
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<tr>
<td>Repayments Structured Against Business Cashflow</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
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<tr>
<td>Speed of Processing</td>
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<td>X</td>
<td>—</td>
<td>—</td>
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<tr>
<td>Likelihood of Approval</td>
<td>X</td>
<td>—</td>
<td>—</td>
<td>X</td>
<td>—</td>
</tr>
<tr>
<td>Reasonable Interest Rate</td>
<td>—</td>
<td>—</td>
<td>X</td>
<td>—</td>
<td>—</td>
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<tr>
<td>Subsequent Loans in Increasing Amounts</td>
<td>X</td>
<td>X</td>
<td>X</td>
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<tr>
<td>Inviting, Empowering, Professional Culture</td>
<td>X</td>
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<td>X</td>
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<tr>
<td>Clearly Pre-explained Terms and Costs</td>
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<td>—</td>
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<tr>
<td>Other Financial Services at Reasonable Cost</td>
<td>X</td>
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<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>No Compulsory Training</td>
<td>X</td>
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<td>—</td>
<td>X</td>
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<tr>
<td>Mutual Support Network</td>
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message that undermines a loan instrument with a “grant culture” that does not press delinquent cases nor encourage timely repayment.

Although Fundusz Mikro was modelled after the leading microfinance organizations in developing countries, in terms of what it represents in the industrialized world, it is a response to the microenterprises’ needs described previously, in that it encompasses the relevant elements of many different kinds of already existing financial institutions.

Microfinance therefore has a similar mission and focus on nonfinancial support to those of public- and voluntary-sector programs; its personal risk assessment methodologies are more like those of credit unions (i.e., based on mutual trust); its business risk assessment methodologies are adapted from those of banks for larger companies (i.e., based on cashflow); it has a highly mechanized back office like that of a credit card company; its organization structure is similar to that of a money-lending institution (combining the best of bottom-up grass-roots loan officers with top-down financial systems and economies of scale); and its financial objective lies roughly between the most grant-dependent and the most profit-seeking. Its goal is, at minimum, to be fully self-supporting, i.e., to cover its total operating costs and maintain in real terms the value of its loan capital. Whatever return it can achieve above that should then be subservient to its strategic goal to offer credit as widely as possible. Figure 1 (see p. 25) shows the elements of its composition.

Regarding client issues in general, three key points should be emphasized:

1. There is nothing fundamentally new or untested about microfinance in the industrialized world; it has all been done before, though in bits and pieces within different segments of the financial services industry. Therefore, microfinance should not be treated as simply the newest fashion in development economics, a fashion that could well be discarded within a decade. Rather, it should be
understood as a revival of a centuries-old system of trust-based lending. In fact, the derivation of the word “credit,” which is *credo* or *credere* meaning to believe or trust, which, together with the equally important concept of mutuality, is at the very root of lending.

Microfinance works because it taps into the natural predisposition of all animal species to cooperate with each other for reasons of enlightened self-interest. Benefits and obligations must be balanced to produce a water-tight system of “metaphysical” collateral. Defaults generally arise from poor program design or implementation, not from any essential problems with the borrowers.

2. It is important to remind ourselves of why trust-based lending is no longer the norm in many industrialized countries. This is due not to repayment problems but to the need of financial institutions for both profits and year-on-year growth in profits. This objective precludes small transactions, however safe, from being attractive. (Those institutions still using a trust-based methodology, such as credit unions and money-lending companies, still have excellent repayment results.)

What has happened therefore is a shift in the meaning of the word “creditworthy,” from “being able to repay the loan” to “being able to offer a minimum profit to the lender.” Muhammad Yunus, Managing Director of Grameen Bank, has declared credit to be a human right, i.e., a universal right. I would disagree—I believe one must be creditworthy to take on credit. However, my definition of creditworthy is the original one and includes anyone who can repay a reasonably priced loan, however small a profit it may generate for the lender.

3. The upper and lower limits of microfinance need to be recognized: At the upper end, microfinance breaks down when the
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Figure 1: Key Microfinance Elements in Existing UK Financial Institutions

- Credit Unions
  - Personal Risk Business (Cashflow-Based) Risk Assessment Methodologies
  - Mission to Support the Financially Excluded
  - Focus on Skill Development
  - Mechanized Back Office

- Commercial Banks
  - Objective to be Fully Self-Supporting but not Profit-Maximizing
  - Institutions Pursuing Sustainable Development
  - Bottom-Up/Top-Down Organizational Structure

- Credit Card Companies

- Money-Lending Companies

Public/Voluntary Sector Programs
loan sizes reach the level at which, with all the will in the world, borrowers are unable to raise the sums needed to repay the loan from their own savings, as well as from all their friends’ and family’s contributions, if their businesses collapse. Peer group guarantees are better than physical collateral only when the combined resources at the group’s disposal can provide an effective back-up repayment source. After that, physical collateral-based lending should take over.

At the lower end, microfinance stops short of helping the poorest and most destitute. The financial instruments most suitable for such people may include savings and cash management instruments, such as emergency funds, pensions, and disability/life insurance schemes.

Where credit is granted, there must be a business, however tiny, which generates net cashflow surpluses. Some public-sector and voluntary-sector programs incur large defaults because they do not observe this rule when they finance start-ups. When interest-bearing debt is used as a substitute for seed equity, it inevitably puts a huge burden on fragile, uncertain cashflows. Fundusz Mikro will lend to any microenterprise with at least three months’ net cashflow surplus, however tiny. This is our definition of a creditworthy start-up, and we have found that while it does not preclude anyone with a serious idea from starting and returning in three months, it does effectively screen out businesses that people are only prepared to try with someone else’s money—most failures are from this latter group.

**Institutional Issues**

If we approach the institutional requirements of microfinance organizations by reviewing the main obstacles to be overcome, the two problems
most frequently cited by banks (as to why they do not engage in microfinance) are high credit risk and high transaction costs. I hope the previous section has sufficiently addressed the credit risk issue to conclude that just as it is not a problem in the developing world, neither should it be one in the industrialized world. It just needs a specific approach.

As regards transaction costs, these have been addressed in developing countries partly by highly streamlined procedures, partly by vast economies of scale, and partly by charging substantially higher interest rates than bank rates (although still significantly lower than those of money lenders). In industrialized countries, it is equally possible to streamline the procedures and to create economies of scale. For example, in Fundusz Mikro we had three loan-processing clerks looking after a 1,000 client portfolio in 1995, and now, with 10,000 clients, we still need only four. Interest rates, however, are another matter.

**Rates of Return**

The interest rate affordable by a microenterprise is a direct function of its gross profit margin. The poorer the country, the higher this margin is likely to be, especially on exported products. In industrialized countries, not only are markets tougher and more competitive but so also are microenterprise owners’ expectations of what constitutes a fair interest rate on a loan. Whereas in developing countries bank rates are not considered a relevant marker, in the industrialized countries they are. Hence microfinance organizations in industrialized countries can only partly address the transaction cost issue, but in Fundusz Mikro we have shown that this can be done sufficiently to become, at least, self-sustaining. Comparing some example interest rates being charged today in the UK throws further light on the potential levels of profitability of microfinance organizations in industrialized countries (see Table 2, p. 28).
Table 2: Examples of Current Interest Rates in the UK

<table>
<thead>
<tr>
<th>Lender/Borrower Interest rate (example APR)</th>
<th>Nature of transaction costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Structured bank loan to small business</td>
<td>12% to 14%</td>
</tr>
<tr>
<td>Personal credit card to individual</td>
<td>14% to 24%</td>
</tr>
<tr>
<td>Money-lending company making consumer loans</td>
<td>40% to 160% assessment</td>
</tr>
<tr>
<td>Credit union consumer access loan to member</td>
<td>12%</td>
</tr>
<tr>
<td>Fundusz Mikro interest (zloty) (average Polish inflation during period charged: 15%)</td>
<td>27%</td>
</tr>
<tr>
<td>Potential UK micro-finance institution</td>
<td>20%</td>
</tr>
</tbody>
</table>

What we see is that in order to maintain their required rates of return, banks can charge only 12% to 14% if the transaction size has a certain minimum value. Below that, they have to offer cheaper products such as personal overdrafts where no business assessment is involved. Credit card companies and money lenders both offer microsize loans, and their rates show what needs to be charged in order to obtain a commercial rate of return involving, respectively, computer-based and tailored/manual assessment processes. Credit unions’ rates are neither fully costed nor intended to provide a commercial return to investors. In comparison with these institutions, if we agree that business risk assessment involves more work than personal risk assessment, which is in turn more work
than a computer-driven process, Fundusz Mikro’s (real) rate looks cheap, even after taking into account the low rate of return to investors. The reason for this lies in the simplification and elimination of administrative procedures.

In the UK, though the nominal interest rate needs to be lower than Poland’s, the real rate may be similar, indicating that investors in the two countries can expect a similar rate of return as each other. Since the Polish and UK rates reflect their respective countries’ typical gross profit margins for microenterprises, they are probably the maximum rates generally affordable. This then more or less caps the returns the industry can generate in industrialized countries, barring some further streamlining of procedures in the future.

Therefore, though commercial banks should bear some social responsibility, microfinance cannot be the responsibility of the banks alone. This is both because of its low potential returns in industrialized countries and because of the quite distinctive nature of the business which suggests that it is far better undertaken by specialist institutions. These reasons are also to some extent connected in that asset-driven lending methods (used by banks), minus the assets, are bound to create default problems.

On the other hand, microenterprises represent the next generation of small business clients for banks and an additional market for noncredit products. Banks should therefore have an interest in supporting their development. Also, though their lending approach may be completely different from that of microfinance institutions, commercial banks have a great deal of experience that they can share quite cheaply with microfinance organizations, for example, in the areas of governance and supervision, asset and liability management, internal financial control and audit systems and software programs to fully integrate the treasury,
and accounting and loan administration records. (These are areas in which most microfinance organizations are particularly weak.)

What is therefore needed is a partnership approach which enables banks to contribute funding and know-how on a wholesale basis, i.e., to independently managed (retail) microfinance institutions with grants and/or low cost financing from the public and voluntary sectors to cover a major portion of the shortfall in banks’ rates of return. The principle of partnership is, of course, already familiar and accepted amongst UK banks, government, and the voluntary sector. However, it has yet to result in any really large-scale programs of this type.

**Development Methodology**

So far I have reviewed the key institutional issues only with respect to full-grown microfinance institutions. Another set of institutional issues, however, revolves around the optimal method of growth and development for a brand new microfinance institution. If financial sustainability is the goal, one of two alternative approaches can be taken: to minimize costs, or to maximize revenue. The cost-minimization approach may be seen in those local community loan funds and credit unions which are volunteer-run or have part of their operating costs donated in kind. Their advantages are that they require low investment and can rapidly become self-financing. On the other hand, because their outreach is small, their impact is limited, and growth beyond the local level is prevented by both the vision of those involved and the lack of contractual agreements against which to secure funding for growth.

The revenue-maximization approach, which makes impact and outreach the top priority, involves building a large organization in order to benefit from economies of scale. Most people taking this approach have done so by starting small and gradually adding local branches as each one in turn becomes profitable. This strategy has enabled the initial loan
capital investment to be kept as low as possible. However, it has created a much longer lead time to sustainability (i.e., the point at which there are enough branches to fully cover the central overheads as well as the local costs), and until that point is reached, the institution has remained grant-dependent. Grameen Bank took at least 20 years to reach this point and Banco Sol (in Bolivia) 11 years.

The challenge we set for ourselves in Fundusz Mikro was to find a way of combining the best of both approaches—i.e., the speed to sustainability of the cost-minimization model with the outreach and impact of the revenue-maximization model. If we could achieve this, we felt it would ultimately be the cheapest (i.e., least draining on grants during the years of operating deficit), as well as provide financial support to the maximum number of microenterprises within the shortest possible timeframe. To achieve these objectives, the method we adopted was to design the full-scale institution upfront, to hire the future senior managers immediately, and, after an initial pilot testing period of a year, to open as many branches as possible. While this involved greater financial exposure by creating higher short-term operating deficits, over a five year period it was a much cheaper, shorter, and surer way to the sustainable state we have since achieved. For future microfinance institutions in the industrialized countries, I now feel convinced that this is the optimal development route for anyone whose goals are wide outreach and rapid impact at the cheapest ultimate cost.

Wider Issues

In the course of my efforts to promote the Fundusz Mikro model for the UK, I have come to experience firsthand the main obstacles that such a project must overcome and therefore I feel uniquely qualified to write about them! First, let me list them:

- A problematic definition of charity under British law.
• The lack of any public-sector or voluntary-sector commitment to
the concept of “optimal project funding.”
• The lack of an internal organization structure in today’s financial
institutions, companies, charities, and government bodies capable
of evaluating and responding to proposals that fall between profit-
maximizing and being charitable in the conventional sense.
• The difficulty for commercial banks to fund the start-up phase of a
lending business which uses alien methodologies to its own and
potentially serves a market that they themselves have rejected or
with which they have incurred high defaults.
• The lack of fully integrated welfare-to-work incentives.
• The lack of any appropriate legislation, regulation, and supervision
for the microfinance industry.

The following section will examine each of these issues more closely.

Definition of Charity
The story is told of a father who was trudging home through the forest
with his young son. The son says to his father, “Father I am tired. Please
carry me.” The father replies, “Walk on as far as you possibly can, and
when you can go no further, then I will carry you.” Most people hearing
this story nod wisely and agree with the father’s response. According to
the law, however, “self-help” and “charity” are placed in diametric oppo-
sition to each other, such that if people do something for themselves,
they cannot by definition be recipients of charity. Unemployed persons
may need a large amount of external support but can still manage to do
something for themselves. Similarly, employed or self-employed persons
with a lower than subsistence income, though mostly self-reliant, still
need some external support.
At an institutional level, a school for disabled children, for example, may be able to raise some revenue from parents’ contributions, while the rest must come from charitable sources; similarly a sustainable microfinance organization may be able to generate enough income from its lending operations to cover its operating costs but not enough to also cover the commercial cost of its capital. The point here is that if we agree with the father-son basis for helping people or institutions which help people, then “gap-filling” support should become eligible for charitable status and for tax-exemptions for the donor. This could be achieved, for example, in the UK, by making it an eligible activity under the Enterprise Investment Scheme and by enabling it to qualify for corporate tax-exempt bonds.

**Optimal Project-Funding Concept**

In the same way as we think about how best to help people by first requiring, encouraging, and empowering them to do whatever they can by themselves, so too may we think about how to appropriately allocate public or donor funds to charitable projects. Microfinance has been criticized rightly, in my opinion, for “using up precious grant monies” intended for poverty alleviation, thus leaving the hungry, sick and destitute with inadequate support. If one assumes that pure grant-funding is the most limited form of funding available and commercial capital the most unlimited, the concept of optimal project funding is simply about allocating funds with the highest affordable cost of capital to any given project.

This means that if a project needs only partial grant-funding and the rest can be equity or debt, then it should not take grant-funding for the whole. It also suggests the need for a measurement tool to help investors/donors equate (e.g., a low yield 10-year loan to a commercial 10-year loan plus a grant in present value terms) and obtain a tax-
exemption for the grant-equivalent provided. Projects requiring funding would then be evaluated and compared along a “subsidy spectrum” for any given funding level, as well as in relation to their goals, achievements, or outputs. As a result, much more “socially-directed” funding should become available, requiring rates of return ranging from part-grant, part-capital-retention to “ethical” investment rates a few points below pure commercial rates.

Internal Organization Structures

At present, neither the British government, nor the European Commission, nor commercial financial institutions, nor companies, nor charities are set up to properly evaluate and respond to requests for “intermediate” funds. Private sector organizations either seek to maximize their profits or to “minimize” them (i.e., give them away in the form of charitable donations). There is therefore no proper value ascribed to a sustainable project. Whatever does not generate commercial returns will fall into the charity department, and with charitable funds being strictly limited, no high-impact, sustainable project requiring economies of scale, and therefore larger investment amounts, is likely to be within their budgets.

As regards government money, only grants are, so far, possible for microfinance. Within the charity sector, a few institutions do make investments or loans but this needs to be much more widespread. (The Program-Related Investment Model pioneered by the Ford Foundation in the U.S. is an excellent reference point.) As for other potential providers of intermediate funds, I believe, both at an institutional level (e.g., the Church of England’s investment portfolio) and at an individual/community level, there is a vast, untapped market of would-be investors in socially directed projects who understand the superior value of recycling their funds again and again, versus
making one-off donations, but they are not encouraged by the charity and tax laws to do so.

**Specific Difficulties for Commercial Banks**

In respect to microfinance specifically, what we are asking of commercial banks is quite a tall order; not only are they required to admit to the scale of population they are failing to serve, but also to agree that a brand-new organization, with no track record and a set of intended practices in direct opposition to their own, is more likely to succeed than they are. So much so, that they are willing to fund its start-up, conditionally commit future success-based funds for its development, and agree to a social rate of return.

If microfinance were not about an activity (i.e., lending money) at which banks feel they ought to be the experts, it would probably be easier to approach them for funds, as they would not be tempted to assume at least as high a level of industry knowledge as the applicants’ own. Even then, however, as the funding required in the first instance would really be for start-up venture capital, it should rather be requested from socially directed venture capital funds. Banks could then lend or invest the major portion of the loan capital in the post-pilot phase, once a track record had been created from the pilot loans.

**Welfare-to-Work Incentives**

At present, anyone on welfare who starts a business (officially) will immediately start to lose their benefits, despite the lack of subsistence level profits from the business. This clearly needs to change, but, in the meantime, if there is an implicit understanding that a reasonable amount of gray-market income fulfills an important role in helping people through the transition phase to the formal economy and is a necessity until the laws change, then microfinance can act as a useful tool to
encourage the transition process. In Fundusz Mikro, we do this by tying the loan amounts for which borrowers are eligible to the percentage of their undeclared income, which will be recognized in the cashflow calculation. The higher the loan amount, the lower the percentage of undeclared income that will be recognized. Thus the borrowers always have the choice of how much to declare but the less they declare, the smaller the loan for which they are eligible.

**Microfinance Legislation, Regulation, and Supervision**

What kind of license does a microfinance institution need to properly serve microenterprises?

1. The ability to use up to 100% of its loan capital on unsecured lending.
2. The ability to start lending with a very small capital base.
3. The ability to take client deposits.
4. The ability to lend out of borrowed funds as well as out of its own capital or grant monies.
5. The freedom to make loans or take deposits without the restrictions imposed on institutions such as credit unions or mutual credit societies.

If such a license were created, what measures could be taken to protect the health and safety of the microfinance industry?

1. The deposits of microenterprise owners need to be safer than those of average (richer) bank depositors. There should therefore be a lower cap on the microfinance institution’s capital: asset ratio, and perhaps a graduation policy such that, for brand new organizations, it is lowest and then rises with the track record of consecutive years’ lending with a minimum repayment rate.
2. There should perhaps also be separate ratio requirements in relation to client deposits (only) vs. total risk assets, based on the size and track record of the organization.

3. The national deposit insurance scheme covering bank clients should also include clients of microfinance organizations, or a separate scheme should be established.

4. An industry-specific set of institutional risk-assessment measures should be formulated.

5. Standardized definitions of terms, such as delinquencies, defaults, operating, and financial sustainability, should be created.

6. Standardized performance measures to compare asset quality, operating efficiency, etc., between different institutions, should be introduced.

7. Incentives should be provided for banks to offer their know-how to microfinance organizations, to strengthen areas such as governance, internal control functions, and back office systems.

8. There should also be incentives for insurance companies to develop an institutional insurance product for microfinance organizations to protect them from systemic risks in the portfolio. Whereas banks tend to collapse because of problems in or overexposure to a particular industry sector, this is much less likely to happen in a microfinance institution, unless it is badly managed. The main risks in (well-managed) microfinance institutions are that of flood, drought, acts of war, etc. If they occur, they can affect a substantial proportion of the total loan portfolio. This, however, should be insurable and must become so if the industry is to survive.

Several lesser-developed countries, including South Africa and Peru, and industrialized countries, such as Bosnia, have enacted or, at least
Social and Economic Impact

The impact of microfinance is visible at many levels. For individual borrowers, these loans first and foremost directly affect the chances of survival of their business and therefore the continuation of their livelihood. In particular, loans provided for working capital during times of cash shortage are crucial. Second, these loans psychologically boost borrowers’ self-confidence and self-esteem by giving the borrowers greater control over their lives and expanding their options. Third, since the loans are accompanied by frequent interactions with the loan officers, borrowers enhance their business skills, particularly in the areas of risk assessment and risk management, cashflow and inventory management, the optimal use of debt, and the maximization of return on long-term investment. Fourth, microentrepreneurs borrowing under group-lending schemes derive considerable benefit from the mutual support (albeit accompanied by joint and several liability) provided by their group members. This increases their security and morale and helps strengthen their local communities. Fifth, microloans have a rapid effect on borrowers’ incomes and wealth. In Fundusz Mikro, every loan has increased a borrower’s income by about 20% over an average term of 9 months. Businesses that started borrowing in 1995 are now 2 to 3 times bigger in terms of income, assets, and employment.

At a community level, in addition to strengthening the bonds between people through group-borrowing, microfinance programs have also, without excluding others, particularly benefited women and minority groups whose self-confidence to apply for a loan may be lower than average. They have also had a particularly strong impact in smaller towns.
and rural areas where financial institutions are absent or less prevalent and the social bonds between people are greater and enable easier adoption of the group-lending approach.

At a macroeconomic level, the benefits of microfinance include substantial job creation through increases in employment of businesses that would otherwise have been stable, survival of businesses that would otherwise have folded, and graduation into the formal economy of businesses that would have remained gray-market activities.

A recently commissioned social impact study on Fundusz Mikro’s clients shows, despite only four years of lending, a significant increase in the survival rates of client businesses over those of similar, nonclient businesses. In Britain, the Department of Trade & Industry (DTI) estimated that 500,000 new businesses were established in 1997 while, in the same year, 480,000 businesses ceased trading. By contributing to a major reduction of the latter figure, microfinance can significantly improve the level of net new business creation. The Fundusz Mikro study also shows six times the proportion of clients who have grown to employ five or more people as the proportion in the Polish microenterprise population as a whole. This equates to 47 new jobs created by every 100 clients over 3 to 4 years. With 15,000 clients having borrowed from Fundusz Mikro since 1995, the study estimates that 7,000 new jobs have been created.

Two other macroeconomic impacts that have been visible from microfinance are, first, the increase in long-term capital investment rates in microenterprises. Among Fundusz Mikro’s clients, over six times the proportion made annual investments of over US$22,500 as the proportion in the Polish microenterprise population as a whole. Second, the informal training and skill-building received by clients have provided commercial banks with a greatly improved stream of new (graduating microfinance) clients, which has lowered their default rates on small business lending.
Overall, therefore, microfinance makes a very important contribution to the psychological, social, and financial well-being of microentrepreneurs. It strengthens the bonds of support between people and it reaches out to the most needy communities. It creates long-term, unsubsidized jobs in an organic way, increases the skill base of the workforce, increases the capital investment rates in small businesses, and offers mainstream financial institutions an attractive pool of new business clients.

**Conclusion**

Microfinance in the industrialized world is at present hardly existent, and certainly not in a way that is capable of making a significant impact within a short period of time on an affordable, long-term basis. Yet for millions of people, it is a more appropriate tool to help them become self-sufficient and move towards mainstream bankability than any means of support currently offered. If it is to become widely available, it must be affordable. This means that it needs to be provided by financially self-supporting institutions.

The worldwide microfinance industry currently comprises about 7,000 to 10,000 institutions, out of which no more than 100 to 200 are both profitable and serving tens of thousands of clients, and none of these are in any industrialized country. Within the 300 to 500 industrialized country programs, Fundusz Mikro has come considerably closer to profitability and scale than any other, and it is for this reason that its methodologies are described to such an extent in this article.

A simple recommendation for the creation of many Fundusz Mikro-style organizations across the industrialized world is not, however, the answer. This is because there is no one in whose interest it entirely falls to take up such a recommendation. The social rates of return that the industry can offer across the industrialized world therefore require a partnership approach to be taken by the banks, the government, and the
voluntary sector. In addition, a whole set of legal, regulatory, organizational, and attitudinal changes in the wider environment must accompany these partnerships in order to make them truly effective.

If this can be achieved, the rewards will be immense: for individuals, microfinance improves psychological, social, and financial well-being; for communities, it strengthens ties of mutual support and reaches out to the most needy; and for the country as a whole, microfinance can create tens of thousands of jobs in only a few years, increase the survival rates of microbusinesses, improve the skill base of the workforce, and support a whole segment of society into the financial mainstream.
Rural Towns as Partners in the Utilization of Financial Credit:

A Viable Option for Accelerated Development in Africa

by Napoleon Bamfo

ABSTRACT: One option of development that governments in Africa can pursue but which does not appear to have crossed their minds, is encouraging towns, represented as incorporated units, to borrow financial credit. There are several reasons why this appears to be a viable option of development. No government has the financial capacity to address the social and developmental needs of every town under its jurisdiction. A government that encourages or makes it easy for individual towns to utilize credit available from financial institutions, therefore, will be opening a hitherto underutilized component of development in the form of local savings and entrepreneurship in addressing the particular needs of communities. That the constant demands of several communities on government for developmental assistance will be substantially mitigated will also be complemented by the fact that the simultaneous engagement of several towns in myriad development projects may be the most cost-effective way of accelerating economic development. This paper examines a developmental option that could potentially relieve poverty in Africa by examining the feasibility of
Although rural communities and townships have been the backbone of economic activity in many nations, governments have rarely compensated them for their efforts. Thus, rural dwellers the world over continue to suffer lower standards of living than their urban counterparts. In most nations, whether developed or developing, government policies tend to be so pro-urban that the gap in living standards between urban and rural dwellers continues to widen. Nadler (1992) in the Bankers Monthly made an observation about the future of economic development that could be as applicable to rural communities in Africa as to the towns in the United States he was addressing. He suggested that one specific goal banks must promote to achieve economic recovery, was a “sympathetic attitude toward financing operations that can help American towns and generate jobs.” This article examines how governments in Africa can redirect the nature of development in rural areas by making financial credit available to small and medium towns in their capacities as incorporated entities. This is an attempt to look at economic change from below by tapping into reservoirs of resources that have persistently been overlooked by governments and policy makers, generally preoccupied with the promotion of policies that tend to perpetuate the centralization of political and economic power. The incorporation of towns so as to enable them to undertake major economic and social roles will be an important step to reversing this anomaly of development in most African countries. The legal protection that incorporation could provide towns would make it possible for these hitherto neglected rural communities to be effectively drafted into the mainstream of national development. They

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would be able to undertake bold economic ventures without the risk of individual private assets and community property being liquidated in case of indebtedness. For real sustained economic development to occur in these rural communities, devoting resources to education and training, and discovering latent talent, may be equally as important as making financial credit available.

The rapid urbanization that took place in Africa the past four decades was primarily due to development strategies that emphasized urban growth at the expense of agricultural and rural development (Heyer, 1996). Today, as in the past, African governments have been lukewarm in factoring in the potential contribution individual towns can make in their plans of accelerated social and economic development that they have laid out for their countries. Governments have been uninterested in welcoming towns as partners in their much-publicized efforts to stop deteriorating living conditions in rural areas. However, as reservoirs of untapped financial resources in the form of personal cash and savings, and human resources in the form of intimate knowledge of local economic and social conditions, towns are better positioned than any other governmental entity in bringing about rapid social and economic change.

Although governments have not expressly prohibited towns from borrowing commercial credit for their own development, they have neither encouraged rural towns to borrow commercial credit nor promised to provide security for their investments that go awry. The irony, however, is that most countries in Africa are heavily dependent on the resources produced in rural areas for domestic consumption and foreign exchange. Nnwana (1998) has acknowledged that unless governments change this outmoded strategy of development, the accelerated pace for which they have been hoping may never materialize.
The future development of African countries will depend in part on the success or failures in nurturing, supporting, and developing rural areas and the rural economy, particularly in making more financial services available to rural sector inhabitants. (Nadler, 1992)

With their untapped reservoir of loanable funds and special expertise on local administrative matters, rural communities are ascribed with attributes for development that no other entity in a country possesses. Consequently, central governments must support towns financially and logistically to enable them to play a more meaningful role in the developmental process. The task of inducing social and economic change in rural communities, which African governments have found extremely frustrating so far, could be eased considerably if towns were given ample opportunity to undertake aggressive programs on their own. Unquestionably, the generation of jobs and a rise in incomes of rural folks would result from the active participation of towns in economic and social development. More important, designing and implementing projects on their own are likely to bring a sense of accomplishment and independence that could be an uplifting experience for some of these communities that have been depressed for so long. The successful execution of a project in one town is bound to motivate citizens in adjacent towns to emulate that example and and even to surpass the efforts of the first town by venturing into more ambitious projects. Sooner than later, towns across the length and breadth of country would be abuzz with economic and social activity. On the contrary, continued usurpation of political power and economic decision-making at the center will only perpetuate the stifling of local entrepreneurship, creativity, and independence.

If governments encouraged towns to borrow credit from financial markets, which could be invested in projects chosen by the towns themselves, it might become a cost-effective method of eradicating rural poverty. Since small and medium towns in Africa generally are unfamiliar with
handling large amounts of money, they may need encouragement from central governments to take this seemingly bold venture of applying for commercial credit. It is important, therefore, to examine the current economic and social situation of rural areas in Africa and the incoherent policies governments have pursued in the past to eradicate deteriorating economic conditions from the rural areas.

The State of African Economies

Compared to other countries in the world, many countries in Africa have consistently been ranked at the bottom of indicators of economic well-being. It appears reasonable, therefore, that if African countries want to achieve levels of economic development comparable to countries in other parts of the world, governments will have to find more pragmatic approaches of development that will lift their countries from grinding poverty. These uneven levels of development among different regions of the world has been troubling to the World Bank. In its 1998 report, the Bank found it ironic that poverty and suffering persisted in several parts of the world despite the free flow of trade and capital that has integrated the global economy in the past few decades (World Bank, 1998).

One reason for Africa’s slow pace of growth is that the majority of the population, particularly those living in rural areas, have not benefited from economic growth. Traditional practices in agriculture, nutrition, and personal hygiene, as well as unequal treatment of the sexes, especially the underutilization of the full potential of women, constitute formidable setbacks to development. If these obstacles were to be overcome, immediate action would be required in harnessing the untapped reservoir of manpower and financial resources that continue to lie fallow in remote rural communities. Several small communities in Africa have retained their resiliency from the traditional linkages they have maintained with each other through the clan, chief-
tancy, migration, and marriage. Consequently, encouraging towns to help themselves by making cheap financial credit available to them could be a cost-effective strategy that governments could pursue in overcoming the seemingly inextricable trap of underdevelopment in which most of these communities have been caught.

The State of Towns

Despite the widespread nature of poverty in Africa, it is more prevalent in the rural than urban areas. In Africa, regional and sectoral distortions in the patterns of development are common (Hope, 1998). According to Lipton, this persistently unequal nature of development between rural and urban areas is due to the “urban bias,” which has pushed resources away from activities that benefit the rural poor and toward those that benefit urban areas. These pro-urban policies that governments have pursued over the years have caused long-term damage to rural communities through a disproportionate loss of the young, the educated, and the enterprising in rural areas, have stifled innovation (Gugler, 1988). The length and breadth of Africa, like other continents, is littered with towns. The populations of towns, their size, forms of government, and the human and material resources with which they are endowed vary considerably. Consequently, the criteria that may determine towns’ eligibility for credit also vary. The “optimum-sized” town, which this article uses, is one that, given its size and resources, is capable of providing sufficient collateral for credit and possesses the requisite human resources to embark on useful, economic, profit-yielding activities. The optimum-sized towns, therefore, would include the thousands of towns, excluding large metropolises, scattered across Africa. Large metropolises are excluded from consideration of credit because they usually have a larger tax base and might already be engaged in activities or services that generate revenue. Moreover, the heterogeneity of their population usually
undermines the commitment citizens have for communal programs. On the other hand, the unique characteristic of small and medium-sized towns is the relative homogeneity of their population. This, in the past, has helped to create a common identity among citizens. Any attempt to redirect the role of towns and improve living standards by changing their economic orientation must proceed with an understanding of their prevailing values: Who has power, who has influence, what is the ranking system, and who commands respect? As unsophisticated as towns may seem from the outside, their populations generally contain powerful persons who often provide strong leadership within the community. Teachers, religious leaders, traditional midwives, nurses, local merchants, and youth groups have always been active and proved their capability in channeling people’s energies toward useful community activities. For example, in China’s Shandong Province, the concept of village conglomerates (VCs) has emerged since the early 1980s as a vehicle for economic and social development. The pooling of community resources through the formation of cooperatives has led to the formation of elites and the first generation of Chinese peasant entrepreneurs in this remote rural region (Cheng, 1998).

With the exception of extractive industries such as mining of gold, copper, and diamonds that are located at their source, large industries, in the sense of power-driven machinery employing several thousand people, are a rare sight in rural areas. In most parts of Africa, the evidence of scarcity and depravation is so widespread that the only available option to governments interested in reversing this trend is the abandonment of past policies that have not worked. In light of the paucity of resources and governments’ fear that a myriad of projects springing out of rural communities with little or no control from the political center would eventually saddle them with debt, governments have taken the more con-
venient route of discouraging towns from engaging in innovative programs of development.

It is possible to stem the tide of the rapidly deteriorating living conditions in Africa’s rural communities by diverting reasonable sums of capital from the political center to support small- and medium-sized projects in those areas. Historically, rural populations generally have had minimal contacts with banks and other financial institutions. This, coupled with the discriminatory lending practices of banks, has reduced the availability of development capital to rural communities and these communities’ ability to undertake large-scale economic projects. Even when credit has been available, farmers, artisans, and small business owners who apply for it have not usually met the high eligibility standards (Santonu, 1997). Even in the United States where banking and financial institutions are highly developed, financial credit has not always been available to people in rural areas because of inaccessibility to banks and unavailability of collateral (Drabenshtott & Meeker, 1997). Consequently, economic activities in rural areas hardly grow beyond family members and friends, and involve activities that hardly extend beyond small farms and retail trade. Moreover, townships, which appear to be potentially ideal users of bank credit, have never been considered eligible. Nearly 40 years after many nations have attained independence, life in the average rural township in Africa, like that in other parts of the world, is a continual struggle, and there is little hope of conditions improving.

Pootschi’s (1986) description of a typical village in India could very well have applied to any average town in Africa:

A typical village may look more like, if not worse than, a city slum. In this village environment the sight of dunghills, manure heaps, garbage pits, and pools of dirty, stinking and stagnant water affronts the eye. The orientation of houses, buildings, shops, dwelling places are often haphazard. There are no provisions for the sanitary disposal of water, sewage, or refuse.
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Obviously, whatever policies have been pursued in the past have failed to improve the lives of people. The defining characteristics, such as the authority structure, ethnic composition, and the prevailing economic activity within a particular town, are crucial in any plan of development. How different ethnic groups relate to each other, for example, may give important clues as to how a particular town can marshal its human and material resources. That, in turn, may determine the town’s eligibility for credit and the extent to which its people can work to achieve common economic objectives. Any town may consider itself eligible for credit if, considering its size and resources, it feels capable of providing sufficient collateral and marshaling its human and material resources to embark on useful, profit-yielding economic activities. The picture one gets driving through the rural backwaters of African nations is a continent that is dominated by clusters of medium and large-sized towns. Inside these towns are a plethora of economic activities such as subsistence farming, primitive husbandry, and locally made art and handicrafts.

Policy Options

Targeted Assistance to Towns

In order to reverse the declining living standards of towns by enhancing their growth prospects, African governments must embark on a comprehensive program that will encourage towns to fully exploit their resources. This approach could be an aggressive, albeit noncoercive, intervention aimed at gaining the goodwill and active cooperation of rural populations whose role in their own development has been peripheral. Market intervention, broadly applied, is one of the strategies economists have proposed for addressing the problem of unequal income distribution and allocative inefficiency (Sabot, 1988). An intervention of this nature, by which the government seeks to provide assistance to a tar-
geted group, has been tried in other parts of the world. The high-speed economic growth that occurred in post-WWII Japan, for example, has been attributable to a type of investment strategy that allowed the government to coordinate its credit policy with private, financial institutions to help industrialists. In the United States, Congress has passed legislation that has allowed small rural banks to consolidate and increase their assets to make it easier to provide loans to farmers. In Africa, the structural adjustment programs (SAPs) that governments adopted in the 1980s were designed to make significant changes to the national economic structure. In the late 1980s, the government of Uganda introduced the “rural farmers scheme,” which was aimed at boosting agricultural output by lending small sums of money to farmers, mainly women. Most of these loans were in the form of inputs such as hoes, wheelbarrows, or machetes. However, the most popular program any postindependent African government has undertaken to incorporate indigenous communities into the modern economy was in Tanzania. Under the policy of Ujamaa Vijijini, which Julius Nyerere, the first president, promoted, there was an attempt to “mobilize traditional communal values to serve modern developmental objectives. The policy envisaged the creation of producer cooperatives within a village community, in which people will live and work together for the good of all.”

**Incorporation**

Before towns can be entrusted with the management of large amounts of financial credit, it may be appropriate to encourage them to incorporate. Although nothing would prevent an unincorporated town from contracting commercial credit, becoming incorporated, protects the citizens of that town, particularly local leaders, from losing their personal wealth and property in case the town defaults on its loan payment. The governments of Africa, it seems, have learned few lessons from developed
nations such as the United States and Germany whose constituent states have not hindered their cities and municipalities from becoming incorporated. Incorporation allows cities and towns the choice of transacting business and entering into contracts as legal entities for the city’s own benefit and that of its residents. In most developing nations, however, that concept never seems to have entered the lexicon of development planning, because governments have never contemplated granting towns the option of incorporation. Neither have residents of towns, themselves, pressed for that dispensation.

Government officials in Africa make no apologies for not laying the legal framework for towns to incorporate. Neither do they make apologies for not considering towns, legally represented, as appropriate entities to actively engage in economic activities. An example of this occurred in the mid-1980s when the so-called mining towns were completely left out in the sale of mining companies located in their own communities. Towns were not encouraged to purchase block shares of those companies that had been extracting minerals from their soil for several generations. Moreover, the well-publicized policy of economic liberalization, which among other things, involved the sale of public enterprises and loosening up of tight monetary control to credit expansion, was not extended to towns.

Credit Availability
The policy of making towns credit recipients could be made of a deliberate national plan designed to steer the local economy in a particular direction. According to Rajderkar (1998), economic development in India, a quintessential developing country, can occur only if individual communities themselves show a strong will to progress in addition to the efforts and determination of the government to bring about progress through the utilization of productive resources. The World Bank has
advised governments of developing countries to redirect their developmental effort and credit to the small-scale entrepreneur, and not only to big investors. According to the World Bank, policies that promote agricultural growth though credit availability to rural farmers are the most important means of reducing underemployment in low income countries (1979). Not considering towns as investment opportunities for all these years probably explains why numerous attempts by African governments to mobilize domestic and international resources for development have failed. Without a concrete strategy to address imbalances in the national economy, the unregulated credit market will continue pursuing their age-old policy of discriminating against towns.

The establishment of rural banks that specialize in providing credit to farmers and small businesses has been one of the strategies governments the world over have used to address the imbalance between rural and urban areas. The Grameen Bank in Bangladesh, for example, has tailored its lending to meet the needs of farmers and small-scale investors, particularly poor rural women. However, even in nations that have promoted rural banking for several years, age-old prejudices against “unsophisticated” rural clients have not entirely disappeared. Several Indian farmers who applied for loans in the 1970s, for example, had their collateral consistently undervalued, resulting in the payment of higher rates of interest. The hope of African governments to overcome rural economic deterioration may be enhanced greatly through a fresh policy that would seek the partnership of towns, preferably as incorporated units, into mainstream financial markets.

However, according to a World Bank report, rural financial institutions in several nations have operated at a loss because they have been burdened with low collection rates, have been too heavily dependent on subsidies, and have lacked innovative management. The World Bank has warned governments against the unbridled expansion of programs and
services without first considering their capability for continued funding and efficient administration. The Bank’s report has revealed how states’ inability, particularly those of sub-Saharan Africa, to perform their basic functions has resulted in loss of their institutional capability and legitimacy. Obviously, policy recommendations that stress conflicting strategies—one calling for planned intervention, and the other admonishing caution—are likely to put governments in a quandary. No matter how powerfully designed a strategy intended to help towns may be, there are bound to be features of the local environment that can aid, hinder, or frustrate completely the program’s achievements.

Modalities for Providing Credit

Political leadership for incorporation
A model of township empowerment and recognition must be comprehensive enough to be applicable to most towns in Africa; any plan of development must make room for differentiation because of the varying economic, political, and social conditions that exist in African countries. Any policy that seeks to bring townships to participate in commercial ventures through access to finance capital must begin with recognition of townships’ existence as legal entities. This is to reassure lending institutions that the entities with which they are doing business are fully pledged to honor all obligations into which they might enter. Townships, as legal entities that can sue and be sued, would be held solely responsible for any bad investments they make, and the central government would be relieved of the nightmare of having to arrange financial bailouts for those towns that have made bad investment decisions. Incorporation that would permit them to represent themselves as legal entities can be an important first step to achieving that objective. Opening the legal gateway for towns to become incorporated would
require legislative action that would set the parameters that would define their new legal existence. Establishing the legal parameters of incorporation is a responsibility that must be handled by the central government of individual nations. However, the steps must be established in such a way that any towns that apply for incorporation and meet the established criteria must be approved. The criteria for incorporation may include population, the prevailing economic activities in the locality, administrative capacities, the absence of extreme factionalism, and the recent activities and projects in which towns have been involved.

In several countries in Africa, the decision to embark on a capital project is made in a town meeting or by an authoritative body like a town development committee, with the citizens’ input about the proposed projects. The town meeting would decide the project’s size and the mode of financing. This, typically, will be from a special per capita tax levied on citizens and from voluntary contributions. Private philanthropists have occasionally made donations of property and money to local schools, churches, and health centers, and to other nonprofit organizations. Unfortunately, because of the infrequency of such donations, any town that is hoping to satisfy its needs for essential projects through philanthropic donations might wait forever. After purchases of materials for the project, work on it will begin. Skilled technicians comprising bricklayers, masons, carpenters, and electricians, who usually provide their services free of charge, perform the work on a project. A day of the week is usually set aside for communal work in which citizens are required to provide their technical skill or manual labor toward the community’s project. Individuals who do not honor this directive and shirk communal work without reasonable excuse are usually summoned to appear before a magistrate’s court.
Loan Processing

The processing of a town’s application for credit must be subjected to strict scrutiny, similar to what banks require of private business enterprises. On their part, the credit institutions must evaluate each request for credit on a case-by-case basis, as they would any private business enterprise. The activity or the types of activities for which the credit would be used, as well as oversight mechanisms to prevent abuse, must all be laid out. In determining the amount of credit to disburse, the financial institutions may also consider the other tangential issues such as population, membership, and activities of the town’s development committee, as well as future possible changes to the local economy. However, the amount of the financial credit applied for, and the projects for which it is intended, must be exclusive decisions for individual townships to make. The processes involved in making those decisions may vary from one township to the other and also among countries. The amount of a loan applied for, and the economic activity to be undertaken, must be carefully evaluated. In addition, the rate of interest and terms of payment must be carefully laid out.

The only deviation banks may have to allow is the provision of a collateral security. Small and medium towns have never engaged in business activities and may lack tangible collateral in the form of buildings, physical assets, or any form of liquid assets. Rather, the types of collateral towns may provide are those with which bank officials may not be familiar. A few fortunate towns may have expensive jewelry in the form of gold or diamond trinkets in the custody of the local chief or deeds to “stool land” that may be laden with minerals. Mining towns in Ghana, as those of other African countries, may be paid annual royalties by the companies that do business on their land. Projected revenues may be used as collateral. The fact that towns, including those that generate sub-
substantial amounts of revenue, have been unable to improve their economic outlook is symptomatic of rural poverty. Regrettably, this could be perpetuated from sheer disinclination of the population to pursue innovative economic and investment ventures.

Credit Obligations

For townsfolk, the benefits associated with incorporation may be far easier to understand than the intricate legal obligations that come with it. The entire township, representing itself, would be required to make monthly capital and interest amortization on the credit borrowed until the entire debt is liquidated. For rural populations living on subsistence economy, this could be a frightening proposition, even if the activity involved generates a steady stream of income. Another imminent hurdle townships will have to overcome is setting up an efficient financial arrangement to ensure proper accounting of all monies disbursed and the day-to-day operation of the project. Unlike the larger municipalities, towns in Africa lack administrative experience because of the absence of projects to manage. The closest experience in management they have had is overseeing small projects which town development committees have provided on ad hoc basis. The experience of town development committees and the collective wisdom of residents will be needed in planning and executing projects and activities that might be considered. The depth of hidden expertise and the spirit of philanthropy individual members of towns possess are often underestimated. However, when called into action, the smartest brains of an average town, comprising teachers, nurses, civil servants, retirees, and professionals who may be living outside the town, may be able to handle the most daunting tasks involved in financial and project planning.
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The Model

Sources of Finance

Although the idea of making financial credit available for people living in rural communities to set up small-scale enterprises is not a new policy, one that recognizes townships as recipients of credit has never before been tried. A broad-based, market-oriented growth strategy that makes efficient use of rural labor and encourages community self-help can be effective for eradicating rural poverty. Central governments must devise a master plan that would involve commercial banks, as well as rural and development banks opening up, by making credit available to small and medium-sized towns. The plan may encourage credit-granting institutions to break their own age-long taboo of not dealing with institutions they consider to not have an identifiable form. The arrangement in Tennessee (U.S.), in which both the federal government and the state combined to provide assistance programs in helping towns that were too poor to pay for sewer projects, is the type of partnership African governments can emulate. Tennessee has provided sewer-project loans at very low interest to towns but has not offered grants. The federal government, through the U.S. Department of Agriculture, on the other hand, has provided grants up to 75% of a project’s cost. Both the low interest loans and the grants have made it possible for towns to provide affordable sewer services for their residents (Ball, 1997).

With so many African governments unable to balance their budgets and with their financial systems experiencing extraordinary inflationary pressures, satisfying the credit demands of the long list of towns which apply for credit, even with the participation of commercial banks, might be nearly impossible to achieve. Governments may find it prudent, in the early stages, at least, to complement their effort with external assistance in the form of bilateral aid, as they have done in the past for large capi-
tal projects. External aid received toward the implementation of this policy would relieve governments of the decision of cutting other domestic programs. It would also minimize the possibility of governments adding an extra debt burden to their economies. The World Bank and the IMF have participated in similar projects intended to accelerate development in several developing nations. Consequently, they can provide invaluable help not only in program design but also in providing central governments hard cash. In the mid-1980s, the IMF provided highly concessional financial support under its Enhanced Structural Adjustment Facility for several developing nations. In furtherance of this objective, in 1996, the United Nations, the World Bank, and the IMF announced a US$25 billion joint program to strengthen African societies with broad programs of education, food production, and other areas over the next decade by redirecting private investment. External assistance must however not displace government initiative and support.

Investment Areas

There are wide-ranging sets of activities in which towns can engage; they include health, education, sanitation, and small manufacturing plants. Some of these activities require large overhead costs in capital, and some have potential for yielding high financial rewards. The type and scale of activities that are chosen must be the town development committees’ decision to make, subject to the final approval of the financial institution. The supply of good drinking water is one of the economic ventures having high revenue potential. An examination of the great potentialities of water as an opportunity for investment illustrates how a carefully selected project could have an infinite number of possibilities.

Providing clean drinking water is one activity townships can undertake without expending too much investment capital. Providing clean, pipe-
borne water has, hitherto, been the exclusive responsibility of governments, often with financial assistance from international agencies. This is attributable to the high cost of equipment necessary for the project, involving the laying of steel or polyurethane pipes, heavy-duty pumping machines, and reservoirs. An exclusive government monopoly over the supply of clean water has resulted in only a small fraction of the population in several African nations being served, and the prospects of the pace of supply increasing are not encouraging. At the International Conference on Water for Peace held in Washington, D.C., in 1967, Zandi, a water resource specialist, warned that in most developing countries, the ancient wells, ponds, cisterns, and a few river development projects could not provide enough water anymore. Consequently, he called for a comprehensive development of water resources including the training of water resources specialists. Over the years, people in small towns in many developing countries have relied on unsafe water from streams, wells, rainfall, ponds, and rivers. In monetary terms, it costs little or nothing to get water from the aforementioned sources; however, the process of getting water, in alternative terms, is inordinately expensive. Obtaining water requires several thousand man-hours per individual every year. Moreover, because water from these sources contains so many impurities, water-borne diseases are rampant in many places in Africa.

If townships were encouraged to assume the responsibility of providing their own clean water, they could lower the scale and cost of water projects through low-cost investments in wells. Strategically placed, roofed, and fitted with rollers and spouts, wells may serve a more utilitarian purpose than public faucets connected by a network of pipes, sprinkled here and there to serve the entire town. Any additional costs that townsfolk want to incur by building reservoirs or providing proper drainage is their decision to make. This approach, which allows citizens to make their own decisions about capital expenditures with little or no input from
government bureaucrats, would not only reduce the cost of providing those services but would also reduce the time it takes to provide them.

Some potentially high revenue-generating activities that have thus far been underutilized include festivals, conventions, and tourist spots such as shrines, palaces, and castles. If towns would sell themselves to tourists, both domestic and foreign, they could generate considerable revenues. Tourism, in several African nations, is still in the early stages of development, and governments have not yet recognized it as a revenue-generating activity. Towns, therefore, need to do a lot more to promote themselves and their culture. A little planning is all that is required to advertise upcoming events in the community to the rest of the country and to set up a visitors’ bureau to advertise local products such as artifacts and food. The brochures that the towns can provide to visitors and temporary stalls built as shelters for hawkers could attract small fees.

**Costing**

Probably the most difficult task facing any township in investment decisions is setting the price for the service provided. Charging a unit price for each service consumed, such as a bucket of water fetched or a toilet facility used, might be the quickest way to generate revenue. It will also minimize wastage by ensuring economy of use. However, it might require a higher administrative cost in providing that particular service since full-time or part-time officials would have to be employed to collect the payments. The alternative of charging a fee for every unit consumed is by levying a flat fee per household, collectible at the end of the month or at the end of the quarter. If compliance is high, it will help lower the service’s overhead cost.
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Problems

Any plans for development in rural communities, no matter how well conceived and designed, are bound to encounter a host of obstacles. Geographically, most towns in Africa are located far from urbanized areas. This makes them closer to the past and to tradition, and usually less influenced by modernization, than large urban centers. There is a higher concentration of semieducated and low-skilled people in towns than in urban areas. Localized conflict and disagreements are based on clans, and family disagreements are prevalent. Moreover, the absence of opportunity and continued deprivation can make rural populations apathetic to accept change and overcoming social taboos about work and the use of resources.

A host of other national and local obstacles may stand in the way of integrating towns into mainstream economic and investment activity. The main political obstacle is acceptance by the ruling class of the primacy of towns in the developmental process. If initial acceptance of this principle by the political leadership is lacking, towns themselves will have a harder time moving beyond the small projects they have customarily initiated. Apart from political insensitivity, a program of this nature may also fail because of local populations that are too apathetic to accept change. Some communities are so riddled by internal factions and conflicts that their people cannot work together, creating an attitude of hopelessness and despair. Towns with large segments of transient or ethnically diverse populations may experience considerable difficulty generating interest in all their residents to invest their time and resources in projects situated in areas where they may have little emotional and ancestral attachment. Problems of geography such as erratic rainfall, poor soil that is susceptible to erosion and drought, and endemic diseases may work to the detri-
ment of some localities in using all of its human and material resources to the fullest. Some remote areas in Africa that have an abundant supply of food and raw materials have been unable to improve their standard of living because of lack of access to more profitable markets. In addition, a paucity of people with clerical, accounting, marketing, and managerial skills has remained a perennial obstacle in earlier attempts by governments to transform rural areas. Consequently, politicians, policy makers, and business entrepreneurs, some of whom were born in rural communities, have hesitated to invest in ventures in small towns because of the factors enumerated above. Nevertheless, numerous opportunities exist for towns to initiate projects that involve the cultivation of land. In nations where there is an abundance of cultivatable land, any improvement in capitalization promises to yield high returns. The crops grown could be for export or the domestic market. An aggregation of these efforts from several towns is bound to make a tremendous impact on the general standards of living.

Conclusion

A policy that seeks to draw towns in Africa into the economic mainstream must be considered important. It will help to mobilize and channel the untapped resources of rural populations into areas that can be expected to make the greatest contribution toward the improvement of people's lives. However, the strategy will never be pursued without strong promotion and support from the political leadership. In the past, when special projects received strong political support, they generally succeeded (McKinley, 1996).

Central governments putting forth a detailed statement of national economic goals and objectives in the form of specific development plans can have a tremendous psychological impact. It can rally the people behind the government in a national campaign to eliminate poverty.
Support of the national government implies providing adequate funding when it is needed, committing the best administrators to oversee the program, and encouraging financial institutions to participate in credit-lending activities. Without a certain degree of aggressiveness and commitment from government officials, apathy from town residents and opposition from traditional bank clientele could undermine the program’s effectiveness. The political leadership must also convince lawmakers about the beneficial impact a policy that gets townships actively involved in business would have on the living standards of people.

Governments can adopt the basic charter of incorporation from nations that have considerable experience in it, such as Canada and the United States. Leaders must also focus their attention to bringing flexibility in the lending practices of commercial banks and rural banks so that they would be sensitive to the particular problems towns, as business entities, would represent. There is little doubt that if a radical policy is not adopted, rural communities in Africa will continue to have second-rate services. These include dilapidated school buildings, ill-equipped hospitals, crumbling bridges, pot-holed roads, unhygienic water and inefficient sewage disposal facilities, as well as the crumbling infrastructure that has made rural living a continual struggle. The spirit of communalism and ingenuity that exists in townships in rural Africa remains, thus far, an untapped resource ready to be harnessed for development, and likely to change the standard of living of rural communities.

References


Journal of Microfinance

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ABSTRACT: Macroeconomic instability is largely detrimental to microenterprises. An unstable economic environment generates inflation and thus hits small business and the poor more severely than the more formal, wealthier segments of the population. Stabilization policies, which eliminate these disadvantages of instability, can help microenterprise.

While healthy macroeconomic factors can positively influence the informal economy, the so-called “informal sector” can strengthen the macroeconomy. Given proper underlying conditions, microenterprise may prove as an engine of growth for an entire economy, and not just a small subsector of only marginal macroeconomic importance.

This article discusses the effects of these macro-micro links with a special focus on IMF-style macroeconomic stabilization policy. It argues that macroeconomic instability imposes high costs on microentrepreneurs. Therefore—contrary to popular belief in the development community—macroeconomic stabilization can ultimately be very beneficial to microentrepreneurs, although it can be costly in the short run.

Any development professional who has worked with microentrepreneurs for any length of time has seen instances in which otherwise well-designed projects fail as the positive effects of the project itself are swamped by the negative impact of bad macroeconomic policies or instability. High inflation, economic recession, or currency devaluations—
when unanticipated by either the project designers or the microentrepreneurs themselves—can sink the most well-intentioned of microcredit programs. This phenomenon is not new; indeed, part of the motivation behind the World Bank’s move into structural adjustment lending at a macroeconomic level in the early 1980s was the bank’s repeated experience of seeing numerous projects fail due to problems in the macroeconomic environment.

While the fact that macroeconomics affects microentrepreneurs is well recognized, the nature and causes of such effects are often poorly understood by microcredit professionals. Likewise, macroeconomists at the International Monetary Fund (IMF)\(^1\) and elsewhere generally have little idea of the interaction between the microenterprise sector and their macroeconomic policy recommendations, and they fail to recognize that in many developing countries, the so-called “informal sector” can be of macro-level importance.

This article discusses the effects of these macro-micro links with a special focus on IMF-style macroeconomic stabilization policy. It argues that macroeconomic instability imposes high costs on microentrepreneurs. Therefore—contrary to popular belief in the development community—macroeconomic stabilization can ultimately be very beneficial to microentrepreneurs, although it can be costly in the short run.

**Characteristics of a Crisis Economy**

Not all developing-country economies in crisis look the same. Different problems manifest themselves with varying intensities in distinct circumstances. Nevertheless, there are a number of macroeconomic symp-
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toms shared by most economies in macroeconomic crisis, which are generally linked to a similar set of underlying causes.

Causes of a Macroeconomic Crisis

The “big three” of underlying macroeconomic problems that generate instability are unsustainable fiscal deficits, unsustainable external current account deficits, and unsustainably lax monetary policy. Simply put, both fiscal and current account deficit problems are induced by over-spending. A fiscal deficit is unsustainable when the government spends more than it can take in through taxes and borrowing. A current account deficit is unsustainable when the country as a whole consumes more goods and services from abroad than it can pay for, through either export earnings or foreign borrowing. It should be stressed that no specific level of government spending is too much per se, nor is any particular pace of imports too high. Some countries are able to finance large fiscal or current account deficits for extended periods of time without crisis because they have ready access to financing. Other countries find such borrowing extremely difficult because they are seen as unreliable, either because of bad current policies (such as overvalued exchange rates or profligate government spending) or because of a high level of accumulated debt from the past. Lax monetary policy is often related to high fiscal deficits as a government, unable to finance its deficits by conventional means, resorts to printing money to cover the gap. Lax monetary policy can also be imposed by a government in an attempt to provide cheap credit to the economy as a means of stimulating economic growth.

Beyond the three macroeconomic causes of instability (fiscal deficits, current account deficits, and loose monetary policy), several underlying problems with the economic structure may lead to a crisis in many developing countries. Most prominent among these, given the economic crises in Mexico in 1995 and East Asia in 1997–98, is financial sector weakness.
In Mexico to a degree, and even more so among the East Asian countries recently suffering from macroeconomic instability, the traditional fiscal and monetary deficiencies that lead to a balance of payments crisis were not major factors. Rather, the unsustainably high current account deficits were related to serious deficiencies in the banking sectors. While the verdict is still out as to the full explanation for the Asian debacle, it appears that poorly monitored and poorly run financial institutions played a crucial role. By overextending themselves with dubious lending, they first fueled an asset price boom and then exacerbated the bust by falling into insolvency when the speculative bubble burst. For the purposes of this discussion, it suffices to note that serious deviations from standard market practices, such as subsidized and directed credit programs and artificially low interest rates, played a crucial role.

Structural problems in the labor market can play a less obvious, but nonetheless important role in macroeconomic instability. In many troubled economies, the labor market is too rigid to permit the kinds of small but steady adjustments that can avert a crisis. The exact problems differ from country to country, but often the formal sector of the economy suffers from tight restrictions on working conditions and labor mobility, overtaxation, unrealistically high minimum wages, and other problems that generate labor market segmentation. The rigid real wages in the formal sector resulting from these problems often contribute to a devaluation-inflation spiral that forces a country with an uncompetitive external position to devalue in order to restore external equilibrium. The devaluation generates inflation, which in turn stimulates increased wages (either from wage indexation or from union pressures), causing inflation to rise even higher. Higher prices and wages once again erode competitiveness, generating a current account crisis—and the cycle begins again.

Other structural rigidities in an economy may also contribute to the macroeconomic crisis, either by exacerbating fiscal or current account
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deficits, or by making recovery from initial macro imbalances more difficult. Among such rigidities are price controls on key products (such as food sales or agricultural output), protectionist tariffs, and quotas on imports.

**Symptoms of a Crisis Economy**

There are two major macroeconomic results of the unsustainable economic policies mentioned above. The first is inflation—the result of some combination of these fiscal, external, and monetary imbalances. Fiscal imbalances can induce inflation as governments resort to printing money to finance the deficit in the absence of other funding sources. External imbalances can provoke inflation via a devaluation-inflation spiral whereby the excessive current account deficit triggers successive currency devaluations in an attempt to regain competitiveness. The devaluations in turn provoke inflation, which, if not kept in check, corrodes competitiveness again and provokes another current account crisis and starts the cycle once more. Finally, because inflation is ultimately a monetary phenomenon, any provocation for increases in the growth rate of the money supply beyond its sustainable rate will result in inflation.2

The second common result of macroeconomic crisis is problems with GDP growth. Countries suffering from current account or fiscal imbalances often suffer either from prolonged stagnation (like Argentina in the 1970s and 1980s) or from boom-and-bust cycles, where unsustainable spurts of growth are followed by sharp contractions (the case of Turkey in the 1990s or Peru in the 1980s). Stagnation can occur when a country attempts to forestall the results of unsustainable policies by maintaining tight controls on the economic structure (which also stunt growth). For example, a country might implement foreign exchange controls and high tariffs in an attempt to stave off external imbalances, or impose interest rate and price controls in an effort to counteract the inflationary effects.
of printing money to finance a large fiscal deficit. These types of restrictions can often postpone a crisis, but the restrictions on imposed economic activity take a toll on the dynamism of the economy. In contrast, boom-and-bust cycles result from a government’s attempt to stoke the furnace of growth via unsustainable monetary or fiscal policy. The resulting imbalances produce a crisis that in turn forces an economic contraction. Once the crisis has hit bottom, the government sees a need to restore growth and again begins its expansionary efforts, producing yet another crisis, and so on.

Effects of Macroeconomic Crisis on the Microentrepreneur

Having briefly reviewed the causes and results of macroeconomic crisis, I now turn to discussing its impact on the microentrepreneur. While it is true that fiscal imbalance or balance of payments deficit per se may not be bad for the microentrepreneur, when these disequilibria generate economic crisis, they can have serious negative effects.

Inflation—The Microentrepreneur’s Worst Enemy

Inflation hits microentrepreneurs hard. In fact, it probably affects them disproportionately compared to other, more prosperous segments of the economy. This is true on several levels. First, inflation is, in essence, a tax on holders of cash money. Those who hold more money therefore pay more of this tax. While this may give the impression that rich people would pay more inflation tax than the poor, that is not generally true. The inflation tax falls disproportionately on those who rely most on cash. The wealthy, especially in high inflation economies, have alternative instruments to use in place of cash-interest-bearing bank deposits, bank accounts abroad, credit cards, real estate investments—which do not pay inflation tax. Microentrepreneurs, in contrast, generally rely heavily on
cash in their business and personal economic activities. They often have very limited access to financial instruments to avoid inflation.

Accelerating or highly volatile inflation rates can have particularly pernicious effects on microentrepreneurs. Sophisticated large enterprises in economies with variable inflation often employ teams of experts to manage their assets against inflation’s corrosive effects. Small entrepreneurs, on the other hand, often use rudimentary accounting systems and rely on markup pricing techniques that can fail utterly in an accelerating inflation environment, causing microenterprises to become decapitalized.4

These negative inflation effects are particularly acute in the area of microcredit. Not only can individual microentrepreneurs become decapitalized by inflation, but entire microcredit programs can collapse. When credit programs involve rotating or guarantee funds, the value of these facilities can be wiped out when inflation kicks in, or when it accelerates beyond the level foreseen when the funds were originally lent. Unlike the private banking system, which will raise interest rates and shorten loan maturities quickly (and ruthlessly) to maintain their profit margins, microcredit programs can be destroyed by inflation because they tend to lend at longer maturities, at lower interest rates, and often lack sophisticated credit management policies. Even when interest rates are adjusted to account for high inflation, volatility in the rate can also cripple microcredit programs.

Consider a country expecting an inflation rate of 8% (plus or minus 2%). A lender can set interest rates at 15% and be confident of a real return of 5% on the loan. If, as in the case of Turkey today, inflation is expected to be 80% (plus or minus 20%), a lender must set interest rates at 110% to guarantee the same 5% real rate of return. The volatility in proportional terms is the same for both cases, but the impact on a borrowing microentrepreneur would be very different. In the low inflation
case, a nominal interest rate of 15% would result in a real interest rate between 5% and 9%, depending on the level of inflation. This variance could be accommodated easily in the investment plans of most borrowers. In the case of high and volatile inflation, on the other hand, the real interest rate could be anywhere between 5% and 31%, a range that could make investment much more difficult for a borrower.

“Boom and Bust” is Bad for Microentrepreneurs

The cycles of boom and bust often produced by a macroeconomically unstable economy can also be bad for microentrepreneurs for at least three reasons. First, boom-and-bust cycles in a fundamentally unstable economy will result in lower growth over the business cycle than stable, albeit less spectacular, growth. To the extent that microentrepreneurs benefit from higher economic growth in general, they would prefer this stable growth to boom and bust. For example, in the ten years since stabilization in the mid-1980s, Bolivia’s growth has averaged a modest 3.5% per year without ever exceeding 6%. But that performance is far superior to what Bolivia experienced in the 15 years before when, despite the seven-year boom in the early 1970s when GDP grew by some 6% per year, the average growth over the boom-and-bust cycle was a meager 1.8% per year. A similar phenomenon occurred in Peru in the late 1980s, when the government of Alán García pushed the economy into an unsustainable boom in 1985–87, followed by a bust in the late 1980s. During the two boom years, GDP grew by more than 9%; but in the succeeding three years, the bust was also nearly 9% per year, leaving the economy with negative growth plus severe hyperinflation during the García years.

Boom and bust can be harmful to microenterprises because it is produced by distortionary economic policies that can discriminate against them. This is the case with the Import Substitution Industrialization (ISI) policies followed in much of the developing world in the 1960s and
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1970s. ISI policies generally involved subsidizing credit and foreign exchange to favored, large-scale industrial development projects, while the remainder of the economy (including microentrepreneurs) paid with higher interest rates, more costly foreign exchange, and expensive imports due to high tariff barriers.

**Underlying Structural Problems Can Also Be Harmful to Microenterprise**

Distortions in the economic structure underlying macroeconomic instability in developing countries can, in and of themselves, pose serious impediments to the growth of microenterprise. Financial sector distortions are one such impediment. As advocates of microcredit programs are well aware, the microenterprise sector is often either ignored or marginalized by formal sector financial institutions, and distortionary policies in this sector to “improve” credit allocation rarely favor the microentrepreneur. Directed credit programs are rarely directed toward microenterprise. In an economy in which some of the available credit pool is directed toward favored firms, the interest rates for the remaining borrowers (microentrepreneurs among them) are higher than they would otherwise have been. Interest rate controls do not work well, but to the extent that they do, they induce credit rationing. Rationing regimes usually favor large, low-risk borrowers, or the politically well connected. The microentrepreneur is not one of the so privileged. More generally, a closed and secretive financial system breeds cronyism, but microentrepreneurs are not the cronies who benefit. Finally, restrictions on the financial system contribute to inadequate development of financial markets and to poorly capitalized banks (particularly when publicly owned). A shallow and poorly capitalized financial system is a recipe for triggering the kind of macroeconomic crisis suffered in Asia in 1997 and Mexico in 1995.
Rigidities in labor markets can also have negative effects on the microentrepreneur. While it may seem paradoxical, regulations in the organized, formal labor market designed to improve wages and working conditions can actually depress incomes and conditions in the microenterprise sector. This occurs because these regulations often contribute to segmentation of the labor market, and segmentation hurts those in the unfavored segments. For example, when regulations push up minimum formal sector wages, those employed in formal firms improve their lot; but firms respond by cutting back formal employment, driving more people into the informal labor market to compete with the microentrepreneurs and laborers already there, driving down their wages.

Similar arguments could be made regarding other structural distortions of the economy, although it is true that not every distortion of free-market forces disfavors the microentrepreneur. Price controls are a case in point; they depend on the products subject to controls. In many African countries, for example, price controls have been imposed on agricultural products. This hurts small farmers, while favoring the small merchants and industrial producers of urban microenterprise. On the other hand, foreign exchange controls often disfavor the microenterprise sector because they are rarely granted access to foreign currency and the more favorable rates.

**Characteristics of Typical “Orthodox” Stabilization Policies**

Having explored both the characteristics of an unstable economy and the reasons why instability is bad for microentrepreneurs, I now turn to the characteristics of the typical IMF-style stabilization policy and its effects on the economy. While in my opinion the oft-heard criticism that the IMF dishes out cookie-cutter stabilization programs throughout the world without regard for national conditions is unfounded, it is true that a
number of characteristics are common to most orthodox stabilization programs (including those not involving outside organizations like the IMF). These policies can be grouped according to the four policy problems they address: fiscal deficits, balance of payments problems, inflation, and structural problems.

**Fiscal Deficit Reduction**

Orthodox stabilization policies generally include provisions to reduce the fiscal deficit for several reasons: The deficit may be unsustainable in the sense that the government can no longer finance it; it may be generating inflation or balance-of-payments problems by boosting domestic demand excessively; or it may “crowd out” private investment, thus depressing growth. Whatever the motivation, some combination of spending cuts and tax increases is commonly recommended to shrink the deficit. On the spending side, cuts ideally are concentrated on less productive government activities (such as military spending or the size of the bureaucracy), with remaining resources redirected toward more crucial government functions. In practice, the degree to which spending cuts approximate this ideal varies greatly from country to country depending on the domestic political environment.

Fifteen or twenty years ago, little provision was made in most stabilization programs for preserving programs that affect the poor, let alone providing additional resources to cushion the costs of macroeconomic adjustment. That is no longer the case. Today it is unusual to see an adjustment program without a special “social safety net” component to catch individuals whose income topples as a result of the program. On the revenue side, stabilization programs commonly include measures aimed at simplifying the tax system by reducing the number of different taxes, unifying tax rates, and cutting tax shelters and loopholes. In the process, however, the overall tax burden generally rises. The exact break-
down between expenditure cuts and tax increases usually depends on the overall size of government spending in the economy (larger governments receive higher cuts), but it might also vary according to other factors (such as limits on a government’s revenue-raising ability).

**Tackling Balance-of-Payments Problems**

In dealing with an external imbalance, orthodox stabilization programs rely on three sets of policies: measures to cut domestic demand, devaluations, and steps to improve financing of the current account deficit. Cutting domestic demand reduces the demand for imports and improves the balance of payments on that side of the equation. Tighter fiscal policy reduces public sector demand and may also reduce private demand, as the government transfers less money to the private sector via transfer payments or as the government extracts spending money from private hands in increased taxes. Tighter monetary policy also depresses demand by raising interest rates, which in turn lower investment and consumer spending financed by credit. Devaluation is another tool often used in stabilization policies to improve the current account. A devaluation raises the price of imports (in domestic currency terms) while making a country’s exports more attractive abroad by lowering their cost to foreign buyers. Obviously, since imports become more expensive, devaluations have a demand-reduction component as well. The final component of a balance-of-payments policy is action to improve financing of the current account deficit. It is generally not optimal for a developing country to run a current account surplus (which means the country exports investment capital abroad). A deficit is desirable to provide needed imports with foreign capital financing investment projects. A balance-of-payments crisis arises only when the gap between exports and imports is larger than what can be financed abroad. In addition to reducing the overall size of the deficit, orthodox stabilization programs provide
money to cover part of the remaining deficit (that is the explicit purpose of IMF loans). The higher domestic interest rates induced by tight monetary policy can also partially finance a current account deficit by attracting foreign capital to the country.

Reducing Inflation

As already mentioned, tight monetary policy is a common component of stabilization policies, because it can assist in a balance-of-payments crisis by both reducing domestic demand and encouraging inflows of foreign capital. In addition, tight monetary policy is an important element in the fight against inflation, both by reducing inflationary pressures from high domestic demand and by restricting the quantity of money available. Fiscal policy also plays a role in the fight against inflation, since it is often a fiscal imbalance that provokes the emission of inflationary quantities of money.

Addressing the Underlying Structural Problems of the Economy

Increasingly, economic crises around the world are provoked by the macroeconomic effects of underlying structural problems. As a result, IMF stabilization programs more and more often include important structural reform components. These structural reforms generally address weaknesses that cause crises and improve overall economic efficiency.

Privatization of public enterprises is often high on the agenda of stabilization programs. In many crisis economies, fiscal imbalances have been exacerbated by losses registered by inefficient government-owned monopolies. Sale of these enterprises to private investors can thus help improve the fiscal balance. In addition, these firms commonly occupy crucial positions in the economy (basic utilities, energy, transport, bank-
ing, etc.), and their inefficiency has negative repercussions for the productivity of the entire economy. In the external sector, structural reform generally requires the reduction and homogenization of tariff rates and the elimination of quantitative restrictions on imports. These measures reduce protection for inefficient domestic industries and the distortion of investment priorities, which arises from differential protection. They can have the negative side effect of aggravating current account problems by making imports less expensive. It is for this reason that trade liberalization is often undertaken in stages or is linked explicitly to devaluation.

As recent experience in Asia has convincingly demonstrated, weakness in the banking system can provoke a macroeconomic crisis, or at the very least aggravate an already existing crisis. Thus, financial sector reforms are taking center stage in the structural reform agenda. Measures enforced in this area include the closure, sale, or consolidation of insolvent banks and deregulation of interest rates, and increased regulatory supervision regarding the quality of banking system assets. The elimination of subsidized or direct lending programs and the privatization of state-owned banks also play an important role in many reform programs.

Finally, labor market reforms can play an important role in economic restructuring, although they often take much longer than the initial drive for stabilization. Barriers to the flexible use of labor are reduced, collective bargaining decentralized, and non-wage costs (social security contributions, taxes, dismissal costs) reduced. Often, public sector wages are cut, inducing a corresponding reduction in some private sector wages. Countries with unrealistically high minimum wages often freeze the wage or introduce new flexible contracts not subject to the same stringent requirements as those of previous workers.
Effects of Stabilization Policies on Microenterprise

To summarize the article thus far, its argument is that macroeconomic instability harms microentrepreneurs in various ways. Instability itself hurts microenterprise by depressing overall economic growth and by stoking the fires of inflation. In addition, the financial, labor, and other structural rigidities that often provoke macroeconomic crisis also have generally negative effects on microenterprise. If this is the case, one might reason that the policies to cure macroeconomic instability should, by implication, be good for microenterprise. This is where my argument becomes controversial, since it is widely held in the NGO community working with microenterprise that stabilization policies are bad for the poor and for small enterprise. Is this a case of the cure being worse than the disease? To answer this question, we now look at how the stabilization policies described in the previous section affect the microentrepreneur. We must be careful, however, about what we compare the effects of stabilization policy with. Comparing the situation of microentrepreneurs before and after stabilization gives an incomplete picture, because the status quo ante was not a sustainable one. That is the definition of a crisis after all—an unsustainable economic imbalance. Rather, the comparison should be between how microentrepreneurs fare under orthodox stabilization and how they might fare if the crisis had continued unchecked or if some other approach to stabilization been applied.5

Any evaluation of the costs and benefits of orthodox stabilization for microentrepreneurs must begin by acknowledging that there are both costs and benefits. Adjustment is not a painless process for anyone in society. Furthermore, some sectors pay more of the consequences of stabilization than others. Moreover, the balance between costs and benefits varies over time. Initially, adjustment can be very costly, with the benefits appearing more and more prominent only over time. With these
caveats in mind, let us examine the impacts on microenterprise in each of the main areas of adjustment policy.

**Stabilization Generally Induces Economic Recessions that Hurt Microenterprise**

As even a casual observer of developing countries realizes, the combination of tight fiscal and tight monetary policies contained in many stabilization policies often provokes an economic recession. The severity of the drop in economic growth depends on the degree of adjustment needed to restore stability, the severity of the prestabilization crisis, and the speed and comprehensiveness with which reforms are undertaken. In some of the most severe economic crises in recent years (Bolivia in the mid-1980s, Peru and Argentina in the early 1990s), stabilization was achieved with relatively little additional reduction in output above what had already occurred in the downward spiral toward instability. These severe cases often showed a rapid return to strongly positive economic growth, perhaps reflecting the depth to which the countries had already sunk, or the speed and comprehensiveness with which reforms were implemented. Nevertheless, it remains the case that, generally, stabilizing countries pay a short-term price in terms of economic growth, and that price is shared by the microenterprise sector. What is not at all clear is whether microentrepreneurs suffer disproportionately from stabilization-induced recessions, as is commonly asserted. Since in many countries recessions do expand the ranks of microenterprise and depress incomes there (as people losing jobs in the formal economy set themselves up in independent economic activities to generate income and compete with existing microentrepreneurs), it is likely that drops in economic activity do affect the small business sector more than proportionately. However, in a stabilization
package where drops in output are accompanied by important anti-inflation and structural adjustment components, the total package may have very different costs and benefits.

**Fiscal Contraction Has an Ambiguous Effect**

Depending on how fiscal adjustment is undertaken in a stabilization, microenterprise could be less or more affected. If social spending programs for the poor are cut sharply in the austerity drive and microentrepreneurs benefit from such programs, then obviously they will be hit hard. If, on the other hand, austerity involves cuts in public sector wages, subsidies to public enterprises, or reductions in large-scale investment programs, microenterprise should fare relatively well. On the tax side, any increases are likely to hit microentrepreneurs less severely than other sectors of the economy because they tend to have relatively low incomes and to be difficult to tax due to their small size.

**Devaluations Often Favor Microenterprise**

Devaluations make imported goods more expensive. Thus the cost of a devaluation falls more heavily on those who import more. On a business level, microenterprises tend to have a much lower import coefficient than large, formal enterprises, so they will suffer less. On a household level, families in the microenterprise sector also tend to consume fewer imported products than those in higher income strata, so here, too, the effects are less severe for microentrepreneurs and their families. Moreover, when imports become more expensive, consumers tend to shift spending toward domestic substitutes for foreign goods. Because microenterprises often produce such substitutes, the demand for their goods can actually rise, improving their incomes.
Tight Monetary Policy to Reduce Inflation Favors Microentrepreneurs

Tight monetary policy is one of the factors causing stabilization-related recessions, so in this sense, tight money can hurt the microentrepreneur. But there are at least two reasons to think that microentrepreneurs are less seriously affected. Tight money contracts output through the effect of higher interest rates on consumption and investment, but since microentrepreneurs are less involved in credit markets, they pay less of the business cost of higher rates. If tighter monetary policy combines with financial sector reforms to make access to credit fairer and more open, microentrepreneurs might actually see an improvement in their access to loans. Even more important, tight monetary policy is the number-one policy tool in the fight against inflation. If temporarily higher interest rates result in a permanent reduction in the inflation rate (entrepreneurs number-one enemy), the net effect might well be favorable for microenterprise.

Structural Reforms Are Almost Always Good for Microentrepreneurs

As discussed in detail above, the structural reforms included in orthodox stabilization programs are generally oriented toward eliminating distortions in the economy that favor some groups over others. Because microentrepreneurs are rarely among the favored few, they stand to lose little—and quite possibly gain much—from such reforms. A few examples from different structural areas illustrate this point:

• Privatization and the restructuring of public enterprises can have a salutary effect on microenterprise by improving the basic public services on which they rely for their business operations (electric-
ity, water, telephones, transport). In some cases, privatization can even directly involve microenterprises.  

- Financial sector reforms generally result in easier access to credit for firms that are not politically well connected, microenterprises among them. They can also reduce the costs of credit as banks improve their efficiency in the wake of deregulation and privatization. In countries where directed or subsidized credit programs target microentrepreneurs, there may be some cost, but in most economies microentrepreneurs would be helped by the elimination of directed credit.

**Conclusion**

This article has argued that macroeconomic instability is largely detrimental to microenterprises. It lowers overall economic performance, which hurts microenterprise along with its economic sectors. It generates inflation and thus hits small business and the poor more severely than the more formal, wealthier segments of the population. And economic instability is generally associated with numerous microeconomic distortions in the labor markets, financial systems, and external trade that almost inevitably hurt smaller, less politically influential economic agents like microentrepreneurs. It follows from this that stabilization policies which eliminate these disadvantages of instability can help microenterprise. While acknowledging that orthodox stabilization policies involve short-run costs for microentrepreneurs, I argue that in the long run, microenterprise stands to gain much more from a stable, growing, and unfettered economy. Furthermore, it does not seem that the microenterprise sector shoulders a disproportionate share of this stabilization burden. Indeed, in terms of the benefits from inflation reduction and structural reform, they may well fare better than most. Given proper underlying conditions, microenterprise may prove an engine of growth
for an entire economy, and not just a small subsector of only marginal macroeconomic importance. There is some evidence that this has already occurred in some economies at some points of their development. During the late 1980s, microenterprises participating in the BRI-KUPEDES credit project in Indonesia directly generated roughly one-eighth of the country’s economic growth. In Bolivia in the early 1990s, successive household income surveys found that the single most dynamic segment of the national economy was small enterprise, contributing significantly to overall economic growth. In Bangladesh, where the Grameen Bank has now had a long history of microcredit lending to large numbers of people, the success achieved has almost certainly been of macroeconomic importance. Other examples could certainly be cited. The argument 20 years ago among some analysts that the informal sector should be ignored or repressed because it lacked any growth potential has been definitively rebutted by events. It remains for governments, NGOs, aid agencies, and the microentrepreneurs themselves to set in place the policies necessary to realize the potential now known to exist for growth and development through microenterprise.

Notes

1. The views expressed in this article are those of the author and do not necessarily represent those of the IMF.
2. A sustainable noninflationary rate of monetary growth would be the rate of increase consistent with real economic growth and financial market deepening.
3. Inflation is a tax in the following sense: The government accrues revenue from printing money (known as seignorage), but printing additional money for a given level of economic activity raises prices, eroding the purchasing power of money holdings. In this way, the revenue accruing to the government by printing money comes from an appropriation of part of the value of holders of money.
4. An example of this occurred in Peru while I was in the process of microenterprise research in 1988, at the start of an inflationary spiral that culminated in hyperinflation. One of the most common complaints of microentrepreneurs surveyed in Lima was decapitalization. When I delved into the causes of this phe-
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It became clear that most microentrepreneurs worked on a simple markup pricing system: They bought their inputs and sold the final product at a price approximately 50% higher than they had paid (a lower margin for commerce). With inflation running at more than 600% per year, a turnaround on production every two months would mean that the ostensible 50% markup was really only 12%, leaving the microentrepreneur without sufficient income to sustain consumption and maintain working capital. Even when entrepreneurs began to factor in a given amount of inflation, they were constantly caught short by the fact that inflation was accelerating.

5. There have been other types of stabilizations. Peru, Argentina, and Brazil all tried so-called “heterodox” stabilization policies in the mid-1980s, which may be compared to the orthodox policies implemented there later. In the recent Asian crisis, Malaysia decided to forego an IMF lending program and implement an indigenous adjustment strategy. In future years this will provide another instructive contrast.

6. Even this conclusion must be tempered. Empirical studies have often found a larger informal economy with lower incomes after stabilization than before. However, that finding alone does not mean that stabilization hurts them disproportionately. Three other considerations should be made—but rarely are—in the literature. First, there is a composition effect: New entrants to the sector may have lower incomes than the existing entrepreneurs, lowering the average income in the sector without lowering incomes of preexisting microenterprises. Second, as mentioned in the main text, the prestabilization versus poststabilization comparison neglects the real possibility that incomes in the sector might well have declined more in the absence of stabilization. Third, although studies showing falling incomes in the sector are fairly common, there is little evidence that falls are larger in microenterprises than elsewhere.

7. Examples of this are an increase in the auto repair business (often microenterprise) when the price of imported new cars rises or an increase in demand for domestically sewn clothes when imported clothes become more expensive due to devaluation.

8. For example, in La Paz, Bolivia, trash collection was privatized in the early 1990s, with microenterprises capturing a significant share of the service contracts issued.
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Small Business Promotion and Microlending:

A Comparative Assessment of Jamaican and Israeli NGOs

by Benson Honig

Abstract: Loan programs in two different countries, Israel and Jamaica, are compared and contrasted, in order to identify common elements of project design, selection, and institutional norms. Utilizing agency theory, this article examines what types of borrowers successfully navigate the credit market and to what extent the bureaucratic processes employed by institutions influence and bias outcomes in unpredicted ways in organizations.

Entrepreneurs are well recognized as coming from a wide range of backgrounds; indeed, it is the very heterogeneity of their origins that allows many to provide the newness of perspective so necessary for their activities. However, hidden or tacit institutional biases were found to work against this diversity, limiting severely the impact of efforts to sustain an entrepreneurial culture and to promote economic development.

The characteristics of the lowest level of organizational actor(s) were found to differentiate successful innovation from unsuccessful attempts. Selection of the appropriate staff was found not only to influence the qual-
Small Business Promotion and Microlending

Introduction

The role of small scale industries in providing employment has increasingly become of concern to policy makers, donors, and researchers. Millions of people in developing countries produce a wide variety of goods and services, often operating out of makeshift locations and under severe resource constraints. Financial services to support these micro and small businesses are becoming the preferred point of support throughout the developing and developed world. GEMINI (Growth and Equity through Microenterprise Investments and Institutions), ACCION, the Grameen Bank, and PRODEM, represent just a few of the better known NGOs (non-governmental organizations) engaged in such lending activities (Hossain, 1988; Lycette & White, 1989; Rhyne & Otero, 1994).

While lending activities have proliferated, research regarding both the outcomes and the processes has been quite limited. Evaluating the influence of credit on various businesses is extremely hard to assess—imputing how much of one firm’s success can be attributed to financial resources, as opposed to entrepreneurial capabilities, market conditions, and other factors, is, at best, a dubious proposition. Most NGOs are obliged to report their comparative success in terms of default data; high repayment rates are considered a success, low rates a failure. While this information is useful to bilateral and multilateral donors, it fails to assess a number of more critical dimensions, particularly which firms are helped and how they are chosen. This is the research gap that this article will examine.

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Background and Theoretical Framework

Consultants, community development agents, and managers are frequently charged with the objective of implementing new programs across widely different cultural landscapes. In doing so, they face formidable obstacles in ascertaining programmatic quality and consistency throughout their organizations. Like the game “telephone line” many of us played as children, ideas that seem clear and succinct at the top of the organizational hierarchy become incomprehensible once they diffuse to the field. Multiple interpretations by employees of the goals emitted from the funding source or top of an organizational hierarchy undermine the potential for rational planned outcomes that reflect the unique environmental qualities of each particular situation. One further complication is that organizations use very different approaches to decision making. Managers at the top of the hierarchy who have a clear line of access to relevant field-level information maintain a distinct advantage over the competition—as do those with greater levels of trust in their subordinates.

While institutional theory suggests that much of what organizations do is shrouded in ceremony and myth (Meyer & Rowan, 1977), limited efforts are typically made regarding understanding the source or root of such institutional norms and values. Turning the organizational hierarchy upside down, I propose in this article that the employees of organizations determine goals that are subsequently legitimized or reconstructed by authority figures. In order to illustrate this assertion, let us turn to examples of organizations that work across wide cultural chasms.

The World Bank and many bilateral agencies, such as USAID, are leaders in promoting and diffusing a wide range of development programs focused on small enterprise promotion and support, primarily in less developed countries (LDCs). For many obvious and well-heralded rea-
sons, bilateral and multilateral donors have a vested interest in ensuring that markets remain open, tariff and trade barriers reduced, and subsidies are eliminated. Supporting new and small businesses is often linked to these ubiquitous policies.

Historically, many developing countries have favored erecting protectionist market mechanisms, such as import substitution, in order to nurture specific industries, including many small businesses. As monetary and financial policies in LDCs increasingly move toward normative world practices promoting competitive conditions, many small businesses and subsectors have fallen victim to radical environmental changes over which they have little or no control. Not only do LDCs exhibit such swings, but so do small businesses in blighted urban areas of many developed country cities. “White flight” and the exodus of the middle class, industry, and accompanied service and retail facilities often render them susceptible to exogenous factors out of their control. To help ameliorate some of these conditions, considerable efforts continue to be made to assist small businesses in economically depressed environments. Well-known examples include the Grameen Bank’s work in Bangladesh, ACCION in Latin America, multiple efforts in Eastern Europe and Africa, as well as the Small Business Administration (SBA) and other regional organizations in urban areas of the United States.

One very popular method of mitigation is to provide targeted assistance toward employment generation and small business adaptation schemes. Indeed, the World Bank proudly proclaims that they have provided many millions of dollars to microbusinesses, and USAID, likewise (under specific direction from Congress) claims to have provided considerable sums to small businesses, while the SBA in the United States had US$15 billion outstanding in over 100,000 loans to small businesses in 1993.
Worldwide, the two most common forms of assistance include small business/entrepreneurial training programs and microlending, of which the latter is the most prevalent. Small loans are popular for three main reasons:

1. They are fairly easy to monitor, in terms of distribution and default rates.
2. They are thought to require limited overhead and staff support.
3. They fulfill a specific need often mentioned by small business persons; namely the limited availability of capital from the traditional banking institutions, who are otherwise inattentive to small and microbusinesses and their financial requirements.

In the 1990s, targeted assistance was rarely a strict bilateral arrangement. As with many private and government organizations that have delayered and now out-source much of their noncritical activities, the aid industry increasingly relies upon outside contractors to perform the “nuts and bolts” of day-to-day operation in the field.

The development industry itself relies upon armies of consultants who are recruited on an ad hoc basis, sometimes taken from larger organizations that can no longer justify their overhead. Behind the rather large sums of money dedicated to small business development are consulting firms (sometimes referred to as “beltway bandits” in Washington, D.C.) located in capitol cities throughout the developing and developed world. Each agency caters toward a number of constituencies, each representing a requisite number of experts as well as policy makers with individual and collective agendas that may diverge from the economic criteria or from the donor at large (Hancock, 1989). Included are issues that may exist far afield of general business promotion, such as factors relating to gender, class, ethnicity, mobility, democracy, education, and free-market capitalism.
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Once consultants have been identified through competitive bidding on the part of agencies, they are frequently sent to work with NGOs and with governments. These institutions exist with histories of their own—separate and unique from that of the donors and consulting agencies. Depending on their organizational cultures, they, too, focus on issues tangential to general business promotion, including factors relating to political partisanship, regional politics, gender, ethnicity, class, mobility, democracy, education, and free-market capitalism, to name but a few.

Finally, at the lowest level—at the point of contact between the aforementioned donors and agencies, and the actual client—exists the actor or development agent, whose role might be further defined as a trainer, educator, loan agent, representative, or program director. While the governance and bureaucratic nature of an organization may be determined by their historic development, or by governmental regulation, development agents are often in a pivotal position to affect outcomes due to individual bias and preferences. In many developing countries, actors may be governed by reciprocity, as characterized by personal market exchange, rather than by impersonal markets (Plattner, 1985). Relationships are long term, open-ended, and governed by noninstrumental components. Asymmetrical and imperfect information, as well as weak legal protection, contribute to this characteristic, as loan agents know little of the backgrounds of the people they assist, and they have limited enforcement mechanisms (Stiglitz & Weiss, 1981).

At the micro level, self-categorization theory provides a useful psychological framework for understanding relationships that evolve between the various actors. Individuals attempting to maintain high self-esteem are said to identify themselves into in categories such as age, race, status, and religion (Turner, 1987). For example, one study demonstrated that in-group members consider out-group members as less trustworthy and less honest (Brewer, 1979). From an individual standpoint, attributes of
the organizational members at the “point of contact” will have a significant influence on the character of the clientele, regardless of the organizational structure or its governance. In situations where information is lacking and results are stringently adhered to, developing biases in favor of clients that resemble the development agent may be a useful survival strategy.

**Theoretical Perspective:**

**The Organization in Combat**

Collective members of organizations typically set goals, make decisions, and implement strategies. The character, conditions, and methods of these processes continue to be hotly contested in the literature, which acknowledges the limited rationality of actors constrained by numerous variables forced to make decisions in a limited time frame (Simon, 1957; Steinbruner, 1974). In addition, international dimensions, resulting from the incorporation of actors representing various cultural and nationalistic perspectives, further compound organizational complexity (Hambrick, et al., 1998; Hofstede, 1980; Boyacigiller & Adler, 1991); however, space limitations prohibit an adequate discussion in this article.

To understand organizational decision-making from a more pragmatic perspective, let us move to a very constrained and structured organizational process: consider a military operation during the heat of battle. At the start of a war, commanding generals are typically in clear communication and control of their troops. They carefully lay down specific goals and objectives: “Take this territory,” “Break through defenses here,” “Proceed to this point,” etc. As the war progresses, communication becomes disorganized, infrequent, and increasingly incomprehensible between the field and headquarters. Reporting becomes sporadic, the big picture appears quite fuzzy, and the original goals and objectives
increasingly appear irrelevant, as the enemy reacts to the situation at hand and changes their position in real time.

In the field, meanwhile, small units, controlled by individual actors, are facing a barrage of stimuli possibly in direct contradiction to what was specified they would face in the original operational plan. These units have two alternatives: They can stick to orders, regardless of the irrelevancy of the original plan, or they can form new objectives based on the situation they now face. The first alternative, that of proceeding with the original plan, may entail considerable risks. For instance, the movie *A Bridge Too Far*, depicts British field officers during WWII refusing to deviate from their initial plan, resulting in the unnecessary mass slaughter of their own troops. In marked contrast, acutely aware of the organizational hazards inherent in failing to adapt and modify plans, the Israeli army learned to train and refine its troops to make battle-level operational decisions “on the fly.” Such decisions are conducted at the field level, sometimes conflicting with, other times directing, real time operational plans at headquarters. This form of limited direction and field-level innovation worked exceptionally well against the Egyptian front in 1967, where, as one analyst reports, “Of the four days that the campaign lasted, only the first was planned in any detail; the rest was pure improvisation” (Van Creveld, 1985).

During the 1973 Arab–Israeli War, contradictory organizational goals, combined with ineffective and inefficient decision making nearly resulted in Israeli military failure. As Van Creveld (1985) summarizes, “During the 1973 Arab–Israeli War, contradictory organizational goals, combined with ineffective and inefficient decision making nearly resulted in Israeli military failure.” He continues,

Instead of certainty being created by means of supervision from the top downward, uncertainty spread from the bottom up . . . . Deficiencies . . . included . . . a faulty command organization; a lack of mutual trust among the senior commanders involved; incomp-
hensible staff procedures; and the absence of a directed telescope to supplement the flow of information from below by an active quest for it from the top. Without exception, these deficiencies were organizational in nature. (p. 230)

As with the Israeli military, many NGOs maintain broad goals and objectives and loose flexible command structures. NGOs in the small business sector typically have formal mission statements that are quite broad and nonspecific. These can be more or less summarized as “providing assistance to all worthy entrepreneurs and small businesses that would otherwise have difficulty obtaining resources,” or something to that effect.

Unlike military operations, where there is generally a winner, or private business, where there may be multiple winners (or losers), NGOs operate in an in-between dimension of political appeal, public policy, and core values.

If we analyze the role of “bosses” (principals) and “workers” (agents) we may conclude that nonprofit organizations will have greater employee-shirking activity than for-profit firms (Alchian & Demsetz, 1972). This occurs because nonprofits have a characteristic separation between management decision-making and control, in that managers initiate activities that are implemented and monitored by others who bear the risks. In addition, the consequences of improved management cannot be capitalized for the benefit of shareholders (Fama & Jensen, 1983a; Fama & Jensen, 1983b). Thus, the failure to institute appropriate monitoring procedures will be of even greater consequence with NGOs than for-profit-making organizations. From a military perspective, imagine generals forced to hire mercenaries whose pay and performance are determined by politicians, based on an array of potentially contradictory goals and outcomes.
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The theoretical basis for the NGO comparison in this article utilizes agency theory (Jensen & Meckling, 1976). The director of an NGO is essentially the agent of the bilateral or multilateral funding agency, who serves as the principal, while, simultaneously, the director, acting as a principal within his or her own organization, employs agents to carry out the tasks of identifying, training, and approving clientele. Conflicts and discontinuities arise when the interests of principals and agents diverge. In this research, the organizations studied were primarily not-for-profit institutions, further distorting the relationship between the two levels of principals and agents—the donor community, and, within the organization, the internal management structure. As agency theory predicts that nonprofit organizations will have greater shirking activity than for-profit firms, the failure to institute appropriate monitoring procedures will be of even greater consequence (Zimmerman, 1979). How can this be overcome?

Comparative Framework: Israel and Jamaica

In this analysis, loan programs in both Jamaica and Israel are compared and contrasted. Minority microlending in both countries is quite limited, allowing for a fairly representative and comprehensive comparative analysis.

The Center for Jewish–Arab Economic Development has been operating a revolving loan fund for Israeli Arabs and Palestinian citizens of Israel since 1991. It is the only one of its kind in Israel and was started to provide opportunities for small business in the Arab sector, which commercial banks viewed as either too costly to evaluate or otherwise too high a risk. The organization has focused on loans to small, innovative Arab businesses that have little equipment or property to utilize as collateral. It has lent approximately US$650,000 to 26 businesses, with an average loan size of US$25,000. The organization provides extensive
business and marketing training and maintains a very low default rate. For this study, more than one-half (14) of the 26 firms that received loans were interviewed at their locations in Israel. In addition, extensive interviews were conducted with each director and with individual loan agents, regarding the goals and process of their lending activities. In Israel, the owners of businesses in half of the loan portfolio were interviewed at their business location. An analysis was made of the portfolio as to the relative affluence, need, educational criteria, and gender of the clientele. Following the field study and analysis, a meeting was held with all the principal employees and managers of the NGO, and a survey instrument translated into Hebrew was distributed.

In Jamaica, the unavailability of credit to the informal sector is frequently cited as a major impediment to the operation and growth of small firms (Anderson, 1992; Dessing, 1990; Davies, Fisseha & Kirton, 1981; Lubell, 1991; Lycette & White, 1989; Statistical Institute of Jamaica, 1993). Although theoretically there are several potential sources of Jamaican credit, including banks, microenterprise lending agencies, family, and informal credit arrangements (partnerships based on cooperative lending pools), the limited scope and availability of such monies for Jamaican microentrepreneurs are widely acknowledged, and practical alternatives are few (Anderson, 1992; Statistical Institute of Jamaica, 1993; Honig, 1998). This dearth of institutional credit has been recognized by bilateral and multilateral institutions such as the International Labour Organization (ILO), USAID, and the World Bank. Beginning in the 1980s, they have undertaken to develop, promote, and support several credit institutions whose primary directive is to provide credit to Jamaican microenterprise.

A commercial credit union, as well as four different NGOs provides microloans in Jamaica, subsidized by USAID, the Dutch and Canadian governments, and other bilateral and multilateral agencies. As in the
case of the Israeli NGO, each organization was evaluated and interviews were conducted with management, as well as the lending staff. Another 74 firms, randomly selected from the clientele fosters of all five micro-credit agencies, were visited on site and interviewed. Loan portfolios of the different institutions ranged from US$100,000 to US$2,000,000, and average loan sizes ranged from US$600 to US$5,000. They had been in existence from between 2 to 10 years, and four of the organizations provided business and marketing training, as well as credit facilities.

**Findings**

The examination of the clientele of a number of NGOs in the two different countries found individuals who did not match the broad organizational criteria of severely limited resource constraints. Many of their clientele were found to be either individuals with considerable access to alternative capital or those chosen by arbitrary criteria that failed to match the overall organizational goals of access and meritocracy. In Jamaica, for example, one firm was found to have borrowed a considerable sum (US$150,000), despite its not meeting any objective criteria as to size (this large factory had over 25 employees). Discussions with the loan agent indicated that the firm was chosen because of the reliability with which it could repay the loan, rather than on the criteria of need. The owner of the firm had extensive working relationships with banks and was utilizing the microloan program because his loan was subsidized at a below-market rate.

The Israeli NGO staff were found to be surprisingly ignorant of the character of their own loan portfolio. For example, six of eight reporting staff members (75%) thought that the average starting capital for the businesses they lent to was under US$15,000, while the mean for the sample was three times that figure (see Table 1). Four of seven reporting staff members (42%) thought they were helping more women than men,
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despite a loan portfolio of 93% male entrepreneurs. Most significant, seven of the eight staff members (87.5%) thought they were loaning to individuals who had no other credit alternatives, while 53% of the firm owners indicated that they had other credit alternatives but were using the loan fund because it provided credit at comparatively favorable rates.

The NGO

The NGOs in Jamaica exhibited similar dissonance between stated goals and empirical reality. A systematic comparison of the organizations’ clientele showed that they tended to rely upon specific strategies or specializations, without being institutionally aware of their biases. Marital status, education, gender, and religiosity all appeared to be operating as credit rationing devices for the different NGOs, but the rates of usage varied considerably (Honig, 1998). For example, one agency was found to be lending substantial sums, well in excess of their official ceiling, to a large successful manufacturing firm. The owner of the firm, a millionaire, admitted that his attraction to the organization was only to obtain substantial credit at subsidized rates—he had many alternative sources, including major banks. To supplement their portfolio, this NGO lent a number of microloans to “model” firms, who were used as showcases during the appropriate international forums and inspections. This strategy allowed them to gain a reasonably high assurance of repayment, while also providing them with sufficient multilateral compliance, in the form of their model firms.

As with the initial plans before entering combat, the NGOs in Jamaica devised clear and explicit mission statements, charters, and business plans. Evaluating this formal documentation and analyzing the interviews conducted with the managing directors demonstrated how similar the formal stated organizational goals were between the different agencies. This was not too surprising, as there was considerable scope for
interaction during joint inter-agency training programs conducted for loan officers, as well as career movement by management between the various organizations. For example, consider the following statements from the managing directors of the agencies, when asked specifically about their goals and objectives:

“The primary purpose is to provide . . . working capital and fixed assets as well as any type of temporary assistance they would require in order to start or upgrade [their microenterprise].”

“To equip people in the small and micro sector to come in ‘mainstream’ by offering financial and technical assistance.”

“To provide credit and to provide technical assistance . . . to the smaller microentrepreneurial sector.”

“We are a credit agency . . . We see ourselves more as a [community] developer.”

Thus, while the organizational literature provided by each of the five agencies was remarkably similar, their practices were found to differ widely. In most cases, relevant literature, policy statements, and even applications could be freely exchanged between organizations with little or no obvious impact or conflict. Despite their similarity, however, they deviated widely from each other, and from their own organizational goals. How did this come about?

**Conclusion**

Having carefully studied a number of microlending organizations in both Jamaica and Israel, it became increasingly apparent that organizational objectives operating at different levels prevented institutions from doing what they claim they had set out to do. Further, it became apparent that a “bottom-up” type of strategy was directing the activities of these organizations, largely unbeknownst to the directors and managers. This observation is likely to have parallels elsewhere, particularly in sit-
uations that result in multiple and conflicting goal designations. For example, transnational firms set goals at the macro organizational level. These goals may conflict with regional or local objectives and may also contradict individual managerial or employee incentives and wishes. This competition between mutually exclusive objectives invariably leaves the employee in the “driver’s seat” regarding which way to navigate the resulting confusion. The outcome is not necessarily beneficial.

Studying the process by which these monies are distributed is critical to understanding how goals and objectives are redirected and it may prove illustrative to many other organizations. Examining decision-making processes in both Israel and Jamaica suggests that too little attention is placed on the character of the implementing actors—the employees themselves. An extensive body of literature exists studying the nature of leaders, leadership selection, organizational culture, methodologies, and processes. While leaders themselves tinker with new methods of com-

<table>
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<th>Firm Owners who have NO credit alternatives:</th>
<th>Expected By agency personnel</th>
<th>Actual Reported by owners</th>
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<td></td>
<td>87.5%</td>
<td>47%</td>
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| Number of employees between 2–5 | 87.5% | 61% |

| Anticipated the correct percentage of Firm Owners with a College Education (25% to 50%) | 62% | 29% had a college degree |

| We help women more than men | 42% | 93% male clientele |

| Estimated Average Starting Capital of US$15,000 or less | 75% | 59% had starting capital over US$15,000; mean of US$40,000 |

Table 1: Israeli NGO: Expectations Versus Reality
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...communication, incentives, and organizational structures, this article argues that it is the character of the lowest level of organizational actor(s) that differentiates successful innovation from unsuccessful attempts. Selection of appropriate staff thus influences not only the quality and nature of the tasks assigned but also the very direction and choice as to what exactly will be done. This is particularly true when goals and objectives are either vague or in conflict with other incentives or individual predilections.

In contrast to what usually occurs, foreign donors often require their principals (managers, representatives, consultants, etc.) to avoid selection criteria on the basis of financial or embedded relations. Such requirements are in place in an attempt to maximize the potential for economic development and avoid accusations of partisanship or nepotism. The NGO managers are thus left in a quandary—how to maintain low default rates, which are carefully monitored, while lending to individuals for whom they have little information. This research suggests that the dilemma was solved as managers provided their loan agents significant leeway in the decision-making process. The loan agents, acting without extensive monitoring and control procedures, characteristically relied upon informal networks, signaling, and in-group characteristics in order to identify reliable clientele. As a result, the organizations tended to conform to a selection process focusing on specific indicators targeted by the loan agents, rather than by the principals and donors. In some cases education was found to be crucial; in others, religiosity was a more important selection mechanism, each presenting an organizationally viable, if somewhat subversive, element to the decision-making process. This suggests a relationship between the tacit, or undisclosed, criteria and the organizational goals and objectives, even when those goals and objectives are not explicitly defined or codified. In these cases, in-group affiliation may be the most salient governing process.
Such decision-making biases, if left unchecked, are certain to have significant long-range outcomes that may even undermine the very activity supported by these institutions. Entrepreneurs are well recognized as coming from a wide range of backgrounds—indeed, it is the very heterogeneity of their origins that allows many to provide the newness of perspective so necessary for their activities. Hidden or tacit institutional biases may work against this diversity, limiting severely the impact of efforts to sustain an entrepreneurial culture and to promote economic development.

Microenterprise credit agencies would be well advised to pay careful attention to the characteristics of their loan agents on a range of dimensions including gender, education, social capital, Socio-Economic Status, and religiosity. Devising monitoring and incentive systems that closely parallel the objectives of the organization are particularly important and appear to have been absent in the case of the many NGOs studied. Failure to introduce new systems may undermine the targeted goals of microlending, while attention to these details should result in greater overall efficiency and programmatic consistency.

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Client Exit Surveys:

A Tool for Understanding Client Drop-Out

by Anton Simanowitz

ABSTRACT: The ability of microfinance institutions (MFIs) to reach and to demonstrate a positive impact on their clients is increasingly recognized as a core principal in poverty-focused microfinance, and there is a growing move toward lower-cost, practitioner-friendly approaches to impact assessment.

Interviews with program drop-outs are an important source of information, and they are incorporated into a number of impact-assessment systems. This article explores how useful impact information can be gained from drop-out interviews and presents ideas from the experience of the Small Enterprise Foundation (SEF) in South Africa. Drop-outs provide a very valuable source of information for program improvement, relating both to the performance of the MFI in relation to client needs, and more generally to how an MFI relates to client livelihoods and external conditions.

Two approaches commonly used are contrasted—the survey-based client exit interview and a more in-depth case-study approach that seeks to understand deeper, underlying reasons for drop-out.

The impact of microfinance on poverty alleviation has recently gained a prominent position on the microfinance agenda. Donors, practitioners, and academics are realizing that microfinance institutions (MFIs) must
concern themselves with more than their ability to reach institutional self-sufficiency. The ability to reach and to demonstrate a positive impact on the poorest is now becoming a core principal in poverty-focused financial institutions. The 1999 Microfinance Summit Meeting of Council, for example, set out a hard-hitting agenda, with key note papers calling on MFIs to meet the challenge of targeting and reaching the poorest (Simanowitz, et al., 1999) and to develop systems for measuring their impact on their clients (Reed & Cheston, 1999).

The World Bank–sponsored Consultative Group to Assist the Poorest (CGAP), a leading donor and policy maker, shows signs of moving away from its former hard-line view on impact assessment. In 1997, Rich Rosenberg, a senior advisor to CGAP, expressed a view which mirrored the approach of CGAP:

If your investee institutions [the MFIs] are pricing their services in a way which covers all of the costs of providing them . . . and if their clients continue to use these services, then you have strong evidence from the persons most likely to know that the clients are deriving benefits . . . . Do you really need to know a lot more than that?

This contrasts markedly with a recent CGAP initiative on “Deepening the Poverty Outreach of Microfinance” (CGAP, 1999), which looked at improving knowledge on poverty outreach and the impact of microfinance on poor clients.

Reflected in the discussions of impact assessment is the growing realization that traditional, high-cost, externally led, survey-based impact studies cannot effectively serve the needs of MFIs. Where an MFI seeks to alleviate poverty through its services, it is imperative that it is able to cost-effectively measure the achievement of this goal on an on-going basis. This will allow for operational and methodological changes to

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improve impact. Traditional impact studies are limited both by their high cost, and by time and communication barriers; this means that although useful information is generated, it is not timely and it often does not translate into useful input into operations.

A number of initiatives to develop more appropriate forms of impact assessment are therefore now underway, both within MFIs, and externally led. The central premise of this new approach holds that impact assessment is implemented “to improve impact, not to prove impact” (Simanowitz, 1999). The AIMS project, for example, takes a “middle-range” approach which seeks to achieve credible results, which establish a “plausible association between changes experienced by clients and their participation in a microenterprise program,” while “generating information which is useful for improving programs” (Cohen & Gaile, 1998, p. 25). The initial terms of reference for a proposed Ford Foundation funded study set out “to develop methodologies to be used by development finance institutions themselves as a management tool to allow them to receive feedback from their clients in order to improve their services and product mix” (Copestake et al, 1998, p. 4).

Thus, there is a growing consensus that the achievement of the impact objective needs to be monitored in much the same way that financial objectives are monitored. Impact assessment, however, is much more complicated, and a major challenge lies in the difficulties in attributing causation. Add to this the financial and staffing constraints of MFIs seeking to reach large numbers of clients, and the possibilities for impact assessment become very limited. The main focus of recent work has been how to achieve credible results that are timely enough to be used as a management tool, yet which do not put great demands on the MFI’s resources. Innovations include developing on-going impact monitoring integrated into the loan application process, and the design of a modular impact assessment whereby information gathered from a number of
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sources and on different occasions can be combined to produce credible results (Simanowitz, 1999; Cohen & Gaile, 1998; PlaNet, 1999).

**Learning from Client Exit Interviews**

Client exit interviews are increasingly cited as an important source of information and are incorporated into a number of impact assessment systems. They have been accepted in both the AIMS guidelines and the PlaNet Impact Knowledge Management framework as an important source of impact information. In this article, I seek to explore in more detail how useful impact information can be gained from client exit interviews and to present some ideas from the experience of the Small Enterprise Foundation (SEF) in South Africa. A detailed drop-out study and on-going drop-out monitoring are important elements of SEF’s impact measurement system.

Commonly referred to as “drop-outs,” clients who have left an MFI’s program can provide very valuable information. On one level, drop-outs may represent the MFI’s failures, e.g., clients for whom the service was not suitable or who suffered a negative experience and chose or were forced to leave. In some cases, where the client has graduated beyond the need for the MFI’s services, drop-outs may represent a success. In either case understanding the reasons and processes leading to clients’ exits can provide valuable information about the strengths and weaknesses of the program, and its relevance to different target groups.

In the case of programs which are genuinely reaching the poorest people, drop-out is a major issue for a number of reasons. First, it is highly unlikely that a very poor person will graduate out of the program for several years. Drop-outs are therefore likely to be a direct or indirect, result of a failure of the program to adequately work in a way that raises the client out of poverty. This may be due to inappropriate products for the needs of the very poor, to the pushing out of struggling clients by more
successful ones, or to business collapse and difficulty in maintaining repayments. In all of these cases, the loss of the clients represents a failure of the MFI to have a positive impact on poverty and in some cases it may be a negative impact.

Impact studies in SEF’s poverty-targeted program, Tshomisano (TCP) clearly demonstrate that since its inception in 1996, clients have not yet reached a stage where they are leaving as a result of their success (Simanowitz, 1999). Where clients remain in the program, a very high incidence of positive impact occurs by the fourth loan (approximately 2 years after the first loan). Where people leave, it is mostly in the early loans, before there has been a sustainable positive impact on their livelihoods, pointing to a failure by TCP to achieve its mission in these cases.

Drop-outs are a particularly valuable source of information, as they are beyond the sphere of influence of the MFI. For existing clients, there may be real or perceived reasons against talking honestly about their dissatisfaction with the MFI’s service or their failure to achieve success in their business. Drop-outs have much less to lose or to fear.

Methodologies for Understanding Client Drop-Out

The AIMS project has developed impact assessment guidelines which propose the use of a client exit survey tool (Cohen & Gaile, 1998). This uses a standardized questionnaire which can be coded and quantitatively analyzed, and which seeks to capture information about all drop-out clients. The questionnaire seeks to find out and track when and why a client left the program, what the client thinks about the program’s strengths and weaknesses, and what its impact is on her or his livelihood and business. It uses a structured format in terms of questions to be asked but it does allow some space for the enumerator to add her or his own comments and observations. The questionnaire is designed to be
Client Exit Surveys

used by a loan officer as part of her or his routine duties and should be administered in about 20 minutes.

Starting in late 1997, SEF began looking closely at the reasons for client drop-out. Monthly “drop-out monitoring” now forms a standard part of operations. However, SEF has opted for a qualitative sample approach, which gives a detailed understanding of the range of issues causing clients to leave the program rather than a descriptive quantitative picture.

By understanding reasons for drop-outs, directors can gain a picture of problems in program design and application. Quantitative measures, produced by a standardized exit-survey approach, give a good picture of drop-out patterns; however, they fail to provide the depth of understanding for one to really be able to understand how program methodology might be changed. This problem is compounded by the fact that gathering accurate information from drop-outs is very difficult. It is easy to get a superficial reason for client exit rather than to develop a real understanding of the underlying causes.

Gaining reliable information about client exit is one of the most difficult research tasks facing an MFI. It is also one of the most potentially rewarding in terms of the quality of information which can be obtained. A number of factors may lead clients to be reticent about giving the whole picture. Clients often feel bad about admitting that their business has failed, or that they have experienced problems as a direct result of breaking an MFI’s policies, for example in poor loan utilization.

SEF, for example, struggled for some time to address the drop-out issue. A major reason for this struggle was a limited understanding of the reasons for drop-out. Asking the question, “Why did you leave the program?” rarely yielded accurate information and certainly did not expose the underlying reasons for exit. Reported answers tended to be that clients were “resting” or had “family problems” or “got a job.” These
answers did not lead to an adequate understanding of the underlying reasons for client exit.

In many cases, these reasons are symptomatic of deeper problems. For example, “family problems” or “problems with the group” are often rooted in changing power relations created by participation in the program, or from financial difficulties created by a failing business.

The key to effective use of client exit surveys is thus to develop an approach which creates the needful space where ex-clients feel comfortable to talk freely about why they left the program, and to develop a way to dig beneath superficial answers to understand the underlying reasons.

SEF’s Experience with Understanding and Monitoring Client Drop-Out

SEF is a nonprofit nongovernmental organization (NGO) working toward the alleviation of poverty and unemployment in South Africa’s rural areas by providing sustainable financial services. It uses a group-based lending methodology patterned after that of the Grameen Bank. An evaluation in 1995 concluded that only 30% to 40% of people reached by SEF were very poor, i.e., living below one-half of the poverty line. Rather than change the structure of SEF, a new project, Tshomisano, was launched to specifically target the poorest sector. Although similar in philosophy and basic structure, the motivational techniques, loan utilization checks, ongoing follow-up, and other aspects of the program have been adjusted to address the needs of the poorer population. Currently 97% of SEF’s 9,500 clients are female. Typical enterprises include small convenience shops, dressmakers, and hawkers of fruits and vegetables and new or used clothing.

SEF began its drop-out research by using a once-off drop-out study. This study used a two-stage qualitative approach, based on an understanding of the potential reasons for client drop-out. Discussions started
with the least sensitive issues and covered all of the potential issues which may have motivated a client to leave. By the end of the discussions, it was clear as to what range of factors may have led to a decision to leave, and only at this stage was the question put directly. The success of the drop-out study in deepening understanding of drop-out, and its major impact in terms of improving the service provided by TCP and in reducing drop-outs, led to the implementation of on-going drop-out monitoring.

The drop-out monitoring uses a similar approach to the drop-out study, building on the understanding of the range of reasons for drop-outs. The group meetings and interviews follow the framework of reasons from this study, with the least threatening subjects being dealt with first, and the question, “Why did you leave?” being left until last.

The first stage is a group discussion which focuses first on the services given by SEF and then examines issues relating to the clients’ group and center. The second stage is an individual follow-up interview which looks in more detail at the issues raised in the group discussion and includes personal issues, such as intra-household relations. The drop-out monitoring is implemented by the assistant zonal manager in collaboration with branch managers, on a monthly basis. This helps to highlight common problems and it focuses the branches’ efforts onto solving them. It also provides a continuing understanding of the patterns and reasons for members leaving the program, whether measures to reduce drop-out are working or not, and whether new issues are arising.

Drop-out monitoring is then implemented on a monthly basis by the assistant zonal manager, in collaboration with branch managers. This helps to highlight common problems and focuses the branches’ efforts around finding solutions. It also provides a continuing understanding of the patterns and reasons for why members leave the program, whether measures to reduce drop-out are working or not, and whether new issues
are arising. A center or the centers with the highest drop-out rates in the proceeding months are first selected. Arrangements are made to meet with all (if possible) the drop-outs from the center(s) identified in a group meeting (see methodology below) and follow-up individual meetings. In practice, an average of about six drop-outs are interviewed each month.

1. Group Meeting

A meeting is set up with as many of the drop-outs as possible. In this meeting a general discussion is held. At this stage it is important not to ask the reasons for drop-out.

Clients who have left the program feel bad or feel pressured to rejoin. By explaining the poverty mission of SEF and the fact that SEF is worried when people leave, the staff should make sure that clients feel relaxed and free to talk about their experiences in the project. The staff then explain that they want to learn what the former clients thought was good and bad about the project—former clients are the best people to learn from because they have nothing to lose if they tell the truth. Existing clients, on the other hand, may feel they will jeopardize their position if they say what they think.

A. The group meeting starts with looking at the participants’ experiences at SEF.

- What did they like about SEF (what was good)?
- What did they not like (what was bad)?

Participatory methods, such as voting forms, are used to ask specific questions as they arise. For example, how was the loan term; how was the loan amount; how was the support from the staff; how was the support from the group? Voting forms give a quick view of the range of opinions, which can then be used to facilitate a dis-
A discussion about why people voted the way they have and why there are differences of opinions.

B. The second stage looks at participants’ business experiences. Matrices or voting forms can be used to look at participants’ business strength before the loan, at present, and at a number of points during the loan.

If the business status has changed, the staff ask why. They try to understand why it improved or if there were problems.

This general discussion generates a good understanding of the clients’ experience in the program, and it is likely that the staff will have a good idea of the reasons for drop-out without actually having had to ask.

The group meeting should not be too long (about 1 hour). The aim is to finish when people are still active, not when they are getting tired. In this way they will be happy to come back for a follow-up meeting. At the end of the group meeting the staff facilitator explains that the meeting yielded a lot of information which is very helpful to SEF. Participants are then asked if they would be available for individual discussions at a later date.

2. Information From Files

Following the group meeting, the files for drop-outs are gathered. Information can be triangulated with the group meetings, for example on loan sizes and business types. Credit discipline, performance, impact monitoring, and comments on the debtors card can also help triangulate information and add to the understanding.

3. Individual Meetings

Individual meetings allow for a more in-depth understanding of an individual’s experience in the program and reasons for drop-out. Prior to this
meeting, the facilitator looks at the information gained in the group meeting and relates this information to the four areas of potential problems: personal reasons, problems with the business, problems in group/center, and problems with SEF procedures.

In the individual interview, the staff member probes the issues raised in the group meeting, trying to get a good understanding of the member’s experience and opinions. Finally, as the last question, the drop-out is asked why she or he left. At this point, there will be a good understanding of the experience, but not necessarily how these related together and what was the final motivation for her or his leaving the program.

4. Interview with the Field Worker

Finally, the staff member talks with the field worker (FW) and discusses the dropped members. Again, this helps to triangulate previous information, as well as improve the overall understanding.

5. Writing of the Report

Reports are written using these headings in the following format:

A. *Introduction and description* of the process for the monitoring—how did you do it, what problems did you have, how was the group meeting (were people open and free?), etc.

B. *Description of the members who dropped*—names, center, group, business, loans received, etc.

C. *Group discussion* (according to the four headings).

D. *Individual members*—results from discussion and information from files (according to the four headings).

E. *Information from field worker.*

F. *Analysis and conclusions*—from the meetings, interviews, files, and FW, what can you conclude are the main reasons for drop-outs (according to the four headings)?
G. *Recommendations* for the members who dropped (is any more follow-up necessary?), for the center where the member dropped, and for SEF.

**Benefits from Using Drop-Out Monitoring**

Using this approach to understand drop-out, SEF has developed a much deeper understanding of client drop-out. There is no simple answer as to why people leave, and consequently there is no simple solution. People’s reasons for leaving are complex and often the decision to leave may be a combination of a number of issues. It is, therefore, not possible to magically reduce drop-outs, but drop-out understanding can have a very significant impact on program performance. In TCP, for example, drop-out understanding led to actions in several areas resulting in a reduction of the drop-out rate from 35% to 14% between April 1998 and April 1999.

Drop-out monitoring has provided a practical tool whereby staff can improve program service and reduce drop-outs. Drop-out monitoring reports are discussed at weekly branch meetings, and action plans are developed to address the issues raised in the reports. Therefore, all staff are aware of the issues facing their branch and their centers and are thus able to take immediate, corrective action.

The reasons for drop-out revealed from the monitoring can be divided into four broad categories into which more detailed reasons fit (a detailed description of the reasons and resulting action is given in the Annex).

1. **Personal Reasons**

*Main reasons:* death in the family; personal or family illness.

*Other reasons:* husband stops member attending; conflict in the family; moving away from the area; other disaster; found a job (this normally is a sign of business failures); afraid of credit.
2. Business Failure (Often Described as “Found a Job”)
Business does not grow or collapses. Reasons for this include: too much selling on credit; money not re-invested into business; money taken from business for household expenditure or emergency; poor loan utilization; inappropriate loan size.

3. Problems in the Group/Center
Paying on behalf of other group members (“patching”); conflict in group/center (mostly caused by patching); poor group formation (members don’t know and trust each other well); thrown out of center.

4. Problems with SEF Procedures
Main reasons: fortnightly payments; loan period wrong (too long or too short); high transport costs; left alone in the group
Other reasons: not enough support from FW; loan too small; didn’t like the loan utilization check.

Conclusions
It is clear that drop-out clients provide a valuable source of information for program improvement. This information relates both to the performance of the MFI in relation to client needs, and more generally to how an MFI relates to client livelihoods and external conditions. This information can form a core part of impact understanding. This understanding feeds into operational development and leads to changes that better tailor the MFI’s services to their target client needs and thus improves the overall impact of the MFI.

Both survey and case-study approaches have their advantages and disadvantages. Survey-based client exit interviews provide a picture of the patterns of drop-out, but there is a strong possibility that they may not
Client Exit Surveys

provide the depth of understanding required for improvements in operations. Drop-out clients are particularly difficult to interview, and often information collected from them is inaccurate or does not provide an understanding of the underlying reasons for drop-out. A case-study-based approach takes a sample of drop-out clients and therefore cannot develop an adequate picture of the patterns of drop-outs. Reasons highlighted by a small number of drop-outs may not be widely applicable to other clients. However, by raising the issues and by understanding the issues, one can gauge their applicability to the rest of the program.

Client exit surveys require the investment of time, which is likely to be difficult for field staff pursuing high productivity targets. The AIMS client exit survey, for example, requires approximately 20 minutes per drop-out. This is administered by loan officers, who are likely to be the most pressed for time. SEF drop-out monitoring requires approximately 1 hour for the group interview, and then 1 hour for each of the individuals in the group interview (approximately six). Drop-out monitoring is administered by the assistant zonal manager and sometimes by branch managers. It is a time-consuming task, but it fits well with the manager’s task of monitoring performance and it increases their general understanding of program impact.

Annex: Report from SEF’s Drop-Out Study

I. Personal Reasons

There are many personal reasons given for drop-out, which include the following: death in the family; personal or family illness; conflict in the family (e.g., husband stops member participating); moving away (temporarily or long term). Personal reasons are important to note for two reasons:
A. Often they are not the real reason but are given as an excuse, either because the member is ashamed of failure or the member has not complied with TCP rules and is afraid to admit it (for example, poor loan utilization).

B. Where the reason is because of something temporary, the member may want to return in the future, or may return with encouragement.

**Action to Reduce Drop-Outs**

1. Understanding reasons for drop out: Where “personal reasons” are given it is important to allow the member time to talk freely about her or his reasons for dropping and to talk about the success or problems in the business. This may give FWS a chance to discover other reasons that they may be able to help solve.

2. The “personal touch”: Members should feel that TCP staff care about them as people not just as loans. For example, if a member is ill or has a death in the family, the FW should visit the member and perhaps a fund should be set up to make a small contribution toward funeral costs. This contact will also help in encouraging the member to return once the mourning period is over, or once they have recovered from illness.

3. Allowing the member to return: If the member gives reasons that indicate a temporary problem, the FW should encourage the member to continue to attend center meetings and maybe to save. The FW should make an effort to maintain contact and give the member an opportunity to return in the future. Important: The FW should never try to force or convince a member to remain in the program or to return.
4. Group formation: During group formation, it is important to discuss issues of potential conflict at home created by the member starting or expanding her business.

II. Business Failure

Failure of a business may be reported directly or can be seen from other information given:

A. Business does not grow or goes down—business value does not increase, or it decreases.

B. Member leaves business to take up employment—this employment is mostly not well-paid (such as a farm or domestic laborer), so it shows that the business was not succeeding in providing a living income.

C. A member often has to be patched by the group or the center.

Common Reasons for Business Failure:

1. Too much sales on credit.
2. Inappropriate loan size—too big for manageable repayments, or too small to do planned business.
3. Too much competition.
4. Lack of business skills—support not given by group/center/field worker to develop skills.
5. Poor loan utilization.
6. Profits not re-invested in business—due to high demands from the family, or poor business management.
7. Unforseen disaster—such as robbery, rain damage, or family crisis that takes money from business.
8. Part-time business—member works as well and is not serious about the business.
Action to Reduce Drop-Outs

Through close monitoring and support of businesses, joined with good problem-solving, we can help reduce the chances of business failure; we can deal with problems early so as to solve any problems before the business fails and the member drops.

1. Understanding of the business: spending time before the first loan discussing the business with the member and group (looking at the market for the business, how it should be run, and how it could grow) helps the member develop skills for running their business and gives the FW and group a focus for the type of support they should be giving.

   Included in this discussion should be competition, selling on credit, the need to re-invest in the business, and often the need to diversify the business in order to grow. From this the member will develop a business plan, which will not just be how much and what she will buy, but how and where she will sell, and how she will grow her business (this need not be written down, but should be discussed).

2. Appropriate loan sizes: Using the business value and impact monitoring information, the FW can assess the strength of the member’s business and her progress. Based on this assessment, an appropriate installment plan for the business should be set. During the business plan discussions, the FW, member, and group should discuss what loan size would be appropriate for the business type, and the member’s planned activities.

3. Support to business development and monitoring: The group, center, and FW should support members in following through with their business plans. This support may sometimes include business skills training, but most skills will be devel-
oped “on the job” through discussion of problems and sharing of experience within the groups and centers and by the FWs.

Regular checks need to be made by members/groups/centers on the performance of businesses so as to deal with problems immediately as they arise.

4. In-depth discussions at center meetings: The financial and reporting side of center meetings should be kept short, and at least half an hour should be allowed for detailed discussions and occasional workshops. Reports from group chairs should show problem areas. These reports can be used to encourage discussion about the issues raised—for example, selling on credit, diversification, good business practice tips, etc. The FW can facilitate this. Sharing experience of problems and solutions is the best form of business skills training and can help reduce drop-outs due to business failure.

5. Good monitoring of loan utilization: Loan utilization checks and loan supervision visits must be taken seriously. It is important that the group chairs take responsibility for this job and that they do it well. FWs must ensure that this happens. Monitoring of loan utilization helps members to take their businesses seriously and to avoid destroying the business by taking money from the business for their families. The monitoring also gives an early warning of problems, which can then be dealt with.

6. Dealing with disasters: Members must be helped to deal with disasters and not to feel that they must leave the program because they are struggling to repay the loan and their businesses are failing (see personal problems).
III. Problems in Group/Center

A. Conflicts within groups or centers: Conflicts often arise from members not making their repayments. This results in other members having to spend time trying to find the member to make them pay or having to make payments on their behalf.

B. Patching for other members: the feeling of “working for others” is a major reason for drop-out in centers with patching problems. The costs of members making additional payments for others, on top of their other costs, may be enough to cause business failure and drop-out, or it means that they are unable to make savings.

Patching results from deliberate nonpayment or problems of some members whose businesses fail. A major reason for this is poor group formation, where the members do not know and trust each other well. This may result from the following:

1. Rapid growth of a center: The centers grows too fast for the FW to ensure that the groups are well formed.
2. Inexperienced FW: Many drop-outs are from groups that were formed by trainees or newly qualified FWs. Again, this is due to failure of the FW to recognize poorly formed groups.
3. Pressure of targets on FW and branch: The need to reach targets can result in a FW or branch manager (BM) pushing through groups that are poorly formed.
4. Deliberate “cutting of corners”: FWs may form groups that they know are not well formed and then train the group to answer questions from the branch or zonal manager in a way that the poor group formation is disguised.

Action to Reduce Drop-Outs

Good group formation is the key to reduce conflict within groups and centers, and is one of the keys to reducing drop-out.
Client Exit Surveys

1. Deal with repayment problems immediately: Field workers must find out in each meeting who is being patched and work to assist the member to pay, or settle the reason they are not paying. When patching occurs, this must be dealt with immediately. Patching one week is a problem; repeated patching every meeting causes a lot of discontent and leads to drop-outs.

2. Pressure from targets: Targets must not be set so high that they create a pressure on the FW or CO to pass badly formed groups. Other targets—such as drop out rate—should be set and the link between group formation and success in these other targets should be made clear.

3. Fast center growth: Fast growth is not good in TCP. This fact should be stressed and fast growth should be checked by BMS and the zonal manager. Again, targets should be developed which are more holistic, reflecting impact and keeping of members, not just numbers.

4. Deliberate “cutting corners”: Checking of group formation is very important, however, the current procedures should be reviewed to see if there are better systems to detect groups which have been trained to pass the group recognition test, despite being poorly formed.

IV. Problems with SEF Procedures

Many former TCP members complained about various aspects of the program. For many issues, strong opinions were expressed, but there were no issues for which there was 100% agreement—even where most people were strongly against something, there was someone strongly in favor of it.
The following are recommendations based on majority and strongest opinions—any changes implemented should be piloted prior to being adopted.

A. Repayment terms: Most drop-outs agreed that repayments should be monthly rather than fortnightly. However, a few members do prefer fortnightly repayments. Some businesses, where income is spread throughout the month, seem more suited to fortnightly payments, but the women running these businesses still express strong desire for monthly payments.

B. Transport costs: Many members are having to pay high transport costs, which in some cases amount to far more than the interest payments on the loan. For people with small loans and new businesses, this may place great burden on their ability to succeed.

C. Loan periods: Long repayment periods for small loans result in difficulties in maintaining the business. Particularly at the start of the business, it is easier for a member to manage repayments over a shorter time period. As loan sizes increase, so should the repayment period. However, some members are also concerned that 10 fortnight loans are too short.

D. Staff support: Support and regular contact with FWs is valued by members and is important to provide moral support as well as advice and skills.

E. Loan size: A loan which is too large for a business may create problems and lead to business failure, however, no cases of this have been reported from the people interviewed so far. Similarly a loan which is too small, for example, to buy enough stock to be viable, may result in the member having to spend household money which puts a strain on the household and results in money being taken from the business.
The fact that under the Visual Indicator of Poverty Test many members came into TCP who are richer than the cut-off line under Participatory Wealth Ranking means that these people may put pressure on TCP to give larger loans. Loan size did not come across as a very strong issue.

F. Failure to re-form groups: When a member leaves a group they must be replaced. This becomes very difficult if three or four members leave. In many cases the remaining members are forced to drop because of their inability to re-form the group.

Action to Reduce Drop-Outs

1. Monthly repayments: It is important for centers to meet fortnightly so as to establish regular contact between members and with the FW, so that problems can be discussed and businesses supported. However, monthly payments should be piloted as either an option or as standard, either from the first or second loan.

2. Transport costs: Alternative forms of disbursement should be implemented to reduce the costs of members collecting their disbursements.

3. Loan periods: There is agreement that 20 fortnights is too long for a first loan. Shorter periods should be reviewed based on the pilots currently being done, and also in relation to the issue of monthly payments. More time should be spent reviewing whether 10 fortnights is too short.

4. Staff: Staff commitment to the success of their members is important (see “personal touch” above). In addition, it is important for staff to be strict in following TCP procedures.

5. Loan sizes: Maximum first loan sizes should be reviewed in the context of the business profiles being developed
to ensure that they enable members to start a viable business.

6. Re-forming groups: We should look at how to make it easier for a member left on her own to continue with TCP. The possibility of allowing centers to re-group themselves once they have been members for some time should also be looked at.

References


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Simanowitz, A. Unpublished reports from SEF impact assessment: detailed village case-studies and analysis of impact monitoring database.


Notes

1. Anton Simanowitz’s work in writing this article was made possible, in part, through support provided by The Ford Foundation and the Office of Microenterprise Development, Economic Growth and Agriculture Development Centre of the Global Bureau, U.S. Agency for International Development, under the terms of Award No. PCE-A-90-98-90039-00. Opinions expressed herein are those of the author and do not necessarily reflect the view of The Ford Foundation or the U.S. Agency for International Development. The support of these agencies is acknowledged, and we thank them for their assistance in enabling us to carry out and to publicize action research into the elimination of poverty.

2. See Reed and Cheston (1999).

3. The AIMEs project is developing credible, practitioner-led, lower-cost impact assessment tools for use by MFIs in their operational management. Three recent (separate) initiatives by The Ford Foundation (Bath, Sussex and Reading Universities), PlaNet, and the IDRC and the African Development Bank’s AMINA, all seek to develop action-research to develop impact assessment and monitoring tools which integrate into MFI management information systems.

4. Assessing the Impact of Microenterprise Services. The project is a technical resource of the United States Agency for International Development, Office of Microenterprise Development

5. A detailed report containing conclusions from SEF’s impact assessment will be available in January 2000.

6. Even where a sustainable positive impact has not been achieved, the majority of clients do show improvements in their living conditions, expressed as (possibly temporary) improvements in food quantity and quality, as well as longer term benefits of improved educational status, improved housing, asset accumulation, improved business skills, and increasing sense of self-worth, self-confidence, and participation in the community.

7. Clients use colored stickers to vote for a range of options, such as very bad, bad, average, good, very good. The use of a visual approach is simple and highlights differences in opinions and experience, which can then be used as the basis for discussion.

8. Counters, such as beans, can be used in a matrix to show relative changes in the business over time. Again, a visual approach provides a good focus for discussion.
9. Three month rolling average of clients finishing a loan who do not receive a further loan in the following month.
In the Fall 1999 issue of the Journal of Microfinance, incorrect information concerning CRECER’s annual percentage rate and portfolio yield (APR) appeared on pages 174 to 176. The error is the responsibility of the Journal staff and we regret the error. The section should have read as follows:

Gap Analysis—Ensuring an MFI Receives the Income It Expects

Setting an appropriate interest rate is a key step in getting on the path toward IFS, but ensuring that the loan portfolio and assets yield the expected rate of return is another challenge. Up to this point in the paper we have focused on managing expenses as a means to increase efficiency. However there are three tools available to measure our efficiency in managing income. In other words, is an MFI generating the expected level of income from the loan portfolio, as measured by the appropriate interest rate? If this is the case, it assuredly has a strong overall management. If not, regardless of how well it manages its costs, it will be very difficult to achieve IFS.

The best way to measure income efficiency is to compare annual effective interest rate, also known as the annual percentage rate (APR)—the total cost the borrower must pay for credit services in a year—with the actual portfolio yield. The portfolio yield attempts to measure how well an MFI is collecting from its clients by comparing interest and fees received from loan clients during a specific period of time (up to one year) to the average loan portfolio for the same period. Differences between the APR and the portfolio yield can imply poor loan portfolio quality or difficulty in collecting interest. Particularly for MFIs with loan cycles of less than one year, they can also imply slow administrative “role-over” of the lending
product(s) due to increasing dormancy among clients on subsequent loans, among other factors, or inefficient management techniques leading to delays in subsequent loan disbursements. Taking the gap analysis one step further, an MFI should also compare interest and fee income received from loan clients during a specific period of time (up to one year) to the average total assets for the same period—referred to as the asset yield. The difference between the portfolio yield and the asset yield indicates how well an MFI has invested its other funds, those not out in the hands of the borrowers.
via loans, in income producing activities. For example, are other funds being kept in noninterest bearing bank accounts, or have they been placed in interest-bearing investments such as cash deposits (CDs) or savings accounts? If there is a large difference between the two, it can indicate that assets other than loans are not being managed properly.

The best-managed MFIs will show very little difference between each of these measurement tools. Institutions with moderate to large differences will note that administrative changes may be in order—of which they may already be aware based on their cost management techniques. Tracking efficiency in managing both expenses and income allows an MFI to ensure it does not stray from the path towards IFS.

The annualized effective interest rates, portfolio yields, and asset yields of our case study MFIs are shown in Figure 5. Here we see that of the three FINCA Uganda has the smallest gap between the APR and the loan portfolio yield, a spread of approximately 1.8% at December 31, 1998. This dramatic reduction in the gap from 12.7% at December 31, 1996 reflects FINCA Uganda’s specific efforts to improve turnover of its loan portfolio by introducing the “17 Week Recapitalisation” incentive to field staff, described in the Staff Incentive section above. However, the difference between FINCA Uganda’s loan portfolio and asset yields was the largest among our case study MFIs, a spread of 25.2%, reflecting high liquidity at FINCA Uganda. As of December 31, 1998, nearly 34% of FINCA Uganda’s total assets were held in cash and cash equivalents; as FINCA Uganda gets this money out in the hands of the poor, the gap should shrink. CARD’s yield gap at December 31, 1998 was approximately 5.6%, which it credits to dormancy among general loan and other basic loan products, which has, in turn, slowed turnover of the loan
portfolio. CRECER is not far behind CARD with a yield gap of 6.6% at December 31, 1998; the gap likely results from slow turnover of 16-week loans with some credit associations.

Based on this analysis, FINCA Uganda will not be able to consider lowering its high effective interest rate of 62.3% until it can be sure that its low administrative efficiency of 71.8% can improve substantially. Given CARD’s current administrative efficiency of 38.7%, there appears to be no case for reducing its effective interest rate of 42.8%. A similar conclusion can be drawn with respect to CRECER given its current administrative efficiency of 33.7% and effective interest rate of 42.0%.
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