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FINANCING RURAL NONFARM ENTERPRISES IN LOW INCOME COUNTRIES

by

Richard L. Meyer

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Department of Agricultural Economics and Rural Sociology
The Ohio State University
2120 Fyffe Road
Columbus, Ohio
43210

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ABSTRACT

Many countries are searching for methods to facilitate the creation and expansion of rural nonfarm enterprises. Attention is being given to increased financial services because: 1) enterpreneurs complain of financial constraints; 2) most funding for such enterprises comes from savings; and 3) what little credit is used is frequently obtained from informal sources which charge high interest rates compared to credit from formal sources. Several factors are given to explain why the supply of financial services to rural nonfarm enterprises may be reduced. An important reason may be the fragmented nature of rural financial markets. It is argued that increased attention is required by policy makers to open up these markets to a wider range of clientele by moving rules, regulations and requirements which fragment markets and offer incentives for broader service. Other methods to improve rural financial services are also discussed.

FINANCING RURAL NONFARM ENTERPRISES IN LOW INCOME COUNTRIES

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INTRODUCTION

A number of low income countries, especially in Asia, are currently placing increased emphasis on off-farm employment as a means to alleviate rural poverty. Although improvements have been made in some countries in rural incomes, there is a growing frustration about the limited impact made by past strategies in materially improving rural welfare. Capital-intensive industrialization has failed to generate significant increases in employment to absorb the available labor supply. Technology oriented agricultural development strategies have eased food constraints but the supposed trickle down of benefits to small farmers and rural workers has been limited. Furthermore, although some small farmer programs appear promising, most have yet to demonstrate a significant impact on the poverty problem. Their scope has been limited and it is not clear if pilot programs can be generalized to all the rural poor. Thus policy makers are turning to off-farm employment as an additional measure to improve incomes of farm households.

As development strategy shifts, a logical question must be addressed: how can the small-scale sector be assisted? In many countries, a viable small-scale sector is dependent upon a deliberate restructuring of the current rules of the game which favor large-scale firms. Once having achieved such a restructuring, however, the question still arises as to what specific programs and policies can be designed to facilitate the creation and expansion of small-scale firms.

The purpose of this paper is to review the financial needs of rural nonfarm enterprises and analyze how rural financial markets can better serve these needs. The first section will briefly review some of the arguments in favor of increased emphasis on such enterprises and various alternatives suggested for assisting them. The second section will review the financing of rural nonfarm enterprises and issues related to providing them with increased financial services.

OFF-FARM WORK & RURAL NONFARM ENTERPRISES

Before proceeding to the discussion of finance, it is useful to briefly summarize some of the recent literature concerning the rural nonfarm sector. Two recent research themes are most relevant. The first concerns the nature and extent of off-farm work for rural households. At one time, this issue was largely ignored by agricultural economists. Part-time farming, for example, was seen largely as a transitional phenomenon. It was believed to represent an intermediate stage for persons moving into or out of full-time farming. Part-time farmers were viewed as a special problem of efficient resource allocation. Public policy was largely directed toward speeding and easing the adjustment from part-time to full-time status.

More recently, however, the part-time farm household has begun to be viewed with more interest as a possible permanent fixture of the rural setting. In such widely divergent settings as the U.S. and Japan, rural residents typically earn a wide variety of incomes from both farm and off-farm sources. In the U.S., the percent of farm household income derived from off-farm sources grew steadily from 43 to 59 percent between 1960 and 1976 (Meyer et al.). In Japan, from 1974 to 1975, nonagricultural receipts grew from 48 to 62 percent of average farm household receipts. The importance of off-farm income for small farms is clear in both countries. Over 80 percent of the household income of U.S. farms selling less than $2,500 in gross sales came from off-farm sources in 1976. This percentage was up from just over 60 percent in 1960. In Japan, farms with less than 0.5 hectares in 1973 earned almost 90 percent of household income from nonagricultural sources, while that percentage was only 30 percent for farms over 2.0 hectares.

The phenomenon of off-farm work is not limited to high income countries. Farm records, surveys and village studies in such widely divergent areas as Thailand, Taiwan, Korea, Sierra

Leone, Nigeria and Egypt[1] show that farm families allocate their time to, and receive income from, a wide var_ ty of off-farm or nonfarm activities. Problems of rural-urban income gap and rural income distribution would be much worse if low-income rural households did not engage in such off-farm activities.

The second research theme concerns the nature, extent and potential of nonfarm enterprises in rural areas. Liedholm and Chuta recently summarized a major research project in Sierra Leone which provides detailed information on that country's experience. Similar information from other selected countries can be found in other recent studies.[2] This research shows that 20 to 30 percent of the rural labor force in many countries is engaged primarily in nonfarm work. In Asia the share was reported as 51 percent in Taiwan in 1966, 40 percent in the Philippines in 1970, and 25 percent in South Korea in 1970. One-half to two-thirds of all nonfarm employment opportunities in Asia were found in rural areas and towns (Anderson and Leiserson). Likewise, small-scale firms, the majority of which are located in rural areas, represent a major share of total employment in several industries. For example, Oshima found for the Philippines in 1961 that firms engaging fewer than ten persons comprised 93 percent of the employment in construction,

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[1] See Meyer et al. and Anderson and Leiserson for a summary of some of these studies.

[2] Some of these results are summarized in Anderson and Leiserson, Gordon et al. and Meyer et al.

94 percent in commerce, 76 percent in manufacturing, 64 percent in transport and communications, and 95 percent in services.

Several studies have tried to assess the characteristics of different size firms. The results suggest important advantages for small-scale enterprises such as they: (1) are less capital-intensive; (2) are more geographically dispersed; (3) offer more opportunities for unskilled and family labor; (4) have greater linkages with the agricultural sector; and (5) have greater export potential than frequently assumed.[3]

Thus, it is concluded that small-scale firms are more consistent than large-scale capital-intensive firms with the current resource endowments and stage of development of most low-income countries. These results lead many persons to argue that more attention should be directed to the small-scale sector, but the question arises, what can be done to assist small-sector enterprises?

ASSISTANCE TO SMALL-SCALE ENTERPRISES

Most countries employ a variety of industrial promotion techniques including customs exemptions, preferential foreign exchange rates, tax incentives and concessionally priced credit. Unfortunately, these techniques are principally geared to modern, large-scale, capital-intensive firms. Small-scale firms frequently do not or cannot benefit. Making these general incentives

[3] See Meyer, et al., for a summary of some of the literature that report these points.

more applicable would help small-scale firms, but some promotional efforts must be pinpointed more specifically to their problems. The specific needs and approach will vary from country to country, but a number of options have been suggested.[4/]

1) Infrastructure. Social and economic infrastructure may make a substantial impact on the development of nonfarm activities. Rural areas typically lack communication, transportation, electricity and other facilities for small-scale firms. Infrastructure requirements may not be very sophisticated. Dirt roads may be adequate rather than highways; diesel generators may serve as well as electrical grids. Furthermore, by providing small-scale facilities, they can be more easily located where specifically needed.

2) Trading services. Small-scale firms frequently lack adequate input and product markets. Healthier cooperatives and trade associations can help assure a steady supply of lower cost inputs and quality products for domestic sales and exports.

3) Research and technical assistance services. Much of the research in many countries is conducted in urban-based institutes and the results have limited relevance for small-scale enterprises. Much of it would be better located in rural areas where it would be more directly accountable to the intended clientele. Nonfarm extension services could be used like existing farm extension programs to encourage the spread of innovations.

4/ See Anderson and Leiserson and Gordon, et al., for a description of these alternatives and current World Bank programs in this area.

4) Vocational training. A large amount of training occurs in small-scale enterprises through apprenticeships and on-the-job training. Formal vocational training may be complementary by providing basic instruction in management, record keeping, marketing, etc., as well as certain specific skills like baking, welding, carpentry, printing, etc.
5) Industrial estates. Providing a variety of services over a wide geographic area may be prohibitively expensive. Several countries have tried to achieve economies of scale by creating industrial estates. These estates provide infrastructure and facilities and some even provide building shells for firms. The Indian experience shows, however, that high cost, poorly located estates will not be fully utilized (Watanabe).
6) Financial services. Finally, most studies identify credit and other financial services as a constraint and propose special credit programs and/or institutions for nonfarm enterprises, frequently in conjunction with technical services.

FINANCING OF RURAL NONFARM ENTERPRISES

This section is divided into two parts. The first deals with the financial characteristics of rural nonfarm enterprises and the second discusses issues involved in providing adequate financial services.

Existing Financial Services

The existing literature clearly suggests that small-scale firms suffer from inadequate financing. Three types of evidence are frequently given in support of this claim. First, businessmen customarily identify finance as one of their key bottlenecks when asked about their business.[5/] They frequently perceive that inadequate finance is the major reason for their limited profits, while in fact their management of limited capital may be the real problem.

Second, small enterprises frequently are started and later expand largely with equity capital obtained from savings accumulated from other activities or from the firm itself. For example, Liedholm and Chuta report that approximately 60 percent of the funds used to establish small-scale industries in Sierra Leone came from personal savings from agricultural activities, trade or business. Steel quoted from the 1973 Accra manufacturing survey which showed that over 90 percent of the firms were started using personal savings or loans from relatives. On the other hand, debt capital frequently plays a more important role in the finance of larger firms in many countries. Thus, the limited use of credit by small firms is taken as evidence of external credit rationing, especially if it can be determined that the firms in question are profitable and appear to have potential for expansion.

5/ Harper discusses research on shopkeepers' perceptions of their major problems in Kenya and summarizes results of other research addressing this same question. Also see Dunlop and Steel for references which report this conclusion.

Third, when credit is used, it frequently is obtained from informal sources such as input suppliers, purchasers, friends and relatives, and moneylenders. The interest rates charged are usually higher than those charged by formal credit sources. For example, Kochov _et al_. report that small industrial enterprises in Korea borrow at rates of 35 to 40 percent from informal sources compared to 17.5 percent from official sources, while in Colombia the informal rates are 36 to 60 percent compared to the official 24 percent. Thus, it is concluded that small businesses are denied adequate formal credit and are forced into higher cost informal sources.

Supply constraints offer one plausible explanation for small amounts of formal credit use. Two other explanations also may be important. Adams and Nehman have shown how borrowing costs are high for small farmers due to high transaction costs. Complicated procedures are often introduced by lenders to assist rationing scarce loan funds, especially when interest rates are set at concessional terms. Thus, total borrowing costs for small loans are far greater than implied by interest rates. The supposed large differential between costs for formal and informal credit may largely disappear when borrowing costs are compared rather than interest costs.

Alternatively, there may be little demand for formal credit by small-scale firms. The economic environment in which they operate may be so uncertain or so biased toward large-scale firms that there is little incentive for them to grow and expand. Input supplies may be uncertain and of poor quality. Product markets may be easily saturated with increased production. Management may be unqualified to handle a firm of greater size and complexity.

Determining which explanation is most appropriate is a complicated undertaking and beyond the scope of this paper. Obviously, the answer depends on the time, the country, the industry and the particular firm. Two firms existing side by side and operating within the same industry may have quite different credit needs. Thus their demand for credit will be different. In a market economy, the credit services are provided and the market sorts out the quantity demanded by each firm at various interest rates. There are a number of reasons on the supply side, however, which may explain a limited amount of credit offered to small firms. By understanding these reasons and working to relax the supply constraints, the demand issues will then be placed in clearer focus.

Factors Affecting Credit Supply

There are a number of factors on the supply side which can reduce the amount of credit offered to nonfarm enterprises. Some are similar to reasons given for the small amount of credit going to small farmers.

Nonfarm enterprises may suffer from inadequate credit because of the heavy emphasis on farm credit in many countries. It is ironic that the more successful countries are in providing farm credit, the less successful they may be in supplying funds to rural nonfarm firms. Through regulations, quotas, rediscount arrangements, special funds and other means, several countries have tried to increase the flow of funds to farmers, and especially small farmers. When these efforts are successful, rural financial markets may become more rather than less fragmented. That is, lenders may spend so much time, effort and funds to meet the farm credit objectives that they have little time or funds left for nonfarm enterprises. Some specialized lending institutions are even legally prevented from making nonfarm loans. Furthermore, lenders may experience low profit margins with farm credit. This may discourage them from making small nonfarm loans which may also have low profit margins. Low inflexible interest rates set by custom or usury laws contribute to insuring low profit margins.

It is customary to recognize that farms are heterogeneous, but in specific agricultural regions they will likely have broad similarities in enterprises, technologies and production practices. Thus, lenders can develop procedures and rules-of-thumb to guide farm credit operations that will likely be fairly valid within the immediate area. Within that same market area, however, nonfarm enterprises would be expected to vary widely, perhaps including a blacksmith shop, bicycle repair, bakery, tailor, cement plant and textile firms and there may be only one or a few of each. It is difficult for the lender, therefore, to acquire enough familiarity with each type of firm and understand their unique problems to feel confident in granting credit and technical assistance.

Lenders generally perceive high risks in small enterprise lending just as they do with small farmer credit. Small-scale businessmen almost by definition have limited reserves to withstand adversity. Although the small-scale sector may appear to have considerable resiliency as manifested by a wide number of firms, the turnover of firms and bankruptcies are often high. These firms can provide only small amounts of collateral and the value of such collateral may be low due to the limited market for it in any one area. Furthermore, the success of small-scale nonfarm enterprises may be inextricably tied to the fortunes of farming. When harvests and prices are good, farmers have income with which to pay old bills and contract for new goods and services. But when yields or prices are poor, so is the market for nonfarm firms. Thus, loan repayment will likely follow a similar pattern for both farm and nonfarm firms and there is likely to be little opportunity for the rural lender to substantially reduce the risk of his total portfolio through nonfarm loans.[6/]

The administrative structure of some lenders mitigates against making many loans in rural areas. Frequently, lenders give little authority to branch staff to make loans. Decisions on loans are often concentrated in the home office. Thus, the branch staff considers itself largely an institution to collect

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6/ Lenders frequently anticipate that repayment performance will be worse with small enterprises. The experience in many countries suggests, however, that small farmers actually repay better than large farmers. Steel reports that small businessmen had a better repayment record than large ones in Ghana. Thus, repayment risk for small loans may not be as high as lenders normally expect.

and channel deposits to urban areas. Little effort is made to aggressively seek out loan customers in rural areas. The expected relationship between collecting deposits from clientele in return for possible loans breaks down so one of the powerful motives for saving may also be destroyed.

Finally, the operational inefficiencies and attitudes of lenders may exacerbate weaknesses within the small-scale firm. Patel found in a study of innovations used to assist small-scale industry in Gujarat State of India that inadequate working capital from banks was a major problem even though long-term finance was abundant from state sources.[7/] Capacity utilization and sales performance of the new firms was much less favorable than projected due to shortages of working capital. The firms faced long delays in sanction and disbursement, large margins, inadequate sanctions of amounts, nonresponse to needs at critical times, and hardening of lender attitudes at the first sign of trouble. Clearly the banks were not as committed to the program as were the state authorities. Thus, the effectiveness of the other components of long-term finance, entrepreneur identification and training, and infrastructure development was blunted.

The limited amount of funds going to rural nonfarm firms and the problems encountered by countries that have tried to increase formal credit supplies suggests a need to rethink how financial services can be effectively provided in rural areas.

7/ Watanabe also concluded that small enterprises in India faced difficulties, not so much in the quantity of loan capital available, but with the low quality of loan services and ignorance of bank officials about local problems.

Several issues need to be faced. First, the current emphasis on implementing credit projects rather than strengthening rural financial markets contributes to fragmenting rather than integrating financial services. A few borrowers are favored by a specific project, while many are neglected. Services to firms outside the project may even deteriorate as staff and agencies strive to service project beneficiaries. Rural financial markets must be opened up to a wider range of clientele. Borrowing and savings services must be broadened. Some of the current rules, regulations and requirements must be relaxed and appropriate incentives given to financial intermediaries.

Second, attention has been given to the type of institution required to effectively provide financial services to rural nonfarm enterprises. Kochav et al. review alternative institutional arrangements. This issue is probably not worthy of all the attention usually given to it. Studies of farm finance show a striking similarity in the performance of various types of institutions in a particular economic environment. The key issue appears to be the objectives and interests of institutions, not their particular form or even ownership. For example, Costa Rica, Jamaica, India, and Bangladesh have nationalized commercial banks as a means to alter their performance. Yet studies suggest that the nationalized banks continue to serve approximately the same clientele as before nationalization. Nationalized banks tend to share some of the same performance criteria used by commercial banks such as unit costs, profit margins and surpluses.

Thus, efforts to force nationalized banks to make loans which cause these performance measures to deteriorate will be resisted strongly. Fortunately, many countries have a fairly well developed set of intermediaries. The challenge is to develop an appropriate set of incentives so they service nonfarm firms rather than create new institutions.

Third, more innovative thinking is required to reduce the costs and risks of lending to small farm and nonfarm firms. Lending procedures need to be streamlined similar to deposit operations. Risks may be reduced through guarantee funds and loan insurance. The group lending experiments reported by Adams may suggest ways to reduce costs and improve repayment performance. The advantage of geographic proximity of lender to borrower needs to be more fully exploited in nonfarm lending. The lender can easily make periodic visits to the firm to assist with financial management. Loan repayments can be scheduled differently. For example, a bicycle shop may logically make daily or weekly loan payments which would be impossible for a farmer due to distance and seasonality of income.

Fourth, increased attention must be given to the terms and conditions of loans. Amortization schedules must be made more flexible. Incentives are required to encourage rapid payments, but simple provisions are also necessary for extending loans and scaling down payments when planned production and sales conditions are not met. Interest rates must be set at rates which reflect the true scarcity of capital in the society and offer an attractive return to the lender. If temporary subsidies are required for the borrower, it is far better to provide them through means other than concessional interest rates which discourage lenders while encouraging borrowers into a more capital-intensive technology.

Fifth, training and technical assistance are required for both the lender and borrower. Lenders need assistance in improving loan services to keep pace with the efficiencies obtained by some institutions in servicing deposits. Loan officials need information on general economic conditions as well as special information on problems and potential of rural nonfarm enterprises. Through improved efficiency and knowledge about loan potential, lenders should be more inclined to make small loans to nonfarm businesses. The lenders need enough information about various types of firms so loans can be made based on projected debt repayment capacity rather than exclusively on arbitrary rules of thumb or procedures. In turn, lenders can provide important noncredit services to borrowers. Most small businesses have little or no recordkeeping. Lenders are logical sources of information on how to establish and maintain accounts, and how to use such information for decision making. In fact, this information may be more useful for the long term survival and expansion of the firms than the credit itself.

CONCLUSION

The new emphasis on rural nonfarm enterprises represents another way to attack rural poverty. The challenge is to discover how to assist these firms. Expanded financial services appear to be a promising area, and the international agencies, led by the World Bank, are developing programs to increase formal credit supplies. The usual approach to meeting a specific target group is to develop a new program and/or institution with special lines of credit. Unfortunately, experience with farm credit programs would suggest cautious expectations about how effectively such programs will work or even how much credit will actually find its way into small businesses. The limited literature suggests a distressing similarity in problems in lending to small farm and nonfarm firms.

Additional effort is needed to address why existing financial intermediaries lend so little to nonfarm firms. The answer may well be due to the fragmented nature of rural financial markets. Where this is the main problem, efforts must be made to open up both the savings and lending sides of the institutions to broader participation. Furthermore, lenders may be in an ideal position to provide assistance in financial management more crucial to the firm than credit. A sound institution that provides timely technical assistance and attractive savings and deposit facilities may be of greatest help to rural nonfarm enterprises.

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