

ARIES

Assistance to
Resource Institutions
for Enterprise Support

Assessment of USAID/Costa Rica
Small Scale Enterprise (SSE) Support Strategy
with Local and International
Private Voluntary Organizations (PVOs)

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Directed by

Robert R. Nathan Associates, Inc.

November 5, 1986

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USAID/San Jose

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ARIES

Assistance to Resource Institutions for Enterprise Support

The ARIES project is designed to strengthen the capabilities of support organizations in developing countries to implement small-scale and micro-enterprise development programs. ARIES builds on the work of the Agency for International Development's former Program for Investment in the Small Capital Enterprise Sector (PISCES) and Small Business Capacity Development projects. It works with intermediary support organizations that provide services to small and micro-businesses and industries, such as private voluntary organizations (PVOs), banks, chambers of commerce, management training centers, business people's organizations, and other developing country government and non-governmental organizations (NGOs).

The contract for this five-year project has been awarded to Robert R. Nathan Associates, Inc. (RRNA) with subcontractors Harvard Institute for International Development (HIID), Control Data Corporation (CDC) and Appropriate Technology International (ATI).

ARIES is core funded by the Bureau for Science and Technology's Office of Rural and Institutional Development (S&T/RD) and the Bureau for Food for Peace and Voluntary Assistance's Office of Private and Voluntary Cooperation (FVA/PVC). Mission funded technical assistance represents \$3.8 million, or almost three-fifths of the five-year budget of \$6.8 million.

The ARIES project has three major components -- research, training, and technical assistance -- designed to cross-fertilize each other. The applied research component focuses on economic, social, and organizational issues surrounding intermediary support organizations to inform AID missions and host country actions in this subsector. The training component includes design, testing, conduct and follow-up of training programs in such areas as finance, management and evaluation for PVO and NGO personnel. The technical assistance component provides short-term technical assistance to AID missions and intermediary organizations to assist small and micro-enterprise development.

EXECUTIVE SUMMARY

Introduction and Purpose

The present review was conducted to provide the General Development Division (GDD) of USAID/Costa Rica with (1) an assessment of the small-scale enterprise (SSE) support strategy which channels funds through local and international PVOs for the delivery of services and credit to SSEs and (2) recommendations to improve the delivery of services intended to upgrade SSE productivity. A team of three members was contracted under the ARIES Project.

The team leader and one of the consultants reviewed financial intermediation and SSE credit support, while one consultant reviewed technical assistance, concentrating on how USAID/CR and the PVOs can better promote and assist SSE development. This involved examining both the technical assistance needs of PVOs and the policy implications for USAID/CR's planning.

Organizational Framework

USAID's program to assist micro enterprises through PVOs has centered on the Coalicion Costarricense de Iniciativas de

Desarrollo (CINDE). CINDE, a non-government, non-profit organization, supported by USAID/CR funds, has been successfully promoting Costa Rican non-traditional export and attracting private industrial investment into the country. A special department was organized within CINDE, known as CINDE/PVO, to manage USAID/CR funds dedicated to support Costa Rican and international PVOs active in a wide variety of development objectives, e.g., income generation, and assistance to small and micro enterprises. A memorandum of understanding was signed in May 1983 with CINDE to channel a designated portion of USAID/CR funds, approximately US\$7.0 million, in grants and loans to PVOs fulfilling project and institutional requirements established by CINDE/PVO, previously approved by USAID/CR. Recently, the decision was made to spin off CINDE/PVO from CINDE and develop a new entity to work exclusively with PVOs and their projects. The new entity is to be totally independent of CINDE and will be named ACORDE. CINDE/PVO personnel are now in the process of reorganizing and establishing new offices. This stage presents an opportunity for USAID/CR to examine SSE support strategy with regard to PVOs.

Methodology

The mission period was short -- seven person-weeks in San Jose, Costa Rica. At the outset of the mission, it was clearly established that the study was to concentrate on the existing USAID/CR strategy of support to SSEs and not to undertake a sector assessment. The consultants complemented information obtained through interviews, and review of existing data, with their own knowledge of the field and the sector, based on many years of experience in Latin America.

To conserve time, the GDD office in San Jose selected eight PVOs that support SSE development. All introductions and arrangements to visit PVOs, banks, and academic or business leaders were made by the GDD office. Cooperation and USAID support from the GDD office was outstanding.

The consultants reviewed all relevant materials on the projects supporting SSEs and interviewed USAID/CR personnel in the GDD Office, Economics Office, and the Private Sector Office. Several working sessions were held at the Inter-American Development Bank (IDB), the Central Bank, and private financial institutions in San Jose and Naranjo. Public and private entities providing technical assistance to SSEs (six NGOs selected by USAID/GDD), as well as academic centers and institutions, were also visited.

The mission's terms of reference were clarified and coordination meetings were held daily in the GDD office at the outset of the study. Two debriefing presentations were made at the end of the second week, concentrating on technical assistance and final recommendations. The debriefing sessions were very well attended by personnel from the GDD, Economics, Programming, and PRE Offices; discussion was lively. The team leader held two final working sessions with the Director and key staff of the GDD office before leaving Costa Rica. A draft report was prepared and left with the GDD Office Director.

Findings

PVOs in Costa Rica have a constituency of the poor, who have developed trust and confidence in the PVOs' highly

dedicated staff. Most of the PVOs interviewed have a social and/or human development orientation. Their programs, planning, and implementation are highly participatory, requiring significant input from project participants; this is time consuming and costly per beneficiary supported. While almost all of the PVOs believe that technical assistance (meaning both technical and managerial assistance) is vital to upgrading enterprise productivity, no funds are set aside for technical assistance to the PVOs themselves. This lack of technical assistance to PVO staff helps to explain the absence of management capacity beyond the director or president level.

As non-profit, non-government service institutions, PVOs must operate like private enterprise. They must mobilize financial resources, manage projects, penetrate markets, and work toward institutional self-sufficiency and project effectiveness. As is true throughout Latin America, the strongest, most effective and most efficiently managed PVOs in Costa Rica have a diversity of donors, mobilize financial support from the local community and/or among project beneficiaries, provide for periodic staff training, and are concerned with cost efficiency and project expansion.

Most PVOs working with SSEs have had little or no experience in financial intermediation and should not be administering credit to project participants. For example, while all PVOs working with SSEs want to manage credit projects, there are no common definitions or measurements of recovery and delinquency rates, and most PVO staff have no idea of the complexities of credit programs. Some PVOs should not be involved with the administration of credit at all. Many are

effectively working in human resource development and training (the pre-entrepreneur level) and should continue with this focus. An effective way to administer credit to SSEs in Costa Rica appears to be through a private financial institution trust mechanism, fideicomiso. This is used to manage the lending and recovery portions of the loan administration process. The PVO carries out the feasibility analysis, develops a business plan with the entrepreneur, and carries out some, if not all, of the appropriate technical assistance and follow-up.

The scale of the PVO projects working to support private enterprise is very limited. At most, 1,000 of the estimated 35,000 SSEs in Costa Rica receive project support. Currently, the PVOs exchange little information, formally or informally, and have very limited leverage with the GOCR, CINDE, the university community, and private sector (business and banks). PVOs need technical assistance and training in project management, mobilization of local resources, and alternative credit mechanisms. They need to coordinate an information exchange or network among themselves and with other sectors of the community. PVOs and the community should also coordinate their efforts to improve SSE support services.

Current restrictions on commercial banks, such as limiting time deposits to six months or longer, severely limit the institutions' ability to capture resources. This erosion in their earnings base reduces the rates that could be paid to attract longer-term deposits, further restricting resource mobilization. In an economy where inflation and devaluations are important considerations, the demand for longer-term

deposits will be negligible, and this limitation will effectively prevent the growth of private sector banks. Presently, private banks in Costa Rica hold barely 3 percent of the deposits and lend less than 7 percent of the value of loans.

Major Recommendation

USAID/CR should continue to facilitate the access of SSEs to credit and technical assistance resources through a delivery system consisting of an umbrella organization and selected PVOs. With the institution of certain operational procedures and policy guidelines, ACORDE will be well suited to the role of the umbrella organization and will be a positive source of support to PVOs, assuming that PACT and USAID provide the human resource and technical support planned for ACORDE.¹ The Central Bank project in support of SSEs (FODEIN) should be continued. With the numerous branch banks in the system, more of the banks should be administering this special line of credit to improve the project's outreach -- especially among the secondary cities in Costa Rica.

The policies inherent in this approach include eliminating the non-price rationing of credit, using positive interest rates, avoiding conflict with the conditions set by the IMF and major aid donors and creditors, and encouraging PVO self-sufficiency.

1. AID/PACT have an ongoing working agreement (OPG) to provide technical assistance to ACORDE.

Details with respect to policy issues, effective strategy implementation, and follow-up measures are provided in Chapter V.

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I. SMALL SCALE ENTERPRISE IN COSTA RICA

Definition of Small-Scale Enterprises

The GOCR defines SSEs as employing up to 20 persons, with up to US\$50,000 in movable fixed assets (machinery and equipment), simple technology, and the active participation of the owner. This study adopts this definition when discussing SSEs. These SSEs are responsible for approximately 10 percent of the Costa Rican labor force, with estimates of 25 percent and higher of new jobs now being created.

From the operational point of view, small-scale enterprises are productive economic units operating in rural and urban areas and, as with larger enterprises, generally combining at least two factors of production: labor and capital, in the case of furniture making or clothing production and assembly; or labor and some type of organization in the workplace, in the case of most petty trading, commerce, and service enterprises. While many are one-person firms (micro enterprises), the activity of all SSEs implies coordination of a variety of functions -- money, marketing, and management -- for a specified economically productive end (Blayney/Otero, 1985).

In general terms, these firms' goods and services are targeted to national markets, differentiating them from

subsistence activity at one end and from export-oriented industry on the other.

Size is the most often used variable in defining SSEs. It is generally agreed that fixed assets (machinery and equipment) and number of wage employees are appropriate indicators for classification. Based on a survey of nearly 5,300 firms in Latin America carried out by Kilby and D'Zmura in 1985, the size characteristics of micro enterprise (less than ten employees) establishments are, on the average: 4.5 persons engaged, including the owner; 78.3 percent wage employees (as opposed to non-remunerated family workers and apprentices); US\$1,900 monthly sales; and US\$5,000 total investment. Fifteen percent of small-scale entrepreneurs in Latin America are women, who tend to own the smallest enterprises. The Costa Rican micro enterprises covered in a 1983 study are estimated to be even smaller than those covered by Kilby, with an average of 1.75 employees (the definition used was different from that of Kilby and D'Zmura).

There are also non-numerical indicators of size which enable better definition of SSEs.

Externally supplied inputs. The smaller the firm, the less access it has to inputs into the productive process, such as finance, imported capital goods, intermediate inputs, knowledge of effective production techniques, or assistance in improving management procedures. Limited access increases the firm's vulnerability and margin of risk, and contributes to market restrictions.

Location. Micro enterprises are often home-based operations or use makeshift quarters. In most cases, these firms

represent one of several productive activities of a family. Each family shifts labor and capital based on need and circumstances and on the present profit-making capacity of a given enterprise.

Small enterprises, in contrast to micros, usually operate out of rented or purchased establishments quite separate from the owner's household or financial activities. These firms also tend to represent the main income-earning activity for both the owner and the employees, with less use of capital for a variety of entrepreneurial activities.

Our preliminary findings, based on interviews with local Costa Rican PVOs, show that SSEs are generally more viable when:

- . they hire workers rather than being a one-person or family enterprise
- . business is conducted outside of the home
- . they operate out of urban areas or rural towns
- . they produce for the local (regional or national) markets

These parallel exactly the findings of Michigan State University in their recent summary of SSE research in selected countries all over the world.

Production and organization. The personnel of most micro enterprises include family labor or apprentices paid in kind. The level of participation by family and apprentices varies among countries and type of enterprise (Ashe, 1985). Management questions related to planning, accounting, and record keeping are resolved on a day-to-day basis, but not in a

planned or systematic way. In Costa Rica, finances rely heavily on local money lenders (prestamistas) and/or extended family. Production varies in quality from week to week. In sum, while labor-intensive, micro enterprises entail little division of labor or production organization, and rely primarily on existing skills and low levels of technology.

Small enterprises, on the other hand, exhibit a more formalized and systematic internal organization based on more defined division of labor and greater technological specialization. With a more developed management system and sometimes even access to formal sector institutions, such as finance and management/business organizations, these small firms may use both local and imported resources and generally manifest a higher productivity level than their counterparts in the micro enterprise subsector (Liedholm).

Skill level. Low level of formal education characterizes small and micro entrepreneurs, though the latter tend to register lower literacy rates than the former. The majority of micro entrepreneurs have not completed elementary school, and lack formal vocational training. They acquire their skills through practice, by serving as apprentices, or learn them through the family (Anderson, 1982). In the case of women, skills perfected through traditional domestic and childrearing chores are often used to generate income, such as in textiles and food processing (Dulaney and Austin, 1985).

Entrepreneurial profile. SSEs tend to be initiated by older men and women who perceive the firm as a permanent economic activity and a major source of long-term income (Kilby and D'Zmura, 1985; Moser, 1985). These firms are not

formed by people needing marginal, temporary employment while they seek higher paying jobs in the formal sector.

Younger people view an apprenticeship to an entrepreneur as a training ground for future productive employment. These apprentices often will leave a firm to establish their own enterprises as a long-term investment of time and capital. For this reason, they often are willing to earn minimal, if any, wages while learning a trade (Blayney/Otero, 1985).

Market Size

The number of small enterprises in Costa Rica is a matter of some controversy. Price Waterhouse reports that there are 60,000 companies of all sizes registered in Costa Rica, but many micro units are not registered. The Ministry of Industry estimates that there are about 15,000 small-scale industrial units, but this does not include micro enterprises in the informal sector. AITEC estimates that all micro enterprise employment in San Jose is 50,000. According to Ashe in his 1983 evaluation of the USAID/CR Employment and Urban Support (EUS) Project, 40 percent of these were industrial or repair enterprises, as compared to 30 percent who were street vendors, 19 percent who were retailers with a fixed location, etc. Dividing the 50,000 figure by the average of 1.75 employees found in the Ashe evaluation, we would estimate that there are 28,500 micro enterprises in San Jose, and perhaps 42,500 nationally. To this we must add the small-scale non-micro units covered by the Ministry of Industries, using the government's official definition.

Tentatively we can say that there are perhaps 42,500 micro and 15-30,000 small-scale units, employing roughly 10

percent of the labor force and up to 25 percent of additions to it. Thirty-five thousand of these are industrial units. More than two-thirds of the units are located in San Jose. The small and micro units as a whole constitute the target for SSE promotion activities, our target market.

Potential for Growth

Economic growth occurs either from an increase in the amount and quality of the inputs employed or as a result of higher productivity. Denison, in his study of economic growth in the United States from 1929 to 1957, estimated that 68 percent of the U.S. growth rate over the period resulted from the increase of total inputs (labor, capital, management, etc.), and 32 percent from higher productivity. Economies of scale and the advance of knowledge were the most important factors accounting for increased productivity. Economies of scale, basically a result of larger markets and the greater specialization they brought about, accounted for 38 percent of increased productivity. Increased knowledge and its application accounted for 62 percent of the higher productivity (Denison, 1962; USAID/CR Training for Private Sector Development, 1984).

Therefore, any growth, either for the small firm or the economy as a whole, will have to come from an increase in the quantity and quality of inputs (e.g., incremental capital from credit) or an increase in productivity (e.g., as a result of technical assistance and extension).

There is evidence that training and technical assistance are needed by Costa Rican SSEs. Data from a survey of 154 Costa Rican small, medium, and large industries suggest a need

for training executive personnel (presidents, general managers, marketing managers) and technical personnel (professionals in administration, production, finance, sales, and advertising). Of the 154 firms surveyed, 65 were export-oriented (USAID/CR, 1984).

The Central American Institute for Business Administration (INCAE) conducted a survey, in conjunction with the Chamber of Commerce, of 200 Costa Rican private sector firms. The results of the survey showed that the areas in which entrepreneurs and managers expressed the greatest need for knowledge and skills included general management and financial strategies, management strategies in times of crisis, accounting, marketing under inflationary conditions; information management systems, general organization, and systems for greater efficiency (USAID/CR, 1984).

In contrast, based on interviews with personnel of eight PVOs and one credit union, the SSE's primary technical assistance needs revolve around management issues. General business planning is needed, as are product diversification studies, quality control, and marketing analysis capabilities, including expansion of local markets and, for the larger SSEs, the "how to" for entering export markets.

Credit is also needed, particularly by micro enterprises. A study of micro entrepreneurs in San Jose indicates that many business owners would like to receive credit but have little access to (formal) financial sources. They express the need for working capital to buy more merchandise, raw materials, or equipment. Half of the business owners are willing to join a solidarity group to receive such loans (Ashe, et al., 1985), and the vast majority of loans are made for US\$1,000 or less.

II. ECONOMIC AND CREDIT CONDITIONS IN COSTA RICA¹

Conditions in the 1980s

As the the 1980s began, Costa Rica was headed for an unavoidable economic downturn. The economy was devastated by the interrelated effects of balance-of-payments deficits, rising debt service requirements (due to larger debt and higher international interest rates), rising import prices, falling export prices, and the world recession (U.S. and Europe especially), which reduced the demand for traditional Costa Rican exports.

The economies of the other CACM members were similarly affected and, in several cases, were disturbed by insurgency and revolution. The affected countries responded with various protectionist measures. The result was a virtual collapse of the CACM and the a loss of the benefits it had brought to Costa Rica. Costa Rica's gross domestic product stagnated in 1980,² fell by 2.3 percent in 1981, and fell by 9.1 percent in 1982. In per capita terms, the declines amounted to 1.6 percent, 4.9 percent, and 11.3 percent, respectively.

1. Sources: M. Sagot, FAO, 1986 and G. Fields, Cornell University, 1986.

2. Real growth of just 0.8 percent.

As domestic interest rates remained unchanged in nominal terms, but inflation accelerated, real interest rates became negative, shrinking domestic financial savings. Private investment fell by more than half -- from 1.6 billion in constant (1966) colones to 0.8 billion. Public debt reached 400 percent of exports. Inflation, which had always been low in Costa Rica, rose to 37 percent in 1981 and 90 percent in 1982 (Fields, Cornell University, 1986).

Summary of Monetary Policies and Major Credit Trends

In the 1980's, money moved from Costa Rican financial institutions and the colon into foreign banks and real assets. Estimated Costa Rican holdings of dollar deposits abroad increased by \$100 million in 1983-84 alone. Private sector holdings of financial assets as a ratio of Gross Domestic Product declined from 40.8 percent to 35.8 percent from 1979 to 1982, rose to 37.4 percent in 1983, and fell to 36.0 percent in 1985. Fixed capital formation declined as a proportion of GDP from 26.2 percent to 18.3 percent from 1979 to 1983.

The decline in the holdings of financial assets (disintermediation) and fixed capital formation were the result of a contraction in domestic savings caused by depressed real income and high inflation and perhaps by negative real interest rates (Sagot, 1986). General political insecurity in the region undoubtedly contributed to the outflow of currency and the disintermediation of savings.

As the crisis deepened, the GOOCR was forced to act. An agreement was reached with the International Monetary Fund

(IMF) and major aid donors and creditors. The policy measures agreed upon with the IMF in December 1982 were:

- . A tightening of monetary policy
- . An establishment of positive or market real interest rates
- . A cut in government spending
- . An increase in taxes, including social security
- . Debt rescheduling with 10 creditor countries
- . An understanding with commercial bank lenders on payments

The conditions tied to the USAID Economic Support Fund of US\$440 million from 1983 through 1985 included the privatization of certain enterprises and the following provisions:

- . Repayment of loans in the currency of origin.
- . Extension of bank credit on a price basis only.
- . Maintenance of interest rates at positive levels. (Appendix D. Definition of Interest Rates)
- . Continued support of a unitary, flexible exchange rate.
- . Removal of export taxes.
- . Reformation of the free zone legislation.

The economic and financial impact of the policy measures listed above appears to have been mixed. Gross National Product (GNP), which had been falling in real terms in 1981 and 1982, rose in 1983. Real GDP grew by 2.3 percent in 1983 and by 6.3 percent in 1984. Inflation also came under control, falling from 90 percent in 1982 to 32 percent in 1983

and 12 percent in 1984. The balance-of-payments deficit improved, reaching 6 percent of GDP in 1984, down from 14.5 percent in 1980-81. (US\$300 million is still owed to Costa Rica on commercial transactions from the CACM.)

On the other side of the ledger, passbook savings (savings deposits, term deposits, and short-term bonds issued by the banking system) dropped from 17 percent of all savings in 1980 to 13.4 percent in 1982, reflecting continuing disintermediation. Public sector deficits, including Central Bank losses, estimated at 10-13 billion colones, continue to be responsible for current tight credit policies. Banks are required to have high cash reserves (32 percent on demand deposits). Interest rates, however, generally do not reflect market rates, and non-price rationing of bank credit continues. This rationing includes capital set aside for small and micro enterprises, which is very limited compared to capital for other economic subsectors (large industry, agriculture, etc.).

Existing Financial Support and Credit Problems of SSEs

Policy

USAID/CR policy toward the credit programs it sponsors (through PVOs or otherwise) must be consistent with its overall financial policies, as expressed in the IMF and ESF conditionalities. While it may be necessary to use both PVOs and banks as credit intermediaries, depending on the circumstances, the credit programs should be rational and sustainable. They must charge positive real interest rates, which permit the credit institutions to be self-sustaining (and ideally avoid decapitalizing their loan funds). Instead of granting a few concessional loans to a favored clientele,

credit intervention should increase the supply of credit and improve the access of SSEs to financial markets. (A recent EEPA study argues that this is the major market imperfection SSEs face.)

It is difficult to estimate the credit needs of Costa Rican SSEs on the basis of presently available data for three reasons. First, the rates at which credit is offered are determined by the lender, rather than the market, and are clearly excessively low.¹ Second, the present SSE credit programs supported by the Mission through PVOs serve small and very segmented markets, and the evaluation team cannot presume that conditions in these markets can be projected for the Costa Rican economy as a whole. Third, it is clear that demand for SSE credit will be a function of the state of the Costa Rican economy. If Costa Rica is able to maintain a steady rate of growth, the demand for credit within the informal sector will be greater than if the economy grows slowly or slips into another crisis.

A national market may be forming in which lenders and borrowers can compete and some overall market rates are set. Limited but important evidence exists for this assertion. AITEC, one of the most efficiently operated credit support PVOs in San Jose, is having difficulty finding clients for its commercially priced credit because other PVOs are offering credit at half AITEC's rate. Similarly, the Savings and Loan Cooperative of Naranjo lost clients to a lower cost credit provider. This is generally desirable for the units charging

1. Even if we could gauge demand at present interest levels, we cannot do so for demand at higher and more appropriate levels.

commercial rates, but they should be on guard against adverse selection by high risk borrowers.

The SSE's need for credit need can be estimated as follows. If each employed person in the informal sector borrowed US\$1,000, the total demand would be US\$228,000,000.¹ However, since each SSE employs, on the average, a total of 1.75 people, including the owner, the adjusted demand would be approximately US\$130,000,000. The demand for short-term, working capital would amount to US\$40,000,000, considering roll-over and short-term loans. The demand for new resources, excluding agriculture credit needs, could probably be met with US\$20,000,000-25,000,000.

The Central Bank/USAID/CR Fondo
de Desarrollo Industrial (FODEIN)
Support of Small Industry

Among the programs USAID has been sponsoring to meet SSE credit needs is a project with FODEIN. Started with US\$3.0 million, this project has been providing credit to small industry and artisans since 1980. Loans cannot exceed 850,000 colones for small industry and 50,000 colonies for artisans -- approximately US\$15,500 and US\$1,000 in 1986 dollars, respectively. The Central Bank has kept exceptionally good tracking records on the progress of the project. For example, it records: (1) amounts lent and recovered by institution, by number of loans and value; (2) amounts lent and recovered, by subsector of industry; (3) late payments or delinquency, by institution and subsector; and (4) economic impact data with pre- and post-loan sales and employment figures.

1. $\$760,000$ (total employed) \times .30 \times US\$1,000.
Source: U.S. Embassy, Costa Rica.

Currently, the project is lending reflows and is fully committed. There are over 11.0 million colones in credit applications and just over 6.0 million colones are recovered monthly.

The project's level of delinquency is approximately 20 percent on average and is likely to remain at that level, due to early detection and legal action taken against slow-paying borrowers. The national average of loan delinquency (as defined by other banks) is over 40 percent, with undisclosed amounts of non-recoverable loans.

Of the two subprojects under this scheme (028 and 040) and the five participating banks, only one was a private bank, Banco Cooperativo Costarricense (BANCOOP). BANCOOP accounted for only 2 percent of the number of loans and 3 percent of the value of funds lent when it entered the project in 1984. In the first half of 1986, these percentages rose to 4 percent and 6 percent, respectively.

Dr. Chavez, the Director of FODEIN, described the lack of participation of the other private banks as due to: (1) a narrow spread of 6 percent between the cost of money to the participating financial institution and the end user; (2) the high administrative cost of small loans; (3) the perceived risk of an unknown sector; and (4) the requirement that 20 percent of the funds lent must be the private bank's funds, which exacerbates the disincentives of the first three factors.

The private commercial banks of Costa Rica can only receive deposits of six months or longer, are restricted in the savings accounts they may make, are limited by interest

ceilings and, as mentioned, can only charge specific margins over their costs of money. Under these circumstances, private bank resources will flow to the best perceived risk, with low real administrative costs. Private banks are reluctant to lend US\$1,000 to SSEs, but might demonstrate greater interest in US\$15,000 loans¹ and in the easing of restrictions and regulations controlling private banks.

Measurement of Delinquency²

One important issue which USAID needs to address in connection with SSE credit is the "measurement of delinquency." An important indicator of financial crisis or risk is the extent to which financial institutions are having difficulty collecting loans as they come due. High rates of loan delinquency are widespread in Costa Rica, even when delinquency rates are calculated in ways that understate the extent of the problem.

There is substantial literature on loan delinquency in developing countries, especially pertaining to agriculture credit and public sector banks. Most of the empirical work is based on asking delinquent borrowers why they did not repay on time. Not surprisingly, most such borrowers report that they were unable to repay due to inadequate income -- e.g., decline in sales of given products.

1. The public sector banking system of Costa Rica accounts for approximately 97 percent of the deposits and just over 93 percent of the value of loans outstanding.

2. Sources: Christen Vogel, Credit Unions in Honduras, 1984; interviews at Savings and Loan Cooperative of Naranjo, Costa Rica, 1986.

Outside neutral observers come to different conclusions. They feel that loans are viewed as welfare grants or patronage, or that borrowers plan from the beginning not to repay and, therefore, divert loans into consumption expenditures (Christen/Vogel, 1984). In an examination of credit union portfolios in Honduras, Christen and Vogel suggest that "the basic model is one in which borrowers are assumed to choose to play either of two lotteries, where one is to repay and the other is to become delinquent." The main advantage of repayment is the probability of receiving a new, larger loan in the future (on which a positive rate of return can be earned).

When the borrower chooses to play the delinquency "lottery," two main outcomes are possible. The lender may do nothing, in which case the borrower keeps the current loan but is cut off from future loans from that lender. The lender may refinance the delinquent borrower with a larger loan and may attempt to pressure the delinquent borrower with penalty charges and additional transaction costs. Increases in financial charges or transaction costs or deterioration in making a new loan may not only make a new loan less attractive but also reduce the borrower's expectation of a larger loan in the future.

"The delinquency lottery is not necessarily riskier than the repayment lottery when risk aversion is included in the model" (Christen/Vogel, 1984). On the other hand, well-run credit programs for SSE have good repayment rates, e.g., Cali, Colombia, Monterrey, Mexico -- often with above 95 percent on-time recovery -- and there is no reason to accept low performance as adequate. USAID should insist on a minimum recovery as a condition of continuing loan programs.

Summary of Major SSE Credit Problems

Readings and interviews with the Central Bank, the Inter-American Development Bank, the Savings and Loan Cooperative of Naranjo, and PVOs suggest several key trends and issues in financial intermediation with SSEs.

Overdependence on external loans and grants. Research on financial markets in developing countries strongly suggests that external loans from international donor agencies are inferior sources of funds because of (1) feast-or-famine cycles, (2) restrictions imposed by the donors on their recipients (e.g., non-price rationing, interest ceilings) and (3) the examination of loan delinquency in a non-economic context.

Current restrictions on non-government financial institutions. Restrictions limit the availability of self-generated resources, which appear to be the crucial factor differentiating healthy portfolios from others. The extent to which a financial institution or a non-traditional financial intermediary, such as a PVO, can mobilize domestic resources depends on savings deposits, rather than donations. Equally important, the extent to which financial institutions can successfully mobilize domestic resources has been directly correlated to real rates of sustained regional and national economic development (Marsden, 1983).

Refinancing. At all levels of financial intermediation and among all sizes of enterprise, refinancing is a common practice to obscure poor recovery and delinquency rates. In some cases, it helps to collect overdue loans. More commonly, however, it makes delinquency appear less serious. The

continuation of current financial practices in Costa Rica, with the more recent inclusion of SSEs in the financial system, threatens to undermine real growth of private enterprise and sustained economic development.

Lack of consistent reporting and legal action. Other than the Central Bank, most financial institutions and all PVOs demonstrate an inconsistency in defining recovery rates, delinquency rates, and real costs of lending, and in maintaining financial records. Legal action against delinquent borrowers is nearly non-existent and legal action against defaulters is limited at best.

Mixed results in recovering credit and lowering delinquency. Results have been the most favorable with formal sector financial institutions, where there are better than average loan follow-through procedures.

Lack of empirical data. The interchange of information that does exist about lending to SSEs in Costa Rica is very limited. In addition, there is lack of data about: the demand and supply of credit for SSEs; to what degree the sector is willing to pay real, economic rates of interest; and open deposit and savings accounts.

III. SELECTED PVOS AND THEIR MODELS OF SUPPORT TO SSE PROJECTS

Effective PVO-centered SSE promotion efforts require PVOs to orient themselves to the client market. At present, most PVOs have no such orientation. They should clearly identify the SSE market segment with which they propose to deal, assess the needs of the market segment selected, and design their programs accordingly.

Common Characteristics of Selected PVO Support Models

This study identified three levels of beneficiaries. Here we provide examples of the PVOs and financial institutions working at each level.

Target Beneficiaries

Pre-Entrepreneurs

Most beneficiaries in this category are located in secondary cities or rural areas and are among the poorest. Many are women who lack any entrepreneurial experience. These beneficiaries are usually reached through community-based projects that include a wide range of components, from human

development to some form of production-oriented enterprise development.

Enterprise development is viewed as a means of reinforcing human development or the community organization objectives of self-determination or independence. In other words, human development or group formation components are seen as prerequisites to initiating self-employment activities. Examples of organizations reaching pre-entrepreneurial beneficiaries are FOV, OEF, and FINCA, which either perform financial intermediation themselves or make use of a fideicomiso with private banks or community resources and funds.

Micro Entrepreneurs

Micro entrepreneurs are generally served by PVOs oriented to solidarity groups. Solidarity groups have been used extensively in Latin America (Reichman, 1985; Blumberg, 1985). They consist of five to seven project beneficiaries who live near, know, and trust one another. The beneficiaries receive one loan to be divided among the group members, and then assume responsibility for the loan jointly and severally. Group responsibility for total loan repayment reduces the need for guarantees or collateral and lowers the administrative costs of recovery. While each member is responsible for the entire loan, each operates and realizes income from his or her individual enterprise.

AITEC and ADAPTE are PVOs working with these groups. This type of PVO either manages its own loan portfolios or keeps a deposit in a private bank, which manages the lending and recovery of the PVOs loans.

Small Entrepreneurs

With some exceptions, credit extension to individual borrowers (rather than to solidarity groups) reaches the larger SSEs. This group is responsible for most of the productivity, employment generation, and income enhancement in the SSE sector. FUCODES (a PVO), the Savings and Loan Cooperative of Naranjo, and other formal sector financial institutions (e.g., private banks, savings and loan cooperatives) serve this level of beneficiary.

Although this study has little documentation, it appears that banks and savings and loan cooperatives are using non-banking intermediaries (e.g., PVOs) to carry out activities such as:

- . Assessment of potential borrowers' reliability and creditworthiness
- . Group formation
- . Supervision of borrowers
- . Management, technical assistance, and follow-up

PVO Management

Despite the diversity of the PVOs operating in Costa Rica, they share common characteristics in management and project administration.

All the PVOs are strongly dedicated to providing services to their clientele and attract dedicated professionals as project managers and staff. Yet, staff salaries are generally very low, and there are problems with keeping trained staff in

the field. In addition, there is a lack of depth in the staffs of the PVOs visited. There is not even a minimum assurance of continuity in the management and effective delivery of services should the manager or project director leave.

Operating goals and objectives (in meeting operational targets), e.g., the number of people, number of groups formed, and classes administered, are well articulated. Economic objectives (productivity, employment and social objectives -- learning, self-confidence, and empowerment), while articulated, are not based on performance standards and hard data, but are usually unquantified goals.

Mobilization of target beneficiaries' financial resources is of interest to all PVOs interviewed, but only two practice it.

Almost all PVOs believe that technical assistance is essential for financial support and for upgrading enterprise productivity.

Though many of the PVOs seek representation in ACORDE, the majority would prefer direct access to USAID/CR funds. All regard each other as competitors for funding. There is also concern that ACORDE is not responsive to the needs of PVOs and often places barriers to open communication.

The concept of a federation of PVOs (within or outside FOV) is considered a good and timely idea among all that were interviewed. Currently, the PVOs have little formal or informal exchange of information, ideas on methodology, etc.

Administration of Credit and
Technical Assistance

Of the seven PVOs interviewed, many hold that the provision of credit is the single most important intervention in assisting target groups. Credit extension is also viewed as an important source of internally-generated funds and a way in which the PVO can become more independent of outside donors.

However, all but one of the PVOs interviewed believe that real rates of interest are neither desirable nor possible for the sector served. The one exception believes in commercial rates, i.e., the real rate of interest plus 10 or 15 percent to cover costs.

There are no common definitions or measurements of recovery and delinquency rates. Common measurements (other than the Central Bank's) of delinquency in Costa Rica rely on soft methods which present "favorable" results.

Financial plans showing the total volume of loans, interest rates, fees, loan charge-offs (administrative costs of lending), or the recovery rates required to break even have not been prepared by the majority of PVOs. However, most PVOs believe that they are capable of determining the economic feasibility of many diverse activities.

Most PVOs use some form of group lending, but not exclusively. Several PVOs use fideicomiso (trust) mechanisms with banks or savings and loan cooperatives to administer credit (document preparation, credit disbursement, and collection). All of the PVOs interviewed, except the Savings and Loan

Cooperative of Naranjo, serve only a small number of people and limited geographic region.

Different Management Characteristics of Selected PVO Support Models

The great majority of PVOs are Costa Rican. The others are U.S., Canadian, or European. SSE start-up and/or expansion is viewed by the vast majority of PVOs as a means to achieve other primary objectives, including:

- . Community development and organization.
- . Human development, with the focus on the poorest and most neglected -- e.g., women, women-headed households
- . Social programming and education in nutrition and health, family planning, and disaster relief

The PVOs utilizing a human development approach to planning place great importance on beneficiary participation at each stage of the program planning and implementation cycle. In contrast, PVOs (AITEC, FUCODES) with a focus on enterprise expansion (productivity gain) and efficiency gear their efforts toward access of SSEs to credit. Both minimize technical assistance and beneficiary participation in their project planning and implementation.

Administration of Credit

Most PVOs are poorly equipped to manage credit programs, as demonstrated by their high levels of late payments and low recovery rates. Some PVOs recognize their limitations and

administer their loan funds through a local private bank or fideicomiso.

Other than AITEC, most PVOs lending to SSEs extend loans for periods of a year or more. ADEPE makes three-year loans.

One PVO (FINCA) makes loans of less than US\$100; others go up to the maximum allowed by ACORDE of US\$18,000. Only one non-government organization lending to SSEs, the Savings and Loan Cooperative of Naranjo, has mobilized significant savings -- 138.0 million colones, approximately US\$2.5 million, 1986 -- among the target beneficiaries. Two other PVOs (FINCA and AITEC) are implementing effective forced savings methods.

Only one PVO (AITEC) is concerned about working toward self-sufficiency in the administration of credit (covering inflation and all administrative costs of credit operations). AITEC is also the only PVO that charges for technical assistance (150 colones per hour of technical assistance at the place of business and 200 colones per educational course). Generally PVOs do not charge for technical assistance, and there is confusion about whether they should. The team's experience is that those programs that charge nominal fees for technical assistance are usually more successful. Almost no program anywhere has charged near full cost recovery. The team includes in Appendix E some internal discussion papers and two extracts on the subject.

With the exception of the Central Bank (FODEIN) project, the Savings and Loan Cooperative of Naranjo (private bank), and AITEC (PVO), collection procedures on loans to SSEs are not strongly enforced. At AITEC, collection efforts begin after a borrower is five days late, and court action begins

when a loan is 30 days late. The Savings and Loan Cooperative of Naranjo also initiates collection efforts after five days; court action is started when loan repayment is 60 to 90 days overdue. The remaining PVOs are much less effective in collection and follow-up of delinquent borrowers.

Few PVOs have mounted effective campaigns to raise local private sector funds.

Strengths and Weaknesses of Selected PVO SSE Support Models

Strengths

Outreach capacity and close working contact with the poorest of the poor. Most PVOs interviewed have a social and/or human development orientation. The planning and implementation of programs are also highly participatory (requiring significant input from project beneficiaries). This approach builds trust, individual willingness to try new ideas, and self-motivation to honor individual and group commitments.

Diversity of approaches. PVOs are private service organizations operating on a not-for-profit basis. In assisting small enterprise, they pursue both social and business objectives. The freedom of not having to show profits, and the mandate to upgrade small enterprises with other than "bottom line" objectives, has produced a variety of approaches in Costa Rica.

Dedicated staff. The PVOs interviewed maintain a high level of commitment among their staff. Their staff is usually

young and dedicated, believe in their work, and work for low salaries.

Weaknesses

A problem in retaining staff. Most indigenous PVOs lack inducements (salaries, monetary and non-monetary incentives, etc.) to recruit and retain highly qualified professionals. Salaries are, in most cases, not competitive with comparable public sector organizations; raising salaries only increases operational costs. In addition, these PVOs do not provide clear, attractive career paths that induce competent young staff to remain for extended periods of time.

Cost inefficiency. Defined broadly as an institution's ability to cover its operating costs from income earned, cost efficiency has not been a priority concern of PVOs in Costa Rica. To a great extent, this is due to the availability of concessionary funds (grants and low interest loans) which seldom bear requirements on project efficiency or project effectiveness -- the latter being the magnitude and quality of the benefits resulting from the goods and services provided (Wilde, Robert R. Nathan Associates, 1983). The emphasis of most PVOs in Costa Rica has been on service provision, training, and human organizational development.

USAID/CR, IDB, I.A.F., and other donors have encouraged loose control by not setting efficiency standards and by not assisting the PVOs to measure or attain them. PVOs have been sustained by grants and contributions (both local and international), and have not relied on themselves or beneficiaries as sources of project income, let alone PVO sustainability.

Though credit projects hold out the hope of permitting a PVO to earn income and become less dependent on a single source of funds, PVOs currently administering credit programs are unable to cover administrative costs with interest earned. AITEC, the most cost efficient PVO interviewed, finds after only six months of operation that it costs US\$200 to make a loan and US\$60 for related technical assistance.

Scale of projects. All the PVOs interviewed reach a small number of SSEs, rarely more than 250. Only one, AITEC, expects to reach up to 1,000 by the end of 1986. Some PVOs have expressed an interest in scaling up their projects and are experimenting with credit administration schemes (fideicomiso and savings and loan cooperative arrangements, working more closely with money lenders). Nevertheless, until PVOs greatly improve cost efficiency in both credit and technical assistance delivery, longevity, let alone expansion, will remain an illusion.

Inappropriate strategies. PVOs are not financial institutions, but almost all working with SSEs concentrate heavily on lending. This demonstrates a lack of imagination in finding ways to assist SSEs. Lending is a volume business, and the high administrative costs of each PVO generally make the overall cost of delivering credit high.

However, examination of available data yields mixed results. CINDE reports that its own overhead is US\$28 and grantees' expenses are US\$41 per job created, i.e., per beneficiary. Thus, the total cost is US\$69 per job created. This is low compared to other projects supported by AID/W -- which usually cost US\$100-500 per job created, not including loan amounts. Of course, many assisted PVOs have spent

substantial additional amounts of their own money to assist their clients, but the amounts involved were impossible to determine. Additional questions need to be asked, such as:

- . What service does a given PVO perform most effectively and efficiently for a given set of beneficiaries?
- . Can PVOs share knowledge, new methods, and beneficiaries based on each PVO's contribution?
- . What are some ways in which PVOs can cover increased amounts of their real costs in the delivery of services?

Conclusions on Selected PVO Approaches to Credit and Technical Assistance

The majority of PVOs in Costa Rica working with small-scale enterprises support a pre-entrepreneurial and micro-entrepreneurial clientele. This clientele often require substantial human resource development training (basic education, communication, and business skills) which is participatory in design and administration, time consuming, and costly.

There is a critical lack of depth in operational management -- especially among PVOs administering credit portfolios.

PVOs recognize that a diversity of donors contributes to PVO longevity. PVOs with greater diversity in funding are more stable than others. The more stable PVOs are also more concerned with cost efficiency.

The mobilization of financial resources from the target beneficiaries is of interest to all PVOs interviewed, but only as a means to effective savings programs.

Almost all PVOs believe that technical assistance is vital for upgrading their lending and enterprise support capabilities. The receipt of technical assistance in improving project cost efficiency and project management is indeed essential for all PVOs.

The concept of a federation of PVOs is considered a good and timely idea among all that were interviewed. Currently, the PVOs have little formal or informal exchange of information and very limited leverage with the GOCR, CINDE, the university community, and the private sector (businesses and banks).

There are no common definitions or measurements of recuperation and delinquency rates.

Prior to managing lines of credit, PVOs should be required to receive training in credit management (e.g., from the Central Bank and savings and loans). The most effective and cost efficient PVOs supporting SSE financial service needs use private banks and fideicomisos to manage lending and recovery. These PVOs carry out the feasibility analysis with the entrepreneur to determine business development needs; they also provide some, if not all, of the appropriate technical assistance and follow-up.

Mobilization of local financial resources and positive steps toward achieving self-sufficiency go hand in hand. PVOs need technical assistance and training in both areas.

The scale of the PVO projects working to support private enterprise is very limited. At most, 1,000 (or approximately 3 percent) of the estimated 35,000 SSEs in Costa Rica receive project support.

IV. USAID/CR CURRENT STRATEGY IN SUPPORT OF SSE PROJECTS WITH PVOS

As an outcome of this study, the team prepared an overview of the present and potential strengths and weaknesses of the current strategy in support of PVO's SSE projects. This overview is presented below.

Strengths of the Current Strategy

The creation of a strong, competently staffed umbrella organization, ACORDE, provides USAID/CR operational benefits that include:

- . Local participation in project planning and implementation
- . Transfer of the administrative and management load of channeling approximately US\$2.2 million in grants and loans to the national and international PVO community
- . Consistency with AID/W and USAID/CR policy of supporting the private sector and privatization

The multitude of approaches used by individual PVOs in support of SSEs is a strength. The current USAID/CR strategy

encourages this diverse approach. For long-term lending (ACORDE to PVOs and PVOs to SSEs), it remains to be determined which approach will prove the most viable. The various concepts of the PVOs could be combined, using the most effective approach in a flexible way that will provide service to urban and rural SSEs.

The creation of a PVO federation could serve multiple purposes, such as:

- . A lobby group to address PVO needs and support issues before the legislature, donors, and education, business, and financial communities
- . A forum through which information dissemination, research activities, and project coordination issues and results could be interchanged and acted upon

The use of the Central Bank Small Sector Industry Lending Program (FODEIN) is a strong component of the overall USAID/CR strategy in support of SSEs due to the Central Bank's:

- . Acceptance of the need for positive rates of interest
- . Use of hard measures to classify delinquency
- . Excellent portfolio reporting and analyses, e.g., recovery and delinquency
- . Good portfolio management, providing leadership for commercial bank lending to SSEs
- . Existing data providing for measurement of socio-economic impact by type of target beneficiary and classification of business

Weaknesses of the Current Strategy

ACORDE apparently does not have written criteria to separate PVOs by their organization goals or project objectives. For example, human development-oriented PVOs are funded following almost the same criteria as are SSE support-oriented PVOs. Though differences of approach are taken into consideration during proposal review, these considerations should be formalized and written down. Further, ACORDE has no SSE market segmentation strategy. It appears that it merely reacts to PVO funding requests. Currently, funding requests are processed in a standard PVO and project review format; and though the selection criteria emphasize potential increases in income and employment increase, few PVOs even strive for these results. Further support is necessary from PACT in assisting ACORDE to respond to the needs of the PVO community.

There appears to be no performance standards required for ACORDE to fund PVOs, such as the number of SSEs to be assisted over a given period of time, or the number of newly generated jobs. There is too much emphasis on reporting inputs rather than results, for example, the number of courses given during the year, other than a target number of entrepreneurs utilizing what they have learned in their place of work.

There is poor recovery of resources. Subsidies are part of the cause, but PVOs are not given much incentive to operate projects efficiently. The study team knows that PVOs will not become entirely self-sufficient, especially when they provide human development and comprehensive SSE support services. However, PVO cost and operational efficiency must be promoted.

Outreach by PVOs in Costa Rica is limited by constraints on human and financial resources.

PVOs supporting SSEs, in some cases, have elevated credit as a solution, overlooking other important and necessary inputs to upgrading SSE performance.

Providing credit to target beneficiaries below positive real interest rates has induced lending to noneconomic enterprises (e.g., sugar cane production), unhealthy client dependence on PVOs, and project expansion due to subsidized resource availability, and has discouraged client "graduation" to use of non-project private sector resources.

PVOs administering credit believe that, because PVOs have run such programs elsewhere, they can effectively administer credit in Costa Rica.

There is an alarming dependence on outside subsidized credit and grant funds, rather than attention to mobilizing savings among target beneficiaries and taking steps toward internal cost-efficiency.

The provision of funds to PVOs with no recommendations or requirements, for example to mobilize savings or deposits, undercuts the efforts by other financial institutions encouraging the mobilization of savings and deposits while lending to members and non-members of their institutions, e.g., savings and loan cooperatives. Only two PVOs in Costa Rica encourage these practices (AITEC and FINCA).

V. RECOMMENDATIONS FOR USAID/CR
SSE SUPPORT STRATEGIES

Policy Recommendations

Based on an analysis of the present and potential strengths and weaknesses of the current SSE support strategy, the study team identified how the Mission, ACORDE, and the PVOs could better assist SSE development via credit and technical assistance. The recommendations concentrate on policy and strategies that USAID/CR can use now and in the near term.

Given the importance of Costa Rica's economic stabilization program, the primary focus of USAID/CR is on macro economic issues, with emphasis on monetary and fiscal policy, privatization, and promotion of non-traditional exports. However, within the Mission Director's Office, the Private Sector Office, Programming, and the GDD Office, there is sincere interest and active support in:

- . Supporting the PVO community, with a focus on (1) enhancing its capacity to reach the poor in the most cost-efficient manner, and (2) achieving independence of single donor funding self-sufficiency, and
- . Assisting SSEs in realizing their real potential (productivity increments, increased income and employment

generation), while experimenting with alternative credit mechanisms and technical assistance delivery, consistent with USAID/CR policy conditions (tied to ESF support - Chapter II)

During the current period of reorganization, a new statement of purpose for SSE support by local and international PVOs should be drawn up by CINDE/PVO for USAID/CR's approval. The statement of purpose should emphasize that SSE support will make a measurable, economically significant contribution to Costa Rica's overall economic stabilization and growth, with assurances of equitable participation in the development process by raising SSE income and employment levels. PVO support of SSEs could make a significant impact both on income enhancement and employment among the poorest of the poor. The consultants estimate that, over a three year program span, employment could be increased by 3,500 and income increments among the SSE target beneficiaries could increase by US\$6.2 million, not counting the increased income of the new employees. To produce these results, project loans would total approximately US\$3.5 million, with technical assistance costs of US\$1.2 million (assuming US\$350 per firm assisted).

The policy implications of these recommendations for USAID/CR are that USAID/CR eliminate the non-price rationing of credit and that ACORDE base project support decisions solely on economic returns. In turn, this policy should lead to greater income and employment gains by project participants, including higher recuperation of credits because of original subproject financial and economic viability.

Starting immediately, ACORDE should require that positive, real interest rates be charged on SSE loans.

ACORDE should also move toward charging commercial rates that cover the delivery and collection costs of small loans. Over the long term, ACORDE should base its lending rate to PVOs on locally accepted, standard rates for financial institutions' inter-lending, e.g., the minimum lending rate of the Central Bank.

The support strategy should encourage movement of the PVOs toward self-sufficiency. ACORDE should develop a means of evaluating the PVOs' progress and monitor indicators such as diversity in donor support, local fundraising, and promotion of internally generated funds (covering credit-related administration costs and charging beneficiaries for technical assistance).

The above policy recommendations, when implemented, will have the added advantage of avoiding conflict with IMF, AID/W, and USAID/CR major monetary policies and conditions, outlined in Chapter II. USAID/CR should not establish conflicting policies, even when short-term goals are seemingly served. For example, changing the current operational policy -- from the "earmarking" of grants and loans to be channeled each year to providing loan funds pegged to positive real rates of interest -- could lead ACORDE and the individual PVOs to finance more economically sound SSE projects. Supporting PVOs with annual socio-economic goals could lead to improved socio-economic project outputs, such as more jobs and income enhancement. The present emphasis on recording the number of SSEs assisted, hours in classes, and target funds expended for a given fiscal year does not assess the PVOs' socio-economic impact on entrepreneurs.

General Strategies and Implications
for USAID/CR Planning

USAID/CR should continue to facilitate the access of SSEs to credit and technical assistance resources through ACORDE and selected PVOs. ACORDE should use its connections with the "major players" in Costa Rica as a source of ideas, experience, and support.

The Mission should continue use of the Central Bank lending project to small industry (FODEIN). To the extent possible, the project should coordinate small industry and enterprise support efforts with export promotion goals:

- . Identify intermediary products and services needed by larger enterprises (exporters of final products) that could be provided by small enterprises
- . Identify new forward and/or backward contracting potentials and mechanisms (other than maquila)
- . Encourage support of small enterprise projects away from low-value, non-export crop production or processing

To encourage PVOs to adopt desired positive strategies, USAID/CR should require guidelines from ACORDE in reference to:

- . Detailed, economically significant but achievable end-of project and annual goals for project-assisted SSE income and employment increases, as well as feasible means to measure them. USAID/CR must, with outside help if necessary, delineate separate expectations for targets in funding social/educational and SSE projects.

- . Commitment from participating PVOs and other resource suppliers to realistic, feasible, and acceptable targets and strategies. ACORDE should organize strategic planning sessions involving representatives from donors, ACORDE, PVOs and their federation, banks, for-profit and non-profit technical assistance suppliers, and public sector organizations.
- . Two sets of selection criteria for funding of PVOs and their projects, one based on social service oriented objectives, and a second for supporting SSEs.
- . An incentives package for SSE projects utilizing credit, based on performance standards of project success -- agreed-upon economic and social indicators for credit and technical assistance components of SSE support projects. For example, ACORDE could provide successful PVOs with additional technical assistance budget grants to improve staff capacity to upgrade project effectiveness (with the potential of a larger funding base the following year), or provide funds to PVOs for performance bonuses to the hard-to-keep field staff. The idea is to encourage the utilization of funds for project and PVO benefits rather than for expenditures to avoid losing the same funds next year.
- . Quarterly measurement of progress toward project objectives and indications of resource utilization efficiency.

A major benefit of PVO consensus building and basing future support on project performance is that PVOs will have additional incentives to achieve change in client sales or profits and employment generation, as well as assuring that future evaluations will be positive.

To assist ACORDE in its planning and implementation tasks, USAID/CR should provide standardized guidelines to ACORDE in reference to:

- . Positive interest rates on loan funds to PVO clients. ACORDE should not approve PVO credit projects unless PVO lending contracts call for positive real interest rates. This should be implemented, at the outset, in a uniform manner for all PVOs and their clients.
- . No maximum ceiling on interest rates. Legal advice should be sought to find acceptable means to boost effective interest rates (e.g., set-up fees, inspection fees, registration, prompt processing fees, compensating balance, discounting of interest and additional, legal ways to arrive at positive real rates of interest).
- . Definitions and measures of the payments and funds lent, by number, as well as by value of loans, should be provided PVOs administering credit. PVOs should be encouraged to measure recovery rates over fixed time periods. As an example, 400 payments due for a total of 2.0 million colones during 1986, 1.8 million is received from 390 payments made; therefore:

1986 recovery of payments is $390/400 = X$,
or 97.5 percent, and

1986 recovery of funds lent $\frac{1.8}{2.0} = Y$,
or 90 percent.
- . Annual reporting of PVOs' financial conditions (Costa Rica operations), not just ACORDE-funded project conditions. Sources and uses of all funds received by a participant PVO are required to determine true efficiency. Efficiency should be one of the criteria for

determining funding and level of ACORDE grants and loans.

Recommended PVO Organization and Project Strategies

ACORDE will need to develop new planning and implementation tools to assist the participating PVOs. It should select participating PVOs and allocate funds based on:

- . PVO market segmentation
- . Project cost-benefit analysis
- . Movement toward self-sufficiency
- . Project inputs from other public/ private entities
- . Linkage of SSE projects with exporters

ACORDE should provide additional funds for technical assistance and training to PVOs to encourage them to adopt improved planning, management, and operation strategies. The use of incentives, both positive and negative, to stimulate PVOs to improve performance and efficiency should be encouraged.

ACORDE should reward successful PVOs by developing mutually agreed-upon measurement factors. For credit, examples could include:

- . Recovery rate -- if recovery is 95 percent, this is worth X points (this should be a high weight factor) in obtaining ACORDE funding support
- . Total funds lent -- so many points per 100,000 colones

- . Borrowers served -- so many points per new borrower

PVOs should develop and describe technical assistance in terms of anticipated impacts. For example, they might report that 25 percent of those who completed an accounting course are applying what they have learned in their businesses. ACORDE should not accept technical assistance measurements in number of courses, hours of classes, or visits.

USAID/CR should use private bank interest in expansion of power to capture financial resources (deposits under six months and savings) and leverage AID/W financial resources with SSEs' need for credit.

PVOs should develop an autonomous federation. USAID/CR should give non-monetary support and should stress contracting services rather than staffing of the federation to implement the aims of its members.

USAID and PACT should work jointly to assure that ACORDE provides access and remains open to the PVO community.

Follow-Up

Research

While USAID policy in support of private enterprise is export-oriented, foreign exchange is not going to solve the problems of the poor, and attention and resources should be directed to enhancing income--hence the backing of SSEs. To further strengthen support of SSEs, USAID should sponsor a number of planning and implementation follow-up steps to this study effort. Some of these steps can begin concurrently.

There remains a question as to the real barriers to SSE expansion. Selected SSEs should be questioned regarding constraints on expanded income and employment.

The economic and social impacts of selected Costa Rican PVO SSE support efforts should be measured. To date, this has been poorly documented.

The potential for increasing deposit and savings mobilization among Costa Rican SSE population should be investigated. The Housing Office within USAID/CR has implemented a successful savings mobilization program with the local savings and loans, Mutuales, in Costa Rica (Blayney, et. al., Federal Home Loan Bank Board, Costa Rica, 1983).

The consultants examined an alternative credit mechanism concept paper (USAID/CR/GDD) which begins to explore ideas of providing credit to micro entrepreneurs in rural areas. This contains a number of practical policy and implementation concepts, including the use of positive real interest rates and incentives to the institution facilitating credit, promoting, among other objectives, effective coverage and portfolio maintenance. It is recommended that the Mission further develop this and other innovative ideas in a Project Identification Document (PID), with the goals of experimentation, learning, and learning dissemination.

Planning

Project and fund availability at USAID and ACORDE levels should be verified and quantified.

Strategic planning methodology should be applied to the current planning process to reach a consensus on strategies and implementation steps by involving USAID/CR, ACORDE, PVOs, and SSEs.

USAID should investigate novel ways to implement the above strategies, e.g., endowment for ACORDE, guarantee fund, placement of USAID/CR, CINDE/ACORDE bank deposits to motivate bank cooperation, for-profit technical assistance sources (Price Waterhouse), resource mobilization from low-income communities, and non-monetary support to a PVO federation.

Implementation

ACORDE should notify PVOs and other selected private sector organizations of clarified project objectives and invite responses illustrating successful implementation of those objectives.

Implementation and output-measurement tools used in other sectors within Costa Rica (e.g., private banks' portfolio control software) and in similar projects elsewhere should be investigated.

ACORDE should investigate how PVOs could immediately use other GOCR-, donor-, or privately-financed projects to improve their SSE assistance efforts. ACORDE should also analyze the results of the INCAE PVO study and use its relevant conclusions, if any, to improve the SSE support project.

APPENDIX A

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APPENDIX B

APPENDIX B. LIST OF ACRONYMS

ADEPE: Asociacion Para El Desarrollo Del Pequeno Empresario
AITEC: Accion International Tecnica
BANCOOP: Banco Coopesativo Costarricense
CINDE: Costa Rican Coalition of Development Initiatives
FINCA: Fundacion Integral Campesina
FODEIN: Fondo de Desarrollo Industrial
FOV: Fundacion de Organizaciones Voluntarias
FUCODES: Fundacion Costarricense de Desarrollo
GDD: General Development Division (of USAID/Costa Rica)
INCAE: Central American Institute for Business
Administration
OEF: Overseas Education Fund
ADAPTE: Agencia de Desarrollo

APPENDIX C

APPENDIX C: TERMS OF REFERENCE

COSTA RICA: SMALL-SCALE ENTERPRISE SECTOR ASSESSMENT

The objective of this assessment is to describe the role of small-scale enterprise in Costa Rica, their constraints, and what can be done to strengthen them. The assessment will serve as an in-progress review of USAID/CR's strategy and policy on small-scale enterprise assistance, taking into account AID's small enterprise policies. Recommendations should be included that can be readily transformed into AID interventions and programs.

The Mission envisions the assessment team make-up as follows:

Team Leader

It is envisioned that the Team Leader will have expertise as a team leader and also cover one of the technical areas. The Team Leader will coordinate the efforts of other team members towards completing the assessment. We will coordinate the team's efforts with USAID and supervise the work activity of the technicians. As Team Leader, this consultant will be responsible for conducting periodic briefings with the designated USAID officer. He will oversee the drafting of the small-scale enterprise assessment. He will be responsible for assuring that USAID/CR receives a preliminary draft report, including summary documentation and back-up materials before the Team's departure from Costa Rica. The final assessment can be completed in the U.S. and should be presented to USAID/CR within 45 days upon completion of data collection. The final assessment will include the conclusions of the aforementioned reports and recommendations for developing a strategy to increase production and employment by strengthening small-scale enterprises throughout Costa Rica.

Credit Technician

- . Provide a summary of major credit trends, problems, and potential problems.
- . Analyze the descriptive data and draw conclusions on the significance of small-scale enterprise credit needs and its future growth.

- . Review USAID's concept paper on alternative credit mechanism and comment on its feasibility.
- . Analyze the merits of PVOs, as identified by USAID, in managing credit programs.
- . Determine the willingness of private banks to assist and open lines of credit with small-scale enterprises.
- . Identify the incentives which would be required for private banks to provide credit to small enterprises.

Technical Assistance Consultant

- . Identify how the Mission and others could better promote and assist small-scale enterprise development via technical assistance.
- . Identify the primary technical constraints restricting further growth of Costa Rica's small enterprises.
- . Recommend how specific PVOs could strengthen their technical assistance role in assisting small enterprises.
- . Identify specific constraints which could be overcome through the provisions of technical assistance.
- . Develop a list of policy implications and recommendations based on the above analysis for USAID/CR's planning purposes.

APPENDIX D

APPENDIX D. DEFINITION OF INTEREST RATES

Real - The nominal interest rate minus the rate of inflation, thus, the real cost of money.

Positive - Real interest rates greater than zero, thus, a positive cost of money rather than a premium paid to borrowers.

Market - That interest rate at which the market clears, the amount offered and demanded for lending is the same. This can be determined by seeing what rate private unregulated lenders use. However, one must be careful that one is comparing loans of comparable risk and uncertainty.

Commercial - The kinds of rates charged by private commercial lenders.

5

ARIES

Assistance to Resource Institutions for Enterprise Support

The ARIES project is designed to strengthen the capabilities of support organizations in developing countries to implement small-scale and micro-enterprise development programs. ARIES builds on the work of the Agency for International Development's former Program for Investment in the Small Capital Enterprise Sector (PISCES) and Small Business Capacity Development projects. It works with intermediary support organizations that provide services to small and micro-businesses and industries, such as private voluntary organizations (PVOs), banks, chambers of commerce, management training centers, business people's organizations, and other developing country government and non-governmental organizations (NGOs).

The contract for this five-year project has been awarded to Robert R. Nathan Associates, Inc. (RRNA) with subcontractors Harvard Institute for International Development (HIID), Control Data Corporation (CDC) and Appropriate Technology International (ATI).

ARIES is core funded by the Bureau for Science and Technology's Office of Rural and Institutional Development (S&T/RD) and the Bureau for Food for Peace and Voluntary Assistance's Office of Private and Voluntary Cooperation (FVA/PVC). Mission funded technical assistance represents \$3.8 million, or almost three-fifths of the five-year budget of \$6.8 million.

The ARIES project has three major components -- research, training, and technical assistance -- designed to cross-fertilize each other. The applied research component focuses on economic, social, and organizational issues surrounding intermediary support organizations to inform AID missions and host country actions in this subsector. The training component includes design, testing, conduct and follow-up of training programs in such areas as finance, management and evaluation for PVO and NGO personnel. The technical assistance component provides short-term technical assistance to AID missions and intermediary organizations to assist small and micro-enterprise development.