

AID. Evaluation Working Paper # 78

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INFORMATION MEMORANDUM FOR THE ADMINISTRATOR

THRU: DAA/PPC, Allison ^{AGH} Berwick
FROM: DAAA/PPC/CDIE, Paula Goddard ^{PG}
SUBJECT: AID's Evaluation Experience with Small and Micro-Enterprise Development Projects

In response to your telephone request for findings from AID's evaluations of small and micro-enterprise development projects, CDIE has compiled the attached information.

This is what we could produce as an immediate response to your request:

- (a) a synthesis of AID's evaluation experience with small and micro-enterprise projects;
- (b) a brief summary of another donor's (Inter-American Development Bank) approach to SSE development;
- (c) an illustrative AID micro-enterprise project "success story";
- (d) an annotated bibliography of key evaluation reviews of AID's experience with small and micro-enterprise development projects.

If you would like for us to do more on this subject, for example, provide you with more SSE project evaluation abstracts, let us know.

Attachments

1. Annex I
2. Annex II

cc: PPC/PDPR, Alison Rosenberg

Drafted: PPC/CDIE/PPE:ABinnendijk:mr:0163g

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AID'S EXPERIENCE WITH SMALL AND MICRO-ENTERPRISE PROJECTS:
EVALUATION HIGHLIGHTS

A review of AID'S evaluation experience with Small and Micro Scale Enterprise (SSE) projects indicates that they are among the most successful of development projects in economic terms, generating high economic rates of return.

However, from the perspective of individual beneficiary SSE firms, the financial profitability is frequently low, due to factors such as price distortions and other regulations working against private sector development in general and SSEs in particular.

SSE project performance in attaining financial viability and self-sufficiency also tends to be problematic. Factors such as artificially low interest rate ceilings, high loan defaults, and high inflation typically contribute to the intermediary credit institution's financial problems.

SSEs do contribute significantly to creation of new employment opportunities at low cost per job. Evidence indicates that more new jobs are created by concentrating on the larger of the SSEs, while serving the smallest "micro-enterprises" tends to reduce under-employment of the family owner/operators.

While SSE projects have benefited the intended target group of small entrepreneurs, difficulties remain in cost-effectively reaching the tiny micro-entrepreneurs working in the informal sector. Because the level of SSE project resources are limited and some of the problems are so intractable, the vast majority of SSEs in developing countries are not directly affected by these project efforts.

Recurring patterns common to successful SSE projects help us to formulate appropriate guidelines for designing and implementing these projects to enhance their performance. However, some of the most serious impediments to both SSE development opportunities and to SSE project success are due to a harsh policy environment that can only be dealt with at the national level through policy dialogue with the host government.

AID's EXPERIENCE WITH SMALL SCALE ENTERPRISE PROJECTS

PURPOSE

This brief paper highlights some of the findings of recent evaluations of AID-funded Small Scale Enterprise (SSE) Projects, including micro enterprises. It summarizes our experience with SSE project performance in meeting development objectives, and discusses project characteristics or approaches that are commonly associated with successful performance.

INTRODUCTION

AID's involvement in private sector development goes back several decades. Historically private sector efforts primarily dealt with development of infrastructure, industrial estates, power, transportation, communication facilities, and development finance corporations in support of private businesses of all sizes. Nevertheless, there were over 775 SSE focused projects financed between 1952 and 1980, that provided financial and technical assistance to small enterprises mostly in Asia and Latin America. 1

With the New Directions Mandate in 1973 and the Private Sector Development Initiative in 1981, AID's emphasis shifted towards assisting small scale enterprises even more. SSE development was seen as a primary opportunity for improving the productivity, incomes and employment of the poorer segments of LDC societies. Most typically, the SSE projects of today provide credit, and many also provide training and extension services for small businesses. Other SSE projects are more complex, providing integrated or multiple services, or emphasizing institutional development and 'systems' approaches. Today, AID's portfolio contains over 50 projects aimed at assisting small enterprises. 2

CHARACTERISTICS OF SSEs

In reviewing literature on small scale enterprise, it becomes clear that SSEs are not a homogeneous group but include various groupings of firms, based on size, business sophistication, profitability, growth potential and other characteristics. It becomes important to distinguish among these groupings, because a project's strategy and approach should be tailored to the specific needs of the target beneficiary group. A particular subset of SSEs is the smallest level of enterprise, referred to as micro enterprises or informal sector enterprise, which are typically family owned and operated, employing no more than five persons.

to enter the market place and requires minimal resources or skills, many such enterprises are initiated by the poor.

SSE OPPORTUNITIES AND CONSTRAINTS

Although small, SSEs are important, accounting for the vast majority of industrial employment in most LDCs. SSEs are the primary or secondary source of income for a majority of families in poor rural areas. Moreover SSE activity is growing faster than large-scale industries. Given the factor endowments of the LDC environment, their use of labor-intensive techniques are most appropriate. A recent study of the efficiency with which SSEs used capital in several LDCs concluded that the economic "profit" generated per unit of capital in SSEs were positive and actually higher than larger firms. 3/

The growth of SSEs attributes to their success, yet they do face many constraints, including:

- o a frequently hostile and discriminatory policy environment involving licensing and registration requirements biased towards larger firms;
- o Lack of access to institutional credit, raw materials and supplies;
- o Lack of management and business skills;
- o marketing or demand problems, which are dependent on local economic conditions.

OVERVIEW OF AID'S PROJECT APPROACHES TO SSE DEVELOPMENT

Most recent AID approaches to assisting SSE development have typically included fairly simple interventions that provide SSEs with access to credit and sometimes training and extension services. AID generally provides resources for SSE via an intermediary credit institution (frequently a PVO, development finance corporation, commercial bank, or credit cooperative). Business training is sometimes provided thru management training organizations. Success has been mixed, as detailed in the following sections.

Less frequently tried approaches have included provision of more complex, integrated services trying to cover multiple beneficiary needs and constraints. It has been more difficult to evaluate these projects or separate out the effectiveness of individual components. They tend to have high net operating costs per client, since the revenues generated by the credit component cannot begin to cover the multiple services.

Another type of SSE project that has been tried involves setting up cooperative endeavors involving the poor and unskilled. Often these efforts have been export-oriented and involved major inputs in management/organization, training, technology and marketing. They have not proven to be self-sustaining once outside support is terminated. 4

More recently SSE credit and training projects are emphasizing new ways of dealing with institutional and policy constraints that in the past were considered 'external' to the project, or beyond the direct control of project designers and implementers. This "systems" approach and its potential are examined later.

EVALUATION FINDINGS: THE PERFORMANCE OF SSE PROJECTS

Measuring the success of SSE projects is not a simple or straight forward task, because there are a diversity of project approaches, components, and even objectives. This section generalizes about the overall performance of "typical" SSE projects (that is, those involving credit, and often training/extension components), in meeting objectives of economic development, financial viability, employment generation, and beneficiary impact.

ECONOMIC IMPACT: A recent comparative analysis by Peter Kilby of several AID-funded SSE credit projects operated by FVOs concluded that SSEs are major contributors to overall economic growth. Using a cost-benefit framework that included not only benefits to the individual beneficiary firms, but also broader impacts upon the economy (externalities), the study concluded that four out of the five SSE projects evaluated had economic rates of return on investment of over 100%. These results make SSE lending projects among the most successful of AID's programs. 5

FINANCIAL ANALYSIS OF THE FIRM: However, the financial analysis of the projects in the Kilby study at the level of the individual firms found in most of the project cases, that wages and profits earned did not outweigh the costs. Thus, the credit projects only became economically viable by factoring in the economic benefits that occurred outside of the assisted firms (e.g., backward linkages to other firms, income multiplier effects, consumer benefits).

A review of SSE project evaluations by R. Bunt concluded that providing credit to the small micro-enterprise firms only rarely produced self-sustaining gains. The increases in income were short-lived because the owners were frequently forced to consume profits rather than reinvest. He concluded that the impacts of credit on firm profitability and income were more likely to endure if the loans were given to SSEs larger than micro-enterprises. Thus, he concluded that there appeared to be a conflict between SSE project objectives of promoting business growth and equity (concentrating on the smallest enterprises). 6

FINANCIAL SUSTAINABILITY OF THE PROJECT: The SSE projects evaluated in the Kilby study in general were not financially self-sustaining. That is, project income earned from interest and service charges paid on loans did not exceed administrative expenses or losses due to inflation. Only in one case, the Rural Development Fund program of the Industrial Bank of Peru, did the interest income fully cover the project's administrative costs.

EMPLOYMENT GENERATION: The cost of creating jobs through small scale business are considerably less than what is required in large scale business. Thus, for the same amount of capital, more jobs can be created by a channeling credit to SSEs.

However, the review of SSE project evaluations by R. Bunt concluded that there might be a tradeoff between the objectives of new job creation and of targeting the smallest of the SSEs, the micro-enterprises. According to project evaluation experience, more new jobs are created if credit goes to firms somewhat larger than micro-firms, especially if they are new firms and manufacturing enterprises rather than service or retail trade enterprises. On the other hand, there is evidence to suggest that credit provided to micro-enterprises may substantially reduce underemployment of the owner-families.

BENEFICIARY IMPACT: A major objective of SSE projects has been to benefit the poorer segments of LDC society. Frequently SSE credit projects have promoted equity by limiting credit to those with minimum income or assets. However, the difficulties with monitoring such requirements has frequently proven impractical. Another effective approach has simply been to limit the total size of the loans, thus assuring that the more advantaged wouldn't be attracted.

However, emphasizing the "poorest of the poor" businesses has led to other problems. These micro-enterprises have often been marginal, lacking profit and growth-potential, again highlighting tradeoffs among objectives of equity, and economic and financial viability. Unless the credit project becomes financially viable (or continues to find donor funds), it will eventually decapitalize and thus not "revolve" funds to new beneficiaries. Given that the resources initially allocated to SSE credit projects are typically small compared to the size of the potential target group, the beneficiary impact of these projects has been relatively limited. Surveys of small enterprises have typically revealed that only a small fraction of entrepreneurs have heard of the programs intended to help them, and fewer yet have actually received aid.

SEE PROJECT CHARACTERISTICS AFFECTING SUCCESS

Review of evaluation findings of SSE projects also provide us with some lessons from experience on what works and what doesn't work. That

is, there are some recurring patterns in successful SSE projects from which we can learn and draw guidance for the future. However, it should be remembered that what constitutes "success" in SSE projects may shift somewhat depending upon the relative emphasis placed on objectives of economic development, employment creation, beneficiary impact or equity concerns. The strategies SSE projects should follow to achieve "success" will also vary depending upon which of these, frequently conflicting, objectives are given priority.

Credit:

Nearly all SSE development projects..even the simplest...have a credit component. We will start by examining the general characteristics and procedures of SSE credit institutions that are found to enhance success: 8/

- o a motivated and committed leadership and staff with appropriate management skills and knowledge of SSEs.
- o a flexible and autonomous organization, able to respond to changes in client needs and market conditions.
- o adequate interaction between fieldworkers and beneficiaries, and information feedback to management concerning their needs and perspectives.
- o decentralized credit institutions located close to clients served, and decentralized decision-making so field staff can take actions.
- o a simple, efficient and easily monitored credit application process, so that a reasonable number of clients can be served without exhaustive analysis and delay.
- o beneficiaries that are grouped into cooperatives, business associations or solidarity groups, thus cutting promotion and processing costs, increasing poor beneficiaries reached, and increasing the probability of repayment.

The SSE credit project's impact on economic profitability can be increased by:

- o concentrating on firms with 'backward' linkages, i.e. emphasizing manufacturing instead of retail trade.
- o concentrating on area industries to increase competition and reduce prices to consumers.

The project's impact on the SSE firms' profitability and incomes are more likely to endure if:

- o loans are longer term and for fixed capital.
- o firms are larger than micro-enterprises.

The project's equity impact is promoted by:

- o limiting credit to those with minimum income or assets.
- o limiting the amount of any given loan.
- o providing the short term, working capital required by the smallest micro firms.
- o targeting credit to organized groups or associations of the poor.

The project's employment creation impact is enhanced by providing credit:

- o for longer terms.
- o to new firms.
- o to firms larger than micro-enterprises.
- o to manufacturing enterprises rather than service or retail trades.

The project's financial viability and sustainability will be enhanced by:

- o setting loan interest rates high enough to cover administrative costs and losses due to inflation and defaults.
- o having a community based mechanism for selecting clients, based on knowledge of who is reliable and serious about productive investment.
- o tailoring loans to the recipients' capacity to repay and having a strict collection policy, including the use of courts and collateral.

- o securing continued donor or government financial support to cover recurrent costs not covered by interest income.

Technical Assistance:

Another frequent approach to assisting SSE is provision of technical assistance. Many SSE projects involve training or extension services to SSEs, either as components of credit programs or separately. Kilby's cost-benefit analysis of SSE projects found that technical assistance or training components did not appear to reduce cost or permit more rapid expansion for most SSEs studied. For example, the Brazil project spent 30% of project funds for technical assistance/training activities with no perceptible change in SSE behavior or profitability. He concludes that technical assistance may be most useful in preventing the failure of new firms or in assisting larger enterprises involved in organizational changes. 9/

A review of SSE evaluation experience in the R. Hunt study has similar conclusions; that the length of formal training received by small entrepreneurs does not relate to their business success. A far more important factor appears to be previous business experience. Additional findings are summarized below. 10/

SSE training and extension services are most successful if:

- o the advice is tailored to immediate business needs and constraints.
- o the training/extension staff's skills and expertise are relevant to the different sizes, industries, levels of business sophistication, etc., of the small entrepreneurs served.
- o there is a management information system with feedback on beneficiary needs and the relevance of the training and technical advice to their needs.

Formal business training courses are more likely to be successful if:

- o the trainees are from relatively large firms.
- o the trainees are personally motivated, as opposed to taking the course as a pre-requisite for obtaining credit.

Training and extension advice services for the poorest or smallest SSEs are most effective if:

- o the training is simple rather than sophisticated, and deals with basic information and bookkeeping practices relevant to micro-enterprise level needs.
- o they advise or serve as a broker in dealing with government regulations and licensing procedures.
- o the recipients are organized into groups or associations, thus reducing the costs of reaching them.

EXTERNAL FACTORS AFFECTING SSE PROJECT SUCCESS

As with most development projects, the evaluation experience of SSE projects points to the critical importance of a favorable economic and policy environment to project success. - Negative external factors which have most critically affected SSE project ~~performance~~ include:

- o High rates of inflation can seriously affect the financial viability and profitability of SSE projects. Where inflation rates are over 40%, governments and FVOs have been reluctant to charge interest on loans equal to the rate of inflation, imposing a heavy cost on lending. Also, inflation affects project benefits because borrowers are more inclined to use loans for non-productive purposes.
- o Population migration and changing economic conditions affect the local demand for SSE products and services thus affecting their profitability and growth potential.
- o Lack of Linkages between SSEs and the larger business and commercial community.
- o Lack of Business Associations or cooperatives grouping small entrepreneur beneficiaries together.
- o Ceilings on interest rates result in banking institutions' rationing credit to favored large clients and discrimination against riskier SSEs.
- o Trade regulations such as foreign exchange rationing and tariff systems frequently end up discriminating against SSEs.

- o Tax laws similarly often provide concessionary rates to bigger enterprises, or SSEs do not know how to take advantage of them.
- o Lack of SSE Project Support and undue interference by government officials, donors and political elites.

SSE Project Systems Approaches:

Previously, SSE project designers and managers have treated these factors as external, or beyond their direct control. However, some recent SSE project evaluations indicate how some projects have begun to take innovative actions to deal with specific policy or institutional constraints. Some of these successful "systems" approaches include:^{11/}

- o setting up SSE project "boards of directors" with government and private business sector representatives, to promote understanding and support for project objectives among these circles and to provide a forum for policy dialogue.
- o working to establish associations or cooperative groups of small and micro-entrepreneurs, so they can take advantage of project resources and services in greater numbers and more efficiently.
- o providing project credit and technical services in a manner supportive of economic linkages and complementary sectors.

Policy Dialogue:

Despite successes in overcoming specific external constraints to SSE development, the individual projects alone are unlikely to be able to make significant changes in the policy environment. Many of these SSE projects only involve a small amount of resources and alone provide little leverage for affecting national-level policies. Therefore, a critical aspect in AID's efforts to promote SSE development must look beyond individual projects, and begin to link the overall USAID country program strategy to host government policy dialogues.

FOOTNOTES

- 1/ Jennifer Bremer, et al, A Review of AID's Experience in Private Sector Development (April 1985) AID Program Evaluation Report No. 14 prepared for CNIE by Robert R. Nathan Associates, Inc., p. 22.
- 2/ Ibid. p29
- 3/ Carl Liedholm and Donald Mead, "Small Scale Enterprises in Developing Countries: A Review of the State of the Art" Michigan State University International Development Papers (forthcoming)
- 4/ Jeffery Ashe, The PISES II Experience: Local Efforts in Micro-Enterprise Development (April 1985) prepared by S&T/ED by ACCION International/ATRC, p. 26.
- 5/ Peter Kilby and David D'Zmura, Searching for Benefits (June 1985) AID Evaluation Special Study No. 28 prepared for FVA/PVC, p xi.
- 6/ Robert W. Bunt, Private Voluntary Organizations and the Promotion of Enterprise (Spring 1985) AID Evaluation Special Study No. 27 (draft), p. 13.
- 7/ Ibid, p.15
- 8/ Ibid, pp 10-14; Peter Kilby and David D'Zmura, op cit. pp. 114-118; Jeffrey Ashe, op cit., pp-13-17.
- 9/ Peter Kilby and David D'Zmura, op cit., pp 118-119.
- 10/ Robert W. Bunt, op cit p 23-26.
- 11/ Ibid, pp 29-33.

**THE INTER-AMERICAN DEVELOPMENT BANK'S PROGRAM FOR SMALL
ENTERPRISE DEVELOPMENT**

1. The Inter-American Development Bank (IDB) funds small scale enterprises through its Program for Financing Small Projects (PFSP). The PFSP was initiated in 1978 to provide concessionary loans for small business ventures of individuals or groups of individuals who have no access to regular government or commercial credit. Loans for beneficiaries are channelled through intermediaries: private foundations, cooperatives, non-governmental organizations and public banks. The loan amount allowed for each intermediary institution is less than \$500,000.
2. Between 1978 and 1984, 107 projects in 21 countries were funded under the PFSP. Most of the projects were for agriculture-related enterprises and located in rural areas. Approximately a third of the projects were aimed at sponsoring small commercial enterprises in the urban and industrial sectors. All the projects were targetted at the rural and urban poor who had not previously received financial assistance from the IDB's regular programs.
3. A recent evaluation conducted by IDB concluded that the PFSP has achieved its primary objective - to create employment opportunities for the poorer segments of the rural and urban population in Central and South America. Other objectives attained were a) the establishment of enterprises which used domestic raw materials and employ technologies compatible with the socio-economic characteristics of the beneficiaries; b) providing institutional credit for marginal segments of the society which are now dependent on the informal credit markets; and c) using existing private, non-governmental organizations to identify and reach the target population.
4. Problems encountered in the implementation of PFSP indicated that success was more likely :
 - a) Among the less poor population;
 - b) If the project was designed to encourage only one type of economic activity;
 - c) If the project included technical, managerial and other assistance for the lending institution;
 - d) If the lending institution is financially strong and has had previous experience in administering credit to the poor.

DOMINICAN REPUBLIC: THE ADEMI PROJECT (517-0208)

The fundamental fact about ADEMI, The Association for the Development of Micro-Enterprises, Inc., is its remarkable success. ADEMI, created two years ago by a group of influential Dominican business leaders, is an indigenous organization. It had grown spectacularly in its short history. This innovative organization has found a way to dispense with most constraints, and hidden "up front" costs that almost insurmountable to the small micro-entrepreneurs of the informal sector. Procedures are simple and fast: its short-term loans for micro-entrepreneurs are only a few days. A staff of dedicated Asesores (an counselors/promoters) keeps in close contact with the micro-entrepreneur, providing technical assistance in management/bookkeeping/business is handled separately, on a voluntary basis, and is paid by the micro-entrepreneur. Loans are at market rates of interest. The public has been instrumental in ADEMI's formative period, converting 100 pesos from ESP local currencies into the credit account, and providing 100 years for overhead expenses until ADEMI reaches self-sufficiency. And it appears that ADEMI soon will go into a self-sustaining and growing mechanism for generating income for the urban poor. According to its recent figures

-1:

- Creates one job for each U.S. \$818 lent;
- Creates a large increase in profit/month per micro-entrepreneur;
- Rotates its portfolio 3.5 times a year;
- Generates almost U.S. \$12 of new income per year for each dollar invested.

ADEMI's program was created with two program components. The first involved loans to individual micro-entrepreneurs, who had from roughly one to six employees. The second, even more innovative, provided loans to the very lowest level of the micro-entrepreneurial hierarchy: street sellers, recyclers, home-based mini-workshop ventures, etc. With technical assistance from AITEC/Accion International, which devised the methodology, 3-8 of these people were grouped together in a Solidarity Group to guarantee each other's loans.* Common to both components was the idea of the gradually increasing loan size. With each successful, on-time repayment, borrowers were eligible to receive a larger sum.

Individual loans: As of May, 1985, 847 micro-enterprises had been financed, 17% of them female owned. These businesses had created 1,151 new jobs from the 4,408 loans received (average loan = US \$350). Women's enterprises have added an average of 1.5 jobs each vs. 1.3 for men's. This is especially marked in the clothing manufacture sector (involving 150 of the 847 businesses, including those of almost half - 49% - of the female micro-entrepreneurs), where men's businesses expanded by 0.64 employees, on average, while women's businesses added 1.4 jobs each.

"Solidarity Group" loans: By early 1984, 215 of these groups were totalling 1,150 members. Some 43% of members were women, many of them heads of household. Once again, female performance slightly exceeded male. The solidarity group component is now being reorganized to provide a new fund for somewhat larger groups. During its period of full operation, however, its delinquency rate, about 18, was roughly the same as in the individual loan component.

The ADEMI model offers promise for broad replicability. It shows potential for providing substantial economic benefits for large numbers of Third World women and men informal sector entrepreneurs - while paying its own way.

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Annotated Bibliography of Key AID Documents
Reviewing Experience with Small and
Micro-Enterprise Projects

AID Evaluation Special Study No. 28, Searching for Benefits (June 1985) by Peter Kilby and David D'Zurra, presents the results of an economic cost-benefit analysis of five, micro-enterprise credit & technical assistance projects in Upper Volta, Brazil, Honduras, the Dominican Republic and Peru.

AID Program Evaluation Discussion Paper No. 22, Report on the Workshop on Private Voluntary Organizations and Small-Scale Enterprise Development (Spring 1985) provides a summary of lessons learned from recent evaluations of PVO small-scale enterprise projects, summaries of papers presented at the workshop held on October 31 - November 2, 1983, and highlights of the workshop discussions.

AID Evaluation Special Study No. 27, Private Voluntary Organizations and the Promotion of Enterprise (Spring 1985) by Robert W. Bunt discussed some central issues of PVOs' activities relevant to SSE development, and provides a summary of what is known about PVO-operated SSE project performance and approaches.

AID Evaluation Special Study No. 13, The Evaluation of Small Enterprise Programs and Projects: Issues in Business and Community Development (June 1983) by Robert W. Bunt reviews that literature and selected field experience on the issue of SSE project impacts and factors contributing to effectiveness.

The FISCES Studies: Assisting the Smallest Economic Activities of the Urban Poor (September 1981) and the FISCES II Experience: Local Efforts in Micro Enterprise Development (April 1985) were prepared for the Office of Rural and Institutional Development, Bureau for Science and Technology. Phase I of the FISCES (Program for Investment in the Small Capital Enterprise Sector) project reviewed twenty micro-enterprise projects in sixteen countries and identified key elements associated with project success or failure. Building on this research experience, Phase II involved the design, implementation and evaluation of four demonstration projects, in the Dominican Republic, Costa Rica, Kenya and Egypt.

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