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MICROENTERPRISE CREDIT PROGRAMS: DEJA VU

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Abstract

Many recent microenterprise credit programs in low income countries resemble earlier small farmer credit efforts that failed. Authors argue that lessons learned from these small farmer credit programs may provide insights on how to avoid problems in programs that extend loans to operators of small businesses.

MICROENTERPRISE CREDIT PROGRAMS: DEJA VU

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Dale W Adams and J.D. Von Pischke[1]

Governments and donor agencies are funding an increasing number of programs in low income countries directed at owners of small businesses, particularly the smallest firms called microenterprises (Webster, Boomgard). Increased interest in private businesses, a belated recognition that many individuals make their livelihood from tiny firms, U. S. Congressional mandates, and concerns about poor people--particularly women--spur these endeavors. Despite differences across programs, loans dominate these activities (Meyer and Nagarajan). As we point out in the following discussion, these microenterprise credit programs resemble earlier attempts to assist operators of small farms: both programs involve similar assumptions, both contain similar policies, both tussle with definitional issues, both use the same type of project justification, and, as a result, both are likely to encounter similar problems. While many microenterprise programs are too new for definitive evaluation, a review of earlier small farmer credit schemes may foretell what to expect.

Credit for Small Farmers

Small farmer credit programs in low income countries (LICs) have a long history, with some programs dating back to the early 1900s. After World War II there was a surge

[1] The authors are speaking for themselves and not for the organizations for whom they work.

in these efforts that accompanied the growth of modern foreign assistance.[2] During the four decades following the war governments and donors spawned hundreds of small farmer credit projects involving tens of billions of dollars. Most LICs had at least one program, a number of them had multiple programs, while still other countries had a series of endeavors spanning several decades. Most institutions extending loans to farmers under these programs lost money. Many withered away, disappeared, or were sustained by recapitalization.

While institutional arrangements were diverse, many programs were patterned after organizations found in donor countries. The United States, for example, promoted supervised credit programs throughout Latin America that were based on the Farmers' Home Administration. It also promoted rural private banks in the Philippines, in Vietnam, and in Ghana that were similar to U. S. institutions. Several European countries exported cooperatives--particularly to Africa--to provide loans to rural people. In other countries, particularly in Asia, governments and donors formed a variety of institutions to provide rural financial services. In a number of countries large donors such as the World Bank and the Inter-American Development Bank promoted specialized rural development banks. Many countries also introduced regulations aimed at forcing banks to lend a larger portion of their loan portfolio to small farmers, either directly or indirectly through development banks.

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[2] See Bauer for descriptions of a number of the small farmer credit programs that existed in the early 1950s.

Common Assumptions

Key assumptions about the status, potential, and behavior of small farmers were virtually identical to the assumptions involved in many recent credit programs for micro-enterpreneurs. In each case the target group was viewed as being too poor to adopt new technologies without formal loans and also being too poor to save. Operators of small farms were thought to need training and technical assistance in order to progress, and it was assumed that appropriate technologies and productive new ideas were available to communicate to them. Promoters argued that informal finance either played little or no positive developmental role, or that it was an evil that should be eliminated; that most of the target group had "credit needs" that commercial bankers refused to fill for reasons that were neither commercial nor economic; and that many of these borrowers would graduate after several years of concessionary assistance and be able to obtain conventional bank loans. Finally, because most of these credit programs were justified on the basis of expected increases in production, project evaluations concentrated on measuring the impact of loans on changes in borrowers' output, income, or employment. The impact of credit programs on the financial infrastructure was largely ignored.[3]

[3] A interesting example of this occurred in Jamaica during the 1960s and 1970s where a donor agency funded a supervised credit program for small farmers that was handled by a government development bank. A series of evaluations was done on the program, all reporting highly favorable results, but the bank later collapsed because of the excessive costs imposed on it by this and other programs.

Policies

Not surprisingly, common assumptions spawned virtually identical policies and practices in small farmer and microenterprise credit. These include loan guarantees to induce banks to lend to target groups, concessionary lines of credit to stimulate targeted lending, subsidized interest rates on loans made to ultimate borrowers, little attention to deposit mobilization, emphasis on making relatively large- and relatively long-term loans--sometimes with generous grace periods--and almost exclusive reliance on government and donor funds.

Because credit was offered in response to perceived needs, loans funded a large percentage of the cost of the investments made by borrowers. Loans were not based on the amount of cash the farmer could reasonably be expected to repay after satisfying more pressing priorities and after the effects of bad agricultural years or other things that could reasonably be expected to go wrong. Loan size and repayment terms were usually determined from farm budgets constructed primarily to derive the rate of return from the activity for which the loan was issued. Risk was not reflected in these budgets; normal year assumptions were used. Expected returns were often inflated by optimism that was viewed as more conducive to development than was realism. Microenterprise financial models are less oriented to rates of return, but are still largely based on normal year assumptions.

Believers in "credit needs" inevitably view formal loans as being entirely beneficial. While borrowing may allow entrepreneurs to expand their activities, it puts them into debt,

unless loans are grants disguised as credit.[4] While borrowing may allow farmers to expand their activities, it carries with it an additional cost through exposing them to more risk, including the risk of not being able to repay loans.

Because of the nature of funding sources, there was often pressure in small farmer credit programs to disburse funds quickly and to reward staff on the basis of loans made. It was not uncommon for training and technical assistance, loan approval, and sometimes loan recovery responsibilities to be divided among several agencies. An extension agent, for example, may locate and approve the borrower, an agricultural bank make the loan, and then both parties had vague responsibilities to recover the loan. Because of the reticence of private bankers to become involved in political programs, many of these debt programs were implemented by government agencies.[5]

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[4] It is a curious linguistic twist that the terms 'loan' and 'credit' carry a positive aura, while 'debt' always has a negative connotation. Advocates of special credit programs for operators of small farms or microenterprises, for example, never propose that imposing more debt on poor people is an appropriate development strategy.

[5] Occasionally a government-owned bank refused to administer a program that threatened its sustainability. In the early 1960s in Guatemala a donor agency tried to encourage a government-owned bank to charge concessionary interest rates on loans to small farmers. The manager of the bank recognized that these interest rates would not cover the costs of administering the program and refused to lower the rates. As a result the program was transferred to a new agency that was less averse to losing money. Likewise, in Kenya in the 1970s a cooperative bank protected itself by neglecting to make loans under a donor-backed project that involved concessionary loans. Other lenders participating in the project achieved average collection rates of about 30 percent. A third example of this exceptional behavior was the rejection by credit unions in Dominica of a donor-supported project that offered an interest rate spread of 1.5 percent.

Target Group Definition

These projects were compromised by incomplete loops in the procedures and culture of the institutions designing them. One was a general lack of interest in sustainability of debtor-creditor relationships. This stood in marked contrast to the intense concern with definition of the target group and the monitoring of disbursements, number of loans made, and their ostensible use by borrowers.[6] Much time was spent in seminars and conferences on small farmer credit attempting to define precisely the landless, peasants, tenants, part-time farmers, small farms, medium-sized farms, and large farms rather than on searching for the characteristics of loan applicants who would use credit productively and repay on schedule.

Recent discussions of what constitutes a microenterprise, or a small or medium-sized firm, are reminiscent of those sessions. The quest for precise definitions of smallness is driven by the compulsion to target assistance. But if a microenterprise is defined as having ten or fewer employees, is a firm that has eleven employees much different, and does the definition have any relevance for the financing of the enterprise? We think it does not.

Project Justifications

What might be called "The Four Standard Deviation Spread" was used to justify numerous small farmer credit projects. It survives today in promotion of many micro-enterprise credit programs. The spread typically began with citation of horror stories about

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[6] These issues were extensively discussed during the Spring Review of Small Farmer Credit carried out by the Agency for International Development during 1972-73. A summary of that review is provided by Donald.

interest rates charged by informal lenders. Recent research is showing that the levels cited were often two standard deviations above the norm in informal financial markets. In contrast, the project promoted was typically portrayed as free of any material risks for the lenders who accepted the ultimate loan recovery responsibility. This assumption, in turn, was often two standard deviations beyond the norm later experienced in these projects. The spread and its widespread acceptance skirted hard questions about creditworthiness and created ample latitude for project designers to ignore the reality faced by borrowers.

In many cases the torrent of farm credit projects outpaced the corps of donor employees who had banking or farm lending experience. Further, many credit projects were dressed up as programs to promote fertilizer use, purchase of machinery, irrigation, cattle production, or a particular crop or technology. In their heyday, farm credit projects were justified and designed by teams led by a melange of technicians including economists, engineers, livestock specialists, marketing experts, institutional specialists, generalists on a fast career track, and horticulturists. Many of these people had formidable academic qualifications and were experts in their specialties, but they often had little interest or expertise in developing a sustainable and efficient financial system, or in making loans on the basis of creditworthiness.

Accountants were sidelined in this process and few of these projects were fully costed by donors or operated by credit institutions with efficient management information systems. Poor financial housekeeping in agricultural finance institutions was common, and donor records were such that they had no overall view of the financial performance of the projects they supported. Project performance was measured by the number of loans made, tons of

fertilizer sold, number of tractors purchased, acres of land irrigated, number of cattle procured with loans, and acres of crops financed by loans. Collection rates of 75 percent on loans to farmers came to be accepted as "satisfactory," and program sustainability was not a serious objective, except as it could be achieved by repeated donor outlays.

Problems Encountered

While donor agencies and governments have not yet written--and to avoid embarrassment may never write--the final chapter about their experiences with small farmer credit programs over the past 40 years, there is widespread agreement that their strategy was flawed and yielded disappointing results.[7] Most of these programs were transitory and reached only a small percentage of the farmers targeted, who were in turn a minority of the rural population. These programs were unsustainable because they were expensive, collected too little revenue, depended too heavily on outside funding, and they often suffered serious default problems. Even worse, a substantial portion of the subsidies passing through these programs, in the form of concessionary interest rates and lax loan recovery, were captured by people who were not poor.

Low interest rate policies distorted the decisions made by financial institutions in two ways. First, the lower the regulated interest rates, the less incentive lenders had to make small loans. Second, these low interest rates on loans depressed the interest rates paid on deposits, which weakened the incentive to deposit funds. Concessionary interest rates on

[7] On various occasions, the authors have been asked to identify successful and sustainable small farmer credit projects. It is humbling to note how short that list is, especially among low income countries.

discount lines from central banks further reduced the incentives for retail banks to mobilize deposits in rural areas. This increasingly led financial institutions serving farmers to become highly dependent on donor or government funds. Addiction to outside funds subjected lenders to the whims of governments and donors which often created ebbs and flows in funding. Attempts to manage this roller-coaster existence, coupled with the rigidities of official institutions, resulted in overstaffing, that further boosted the high transaction costs of administering targeted funds. Low interest rates made lenders more cordial to their funding sources than to their loan clients or to depositors.

The low quality of services provided by these lenders, combined with the political imperatives that often permeated their operations, led to loan recovery problems that cascaded as programs matured. After a few years the financial problems of the program and the agency handling it typically caused the donors or the governments to abandon the scheme. In many cases the financial institution imploded after subsidies were withdrawn and it became clear that its revenues from loans were far less than the costs of operating the program. In sum, few of the specialized agencies handling small farmer credit programs proved to be viable or sustainable. Their operations were brittle and were seldom able to survive economic shocks in the economy or the onslaught of inflation. Failure became the norm.

Many farmers who participated in these programs "graduated" only in the sense that they returned to self-financing. Very few entered the ranks of regular clients of formal lenders. Likewise, most of the "rotating" credit funds set up to support small farmer credit programs failed to make a revolution. They were quickly consumed by loan defaults, by

declines in their purchasing power caused by inflation, and by administrative costs that substantially exceeded interest collected on loans.

Lessons

Various lessons can be drawn from small farmer credit schemes that may predict what can be expected from many credit programs for microenterprises. After all, from the point of view of the financial intermediary, the problems of serving operators of small farms and microenterprises are similar.[8] The most important of these lessons stem from services offered, credit discipline, loan size, and institutional problems:

Services Offered

1. Lack of funds was not the most important problem faced by most small farmers. Product prices, land tenure, modern input costs and availability, low yields, and risk turned out to be more important factors limiting small farmer development. Yet, credit programs were the most popular response to small farmer problems. It was much easier for donors and governments to create and fund credit programs than it was to address other, more serious problems faced by the rural poor. It may be that

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[8] Several important differences should also be noted. On the one hand, microenterprises typically produce a much wider variety of products and services than do farmers, which compounds the lender's problems of assessing the merits of loans to heterogeneous microenterprises. On the other hand, microenterprises are typically located in urban areas, closer to the financial intermediary than are the widely dispersed farmers. As a result, it may be easier for the intermediary to have contact with operators of microenterprises than it is with farmers.

operators of microenterprise also face more important constraints than lack of funds for investments or operating costs.[9]

2. For most small farmers, reliable access to small and short-term loans was more valuable than having large and long-term loans. Many of them were able to fund investments out of equity capital, or through combinations of short-term borrowing, equity capital, and informal loans. Emphasizing small short-term loans may, therefore, be appropriate in credit programs for microenterprises.

3. Much of the costly technical assistance and training that accompanied loans to small farmers was ineffective. In some cases extension agents had little new appropriate technology to extend and in other cases farmers faced hostile economic environments that diluted the returns from training and technical assistance. For example, no amount of farmer training could overcome an overvalued exchange rate that heavily taxed farm exports. Because of heterogeneity of microenterprises, is it reasonable to expect that effective technical assistance and training for operators of microenterprises will be even more difficult and costly to provide.

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[9] The demand for loans to cover operating expenses may mask managerial or other problems that cause the firm to be short of funds (Kilby, Liedholm and Meyer). Providing the stressed firm with a loan may not solve these more fundamental problems.

4. Loan guarantees aimed at inducing commercial bankers to lend more to small farmers typically had little lasting or positive effect. Many banks covered by these programs lent to only a few small farmers and often only for a short time, until they had satisfied their public relations obligations. Most guarantee funds failed to make ends meet and met the same fate as the lenders they were supposed to protect. Developing sustainable and affordable loan guarantee programs for microenterprises are likely to face similar challenges.

5. Lending to small farmers proved to be costly, even in the most efficient programs. Commercial lenders could not normally cover their costs of lending to these clients, especially when regulations kept interest rates low. Lender transaction costs were highly correlated with loan targeting--the more targeted lending handled by the lender, the higher its costs. This in turn led lenders to ration services that were most costly per unit of money handled--small loans--or to become less financially viable. Unless credit programs for microenterprise are allowed to set interest rates that cover their costs of making small, short-term loans to borrowers with weak credit ratings, they are likely eventually to face similar pressures to ration their services.

Credit Discipline

6. Loan recovery problems were exacerbated when excessive grace periods were attached to loan repayments, when responsibilities for making and recovering loans were shared by several agencies, when funds for lending carried a political aura,

when loans were made in a rush, when loans were given to most people who applied, and when the quality and dependability of financial services were low. New agencies often had more difficulty recovering loans than did experienced lenders, in part because they often emphasized filling quotas rather than making loans in response to creditworthiness. Also, the few programs that stressed deposit mobilization generally recovered a larger proportion of their loans than did agencies relying entirely on outside funds. Microenterprise credit programs are likely to face similar loan recovery problems if loans are not carefully made and where deposit mobilization is ignored.

Loan Size

7. Conceived in response to a subjective perception of need, small farmer credit programs--especially those offering term loans--often imposed excessive debt on their clients. Relatively large loans funded large changes in technology and scale that exceeded the managerial capacities of borrowers and exposed them to more risks than they were equipped to manage. Microenterprise managerial capacities may be similarly limited.

8. High levels of financing produce large debt service burdens. A bad year can devastate a farmer's repayment capacity, easily putting even the most scrupulous heavily-indebted borrower into arrears. The absence of plans to deal with risk resulted in its poor management by lenders, compounding the costs of improper loan sizing.

Microenterprises also face price and production risks that should be factored into loan decisions.

Institutional Problems

9. Bankrupt or financially weak financial institutions (typically cooperatives, agricultural development banks, or supervised credit agencies) became the hallmark of small farmer credit programs. These lenders were difficult and costly to revive and sanitize once they became stained by political loans and serious loan recovery problems. Talented managers and loan officers shunned them, depositors understandably looked elsewhere, and borrowers felt less obligation to repay an organization that had a reputation for making soft loans. Financial institutions can be debilitated quickly after taking a long time to build. Even more fragility and institutional attrition should be expected in credit programs for microenterprises because they are heavily relying on small non-governmental organizations to handle a large part of the funds lent.

10. Some governments and donors "rolled institutions" as their small farmer credit efforts evolved in a country. They moved their lending programs from one financial institution to another as the results of earlier activities proved disappointing. Most of these programs exhibited few loan default problems in the first couple of years of operation; grace periods, refinancing and long maturities often masked bad loans for a time. As default problems became more apparent, earlier institutional forms were

sometimes abandoned, but often the roll simply added new forms. The quest for the institutional form that can defy the "laws of finance" and make and recover large numbers of small loans is likely to continue in microenterprise credit.

11. Evaluations of the impact of loans on borrowers turned out to be difficult, ambiguous, and misleading (Adams and Von Pischke). They were complicated by fungibility and costly data requirements. Studies that compared changes in economic activities between individuals with loans and control groups without loans encountered serious methodological problems. Control groups otherwise identical to borrowing groups would consist of farmers eligible for credit who decided not to borrow--a rare animal in an institutional environment that converted loans, at least in part, to disguised grants. It was usually impossible to isolate the effects of borrowing because of severe data limitations in studies comparing the before-borrowing and after-borrowing situations. Since donors demanded evaluations to demonstrate whether targeting requirements were met, methodological problems were usually disregarded or down-played. For these reasons, evaluations tended to overestimate program benefits. They concurrently underestimated program costs by ignoring the detrimental impacts of small farmer credit projects on lending institutions, on incentives to save, on the sustainability of financial institutions generally and on the damage done to contract enforcement as millions of notes signed by farmers in favor of government agencies were demonstrated to be no more than pieces of paper. Evaluations

of many microenterprise credit efforts are trying to measure the same impacts with the same flawed methods.

12. Unsustainable programs were repeated because project design failed to include response mechanisms that capitalized on experience to correct deficiencies. The absence of self-correcting systems stemmed from preoccupations with disbursing funds and with credit need. It was also a consequence of ignoring the one impact that can be observed relatively clearly in projects for which donors required a separate set of accounts: the impact of projects on the institutions implementing them. Calculating these costs would have provided a foothold for accountability and an incentive to experiment, to control costs, and to build capacity to deal with adversity. Microenterprise credit programs face the same problem of capitalizing on experience and documenting the impact of credit projects on the agencies handling them.

Qualifications

Obviously, not all of the hundreds of small farmer credit programs behaved in precisely the same manner. Repayment rates on these projects in Africa, for example, ranged from more than 99 percent to less than 1 percent. And, not all of the hundreds of microenterprise credit programs are carbon copies of earlier small farmer credit efforts. In fact, initial collection performance of a number of microenterprise credit schemes exceeds that achieved at similar stages in farm credit projects. A few small farmer credit projects

performed well in some respects for certain periods of time, including examples in Kenya, Malawi, Morocco, Thailand and elsewhere. But for each of these programs, many more programs soon failed, and some that once worked well later fell victim to predatory behavior by politicians or their clients.

It should also be noted that several of the lessons from small farmer credit efforts have influenced a few microenterprise lending programs. One of these is the use of PVOs (private voluntary organizations), also known as nongovernmental organizations (NGOs), for project implementation. NGOs can be flexible, and the best of them are problem- and result-oriented because of their values and because their links with donors and governments are as contractors rather than as part of a government establishment. Some NGOs, such as ACCION in Latin America, have been innovative in providing microenterprise credit, although it is not yet clear if their projects will become self-sustaining.

A few microenterprise credit project designers also are more willing to accept the business decisions made by loan applicants instead of specifying the standard formulas or packages so reminiscent of farm credit. Another innovation is greater reliance on groups, with careful attention to the cement that binds a group together. Groups were sometimes used in farm credit, but these were often ad hoc arrangements formed for the convenience of the lender. There is also recognition in a few microenterprise credit projects that highly subsidized interest rates on loans to the poor are dysfunctional and some lip service is given to deposit mobilization. Few microenterprise credit programs are game, nevertheless, to charge and pay rates of interest approaching those found in informal financial markets, which probably approximate lenders' and depositors' opportunity costs.

In spite of a few, positive features, however, two factors will destroy many micro-enterprise credit projects. The first is uninformed replication: adopting the form of a relatively successful model without a grasp of the substance that animates and sustains it. The second is that any attempt at innovation contains risks, many of which are not apparent at the outset in credit projects. These are viruses that are dormant until a certain stage in a life cycle is reached or a certain shock is received, which causes them to multiply and emerge in virulent strength. They inhabit all innovative institutional arrangements and all credit portfolios. Each variety is programmed to erupt in response to different thresholds and stimuli. Exceptional management and exceedingly well-capitalized financial structures may be required to keep them submerged and to resist their influence.

Conclusions

It is too early to draw firm, empirically-based conclusions about the long-term results of credit programs for microenterprises, but the similarities between small farmer debt schemes and more recent debt programs for operators of microenterprises portend similar results. Many of the loans being made to microenterprises will not be repaid, most of these programs are likely to be transitory, and many of the targeted borrowers will not be materially assisted in the long run through programs that increase their debt.

In our opinion, debt is not an effective tool for helping most poor people enhance their economic condition--be they operators of small farms or microenterprises, or poor women. In most cases lack of formal loans is not the most pressing problem faced by these individuals. It must also be recognized that providing financial services to poor people is

expensive and building sustainable financial institutions to do this requires patience and a keen eye for costs and risks. Most formal financial institutions in low income countries currently avoid providing these services for sound commercial reasons, and sources of informal finance are able to offer loans only by charging relatively high interest rates.

While we are skeptical about credit programs for poor people in general, we also recognize that competitive formal financial systems should naturally expand--especially on the deposit side--to serve much larger numbers of these individuals. This can be done on a sustained basis in two ways only: First, financial systems that deal in small transactions efficiently must be developed. Second, innovation is required to assist more poor people to become creditworthy and to have long-term working relationships with formal financial institutions. A barrage of targeted credit programs is unlikely to achieve either.

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