REPLICATING MICROFINANCE IN THE UNITED STATES:

OPPORTUNITIES AND CHALLENGES

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Replicating Microfinance in the United States: Opportunities and Challenges

1. Microfinance and the Third Way

When Bill Clinton swept into the presidency in 1992, he offered a new vision for public policy in the United States. What has come to be called "The Third Way" is built on commitments to fiscal discipline, deregulation, privatization, free trade, and market-oriented responses to social problems. This vision was echoed by Tony Blair as he remade the Labour Party in Britain, and it underlies the political agenda of Gerhard Schroeder in Germany and of Lionel Jospin in France. Clinton's successor, George W. Bush, shares these commitments as well. As we stand at the entrance to the new millennium, the ruling parties in these four nations are celebrating Third Way triumphs.

More than just a compromise between the left and the right, the Third Way aims to encompass the best of both, coupling market-based economic approaches with a commitment to social justice. Robert Reich, Clinton's first Labor Secretary and an early architect of Third-Way strategies, clarifies what distinguishes the vision from traditional approaches:

> If this were all there was to it—deregulation and privatization, free trade, flexible labor markets, smaller safety nets, and fiscal austerity—the Third Way wouldn't be a third way at all. It would be the Second Way, blazed by Reagan and Thatcher. But there's more, and here's the crucial difference.
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> The distinct theme uniting Blair, Clinton, Schroeder, and Jospin is that the economically displaced must be brought along. Rather than redistribute income to them (as was the strategy of the First Way), the idea is to make it easier for them to obtain good jobs and thus become economic winners. The central faith of the Third Way—a faith based, admittedly, more on hope than experience—is that the economic growth spurred by its free-market policies can be widely shared if those who are initially hurt by them are given the means to adapt. (Reich, 1999)

Third Way rhetoric is new, but the ideas have a long history in U.S. anti-poverty discourse, rooted in ideals that propelled the expansion of government in the Progressive Era of Presidents Theodore Roosevelt and Woodrow Wilson. In mounting the "War on Poverty" in the 1960's, President Lyndon Johnson challenged the United States to offer not just a hand-out to keep hunger at bay but to also offer a hand up to help poor households exit poverty for good (Sawhill, 1998, p. 1092). The 1964 Report of the President's Council of Economic Advisors states that the poverty problem could be solved by transferring $11 billion from the rich to the poor each year, "but this 'solution' would leave untouched most of the roots of poverty. Americans want to earn the American standard of living by their own efforts and contributions. It will be far better, even if more difficult, to equip and permit the poor of the Nation to produce and to earn the additional $11 billion, and more." (U.S. Council of Economic Advisors, 1964, p. 77, quoted in Sawhill, 1988, p. 1092).

The Third Way revives the hope of the Progressive Era ideals again, perhaps nowhere as clearly as with microfinance for microenterprise—although now the engine of change is public-private partnerships. In drawing parallels between the Third Way and the Progressive Era, President Clinton highlighted both domestic and international microfinance initiatives, citing them alongside domestic initiatives like urban enterprise zones and "welfare to work" legislation.[1] Through small loans targeted to the poor, microfinance promises to create new livelihoods and enhanced capacity for self-improvement. Most loans go to borrowers who plan to start, maintain, or expand very small businesses (microenterprises). While microenterprises may be small in terms of employment and sales, advocates argue that they can be meaningful in the lives of the participants and their communities.

Bill and Hillary Clinton have been long-time supporters of microfinance (Clinton, 1997). While still Governor of Arkansas, Bill Clinton helped to promote the Good Faith Fund, one of the earliest microfinance programs in the United States.[2] And while President, he went out of his way to support the microfinance movement, both domestically and abroad. During his two terms in office, microfinance has became a much-discussed domestic initiative, although perhaps more notable for discussion than action, and, on the international side, spreading microfinance became a major focus of the U.S. Agency for International Development.

The following chapters assess the progress and promise of microfinance in the United States and internationally. Taken as a whole, early efforts in the United States have failed to approach the kinds of successes achieved by the best microfinance institutions in Asia and Latin America. Arkansas's Good Faith Fund, for example, has re-invented itself and cut back on microenterprise lending after two years during which repayment rates by clients sank to 48% and demand stagnated (Taub, 1998). As Bhatt, Tang, and Painter report in chapter 9, achieving wide outreach and financial strength remains an unmet challenge in the programs they survey in California, a finding echoed elsewhere in the United States (Bhatt, 2000; Bates and Servon, 1998; Taub, 1998). Programs, for the most part, are small (seldom reaching as many as a thousand clients) and heavily reliant on external funding.

Still, the triumph of the Third Way has attracted abundant resources to the U.S. microfinance movement. Can the resources be used to improve existing microfinance models? How can the abundant resources best be used to ensure that microfinance programs work hard to

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[1] Keynote address at the Princeton University conference "The Progressive Tradition: Politics, Culture, and History", October 5, 2000.

[2] The Good Faith Fund was founded in 1988 as a replication of Bangladesh's Grameen Bank. It was created under the supervision of Chicago's Shorebank Corporation and with funding from the Winthrop Rockefeller, MacArthur, Mott, and Ford Foundations (Taub, 1998).

innovate and be efficient? Is microfinance a meaningful answer to the problems facing poor households in inner cities and rural America?

As the chapters in the volume attest, there is already a rich body of experience with microfinance on which to draw. In Africa, Eastern Europe, Asia, and South America, microfinance programs of all sizes and missions collectively serve millions of poor people. Why does microfinance in the United States appear to be so much more difficult than microfinance in Bolivia, Bangladesh, and Indonesia, three very different economies that boast large, dynamic microfinance sectors? Which lessons do developing-world experiences hold for efforts in the United States? To be successful, must efforts in the United States depart sharply from international models?

We sketch some answers in the pages that follow. Two factors color much of the discussion. First, compared to the Third World, the structure of the U.S. economy makes the hurdles to starting small-businesses much higher in the United States, and, second, the microenterprise sector itself is much smaller. The two aspects combine to make business training a far more important component in the United States than in the Third World. They also limit potential demand for microfinance and drive up costs. With costs well above revenues, U.S. programs are far from achieving financial self-sufficiency. With continued reliance on donors, U.S. programs will have to work toward justifying their place among other subsidized anti-poverty interventions, including education and community-building initiatives. This suggests that serious, regular cost-effectiveness analyses should become a much higher priority than it has been.

Our second broad conclusion is that developing inexpensive saving services for the “unbanked” appears to have greater potential for cost-recovery in the United States, and this could open up opportunities for millions of poor households that are poorly served by existing for-profit and non-profit financial institutions. The current focus on micro*lending* in the US echoes the initial focus on lending in Third World programs, but those programs are increasingly recognizing the importance of also developing facilities for safe, convenient savings.

The structure of this chapter

The remaining sections in this chapter cover much ground. We draw large largely on our own practical experience and research to assess prospects for microfinance in the United States. In doing so, we also survey recent research by others and provide a context for the chapters that follow.

The first six sections describe major issues that have been discussed for decades in the Third World and that are now coming to the forefront in the United States. These debates include the structural opportunities and challenges for microfinance and microenterprise, the potential and possible pitfalls of complementing microfinance with training, the tensions and complementaries between attempts to cause large improvements in the well-being of poor microentrepreneurs and the desire to build financially self-sustainable institutions, how governance structures affect incentives for innovation and efficiency (whatever the goals of a microfinance organization), and the importance of the development of savings services that match the demands of poor people. The concluding section assesses the promise of microfinance.

2. The market for microfinance in the United States

The social and economic context for microfinance in the United States differs greatly from that of Bangladesh, Bolivia, and Indonesia, the homes of the best-established microfinance banks. In many ways, microfinance is more difficult in the United States than in the Third World (Schreiner, 2000a), and seven of the greatest challenges are described below.

a) *Size of the microenterprise sector*. The microenterprise sector—and thus the potential market for microfinance—is large in the Third World but small in the United States. This makes reaching a large scale much easier in developing relative to the United States (Hung, chapter 7). With scale, programs can both reduce costs per transaction and have wider impacts. In many Third World countries, most workers are in the microenterprise sector (*e.g.*, De Soto, 1989); in the United States, however, only about 11 percent of all full-time employed men are self-employed (Bates, 1997). While Edgcomb, Klein, and Clark (1996) estimate that self-employment might be a viable livelihood strategy for up to 8-20 percent of poor U.S. households,[3] the working poor in the United States usually turn to wage jobs because self-employment typically means longer hours, more risk, and less pay, especially for women (Schreiner, 1999a; Spalter-Roth, Hartmann, and Shaw, 1993; Balkin, 1989; Bendick and Egan, 1987).[4] The poor person who is well-suited for self-employment is probably also well-suited for wage-employment (Bates, 1997; Novogratz, 1992). In fact, most of the self-employed in the

[3] In 1995, households with less than $10,000 in income started about 136,000 new firms (Dennis, 1998).

[4] Williams (2000, p. 2) finds that an unemployed worker "might be better off with a slightly longer spell of unemployment and subsequent wage-and-salary sector job than with a self-employment opportunity that fails." Likewise, in a study of an experimental test of microenterprise programs, Schreiner (1999b) speculates that incentives to become self-employed

United States also work at least part-time for wages (Sherraden, Sanders, and Sherraden, 1998; Taub, 1998; Servon, 1997; Bond and Townsend, 1996). U.S. microentrepreneurs often seek not primarily economic rewards but rather to set their own hours, live a desired lifestyle, or pursue a vocation (Sherraden, Sanders, and Sherraden, 1998).

b) Functional safety net. The United States, unlike most of the Third World, has a public safety net that serves as a functional alternative to self-employment. Thus, not only is the pull into self-employment weaker in the United States, but the push is also weaker.[5] The safety net—like the abundance of wage jobs—places a floor on the reservation wage of potential microentrepreneurs. It may even sap entrepreneurial spirits as people learn not to look to self-employment for their livelihoods in bad times (Novogratz, 1992).

c) Competition from large firms. Large retailers and service providers like Wal-Mart and McDonald's do not have a strong presence in Bolivia, Bangladesh, and Indonesia; shopkeepers and street vendors there, unlike those in the United States, compete mostly against each other, not against large factories or chains of restaurants or retailers. Manufacturing microenterprises in the United States are unlikely to compete on price or quality against imported goods made by low-wage workers in large firms, and small retailers have difficulty diluting overhead enough to compete against chains. Of course, a few small manufacturers and retailers in the United States do carve out small niches, for example, in the production of trophies, picture frames, tee-shirts,

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may hurt the poor if incentives encourage them to rush to start a small firm with limited prospects and to cut short their search for a wage job.

[5] More households on welfare may become interested in microenterprise as deadlines—put in place as part of the 1996 welfare reform law—approach, forcing more people to move from welfare to work.

or costume jewelry, or in the sale of hobby toys, video rentals, organic produce, or network-marketed toiletries and other household items. The demand for customized products and stores, however, is limited; U.S. households do not spend large shares of their budgets on the output of microenterprises. Furthermore, entry into the most common microenterprise in the world—agriculture—is seldom easy at a profitable scale in the United States.

The service sector offers more opportunities for U.S. microenterprises, although service firms may still not provide a steady income. In promising news for microenterprises, as U.S. households become richer, they tend to demand more customized services. Many U.S. microenterprises make repairs (clothes, plumbing, cars), clean (homes, offices, cars, lawns), cater, or care for children or elders. Many service jobs require little human capital and so may be within the reach of poor, unskilled people, but this also means that they do not pay well.

d) Competition from commercial lenders. Microfinance in the Third World competes with moneylenders and other forms of informal finance (Bouman, 1995; Christen, 1989). Microfinance in the United States competes mainly with credit cards. Many of the poor—if they have a job and a clean credit record—can get a credit card.[6] Of course, credit cards are less accessible to the self-employed than to the wage-employed, but they still provide many U.S. microentrepreneurs with access to small, quick, hassle-free loans. Most borrowers from a

[6] Bird, Hagstrom, and Wild (1997) report that 40 percent of households at or below the poverty line had a credit card in 1995 (up from 20 percent in 1983) even though 40 percent of poor households had been two or more months delinquent in the past five years. A 1999 survey by Freddie Mac and five historically black colleges and universities found that among people with income under $25,000, 48 percent of black borrowers and 31 percent of white borrowers had a record of late payments, delinquencies, or bankruptcies (Associated Press, 1999). Boyd (1997) finds that 42 percent of blacks who had defaulted on student loans nonetheless owned homes (and presumably had home mortgages). Credit in the United States is widely available, even for the poor and even often for those with past repayment problems.

relatively large U.S. network of microfinance lenders had credit-card debt (Himes and Servon, 1998), and they often used microfinance loans to consolidate other debts.

The poor in the United States also have greater access to other forms of formal finance than do the poor in the Third World. Hung (chapter 7 of this volume) reports that among borrowers in his sample of microfinance lenders, less than half in the Third World had borrowed from other sources, whereas about 80 percent in the United States had had other loans. In addition to loans for consumer durables, cars, and homes, U.S. microentrepreneurs have access to a range of "fringe banks" (Caskey, 2000 and 1994a) such as pawn shops and check-cashing outlets.

In the Third World, the task of microfinance is to judge the risk of self-employed borrowers new to formal credit; in the United States, the task is often to judge the risk of self-employed borrowers with bad credit records. For example, 18 percent of borrowers in the U.S. sample of Hung (chapter 7 in this volume) had declared bankruptcy in the past. Likewise, 25 percent of clients of the network studied by Himes and Servon (1998) had bad credit records. Of course, many of these potential borrowers are no longer bad risks and are now willing and able to repay microfinance loans; the challenge for the lender is to learn to distinguish this group from those who are still bad risks.

e) Limits to joint-liability groups. Microfinance in the Third World rests on two new ways to judge risk and enforce repayment. The first is the cash-flow analysis of the household coupled with chattel mortgages on household durables; the second is joint-liability groups that make all members responsible for each other's debts (often called "group lending"). The first U.S. microfinance programs used the joint-liability model of the Grameen Bank of Bangladesh

(Mondal and Tune, 1993; Soloman, 1992). The potential for such groups in the United States, however, seems low, and there has been a slow shift away from them (Taub, 1998).[7] Lenders often fail to manage groups properly, members lack social capital, and the opportunity costs of group participation are high.

One purpose of joint-liability groups is to shift some of the work of screening and enforcement from the lender to the group. In the Third World, this means that group members are self-selected. Memberships tend to form among people who already know each other, and members screen-out bad risks because they do not want to repay the debts of their fellow group members. Furthermore, groups form among people who interact often outside the context of their microfinance loan because these links decrease the transaction costs of enforcement and increase the effectiveness of social or economic sanctions in the event of delinquency. In the United States, however, lenders often place strangers together in groups, losing the potential gains from self-selection and informal contract enforcement (Sternberg, 1998). Furthermore, enforcement of joint liability in the United States has been uneven (Hung, chapter 7 of this volume). If group members doubt that programs will really make them pay each other’s debts, they will shirk the unpleasant task of pressuring delinquent borrowers, and program staff must do most enforcement (Hung, 1998).

Low social capital may also decrease how well U.S. joint-liability groups can screen and sanction members (Taub, 1998; Bhatt and Tang, 1998). Although the poor are often referred to as “low-income communities,” there is often no basis for assuming that poverty, close proximity, and/or common membership in a racial/ethnic group are always enough to somehow impart the

[7] *The 1996 Directory of U.S. Microenterprise Programs* (Severens and Kays, 1997) lists 193 lenders, of which 51 used groups. The *1999 Directory* (Langer, Orwick, and Kays, 1999) lists

social capital of a community. Unlike many contexts in which microfinance has worked in the Third World, the poor in the United States are not tied to a village or plot of land. As a result, they are less concerned about allegiance to local leaders and about the maintenance of an unblemished reputation. This is in part because, like all Americans, the poor move often, and each move cuts some of the social and economic ties that might otherwise strengthen a joint-liability group. The U.S. culture of individualism and the feeling that often "good fences make good neighbors" also make Americans hesitant to throw in their lot with a group. Groups in the Third World typically build on trust and social capital that already exists. Joint-liability groups there may increase social capital (Edgcomb and Barton, 1998), not as a product but as a by-product. In contrast, U.S. joint-liability groups are often seen as a way to build social capital (Anthony, 1999; Servon, 1998), not as a by-product but as a product.

Participation in joint-liability groups may also be less costly for the poor in the Third World than for the poor in the United States. In Bangladesh, the weekly meeting is a valued social event for many women group-members (Larance, 1998). Women in the United States, on the other hand, tend to have more social opportunities, so the non-economic aspects of group meetings, while still valuable, are less attractive than they might be elsewhere. Finally, transport costs may be higher for the U.S. poor. Rural Americans are not always clustered in villages, and even urban Americans may be distant from each other in terms of the time and cost of transport, especially if they do not own cars.

f) Microfinance for housing. In the Third World, the fungibility of cash loans allows microenterprise loans to finance home repairs or improvements indirectly. Microfinance for

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199 lenders, of which 45 used groups. Ashe (2000) records the rise and fall of one of the most

housing is less common in the United States, not because loans are any less fungible, but state and local laws impede progressive home improvements to low-cost homes (Ferguson and Haidor, chapter 6 of this volume).

In the Third World, the home is typically the most important physical asset, and most poor people own their homes.[8] People build their own houses, starting small and adding rooms or floors through time. Mortgages are rare, in part because the poor are loath to risk their main physical asset, in part because macroeconomic factors conspire against long-term deposits and thus against long-term loans, in part because of the underdevelopment of credit-scoring models, and in part because legal imperfections make foreclosure difficult (Fleisig, 1996). Moves by an entire family are rare, and several generations often share a home. In this context, as Ferguson and Haidor argue in chapter 6, many microfinance loans are likely (explicitly or implicitly) to finance home repair and improvement.

In the United States, the home is also the most important physical asset of the poor (Wolff, 1998), although a smaller share of the poor are homeowners. Few poor people construct their own homes. Small repairs and improvements may be financed by credit cards or by home-equity loans. Those options exist due to a stable macroeconomy, extensive credit bureaus and credit scoring systems, abundant wage jobs, and a legal system that facilitates inexpensive foreclosure. For legal reasons, larger home improvements are often left to professionals. For safety and to protect the value of neighboring houses, local governments make and enforce building codes and zoning laws. These laws serve valid purposes, but they also constrain access to small, low-cost houses because they increase the minimum cost of a house and limit

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famous U.S. group lenders.

[8] The next two paragraphs draw on ideas presented in Ferguson and Haidor, chapter xyz, and in Merrill and Temkin, chapter xyz.

progressive improvements once a home is built. Furthermore, single-parent families are common in the United States, and people move often (perhaps due to constraints on progressive home improvements). In the Third World, most constraints on microfinance for housing are financial and technological; in the United States, they are mostly legal (Ferguson and Haidor, chapter 6 of this volume):

> Microfinance of housing may require U.S. financial institutions to innovate in individual pricing of loans and other ways. . . . The greatest change necessary for expandable housing and microfinance in the United States, however, would be a new acceptance by government of smaller units, greater lot coverage, shorter set-backs, and automatic approval of pre-planned expansion of units and of construction of new in-fill units (Lowry and Ferguson). . . . Because of the deep economic and cultural roots of high and inflexible standards, increasing the flexibility of local sub-division and building codes for progressive housing may well require leadership at the state and national level.

In their discussion of microfinance for housing, Merrill and Temkin (chapter 5) state that "microcredit for housing as utilized for the very poor in emerging markets is not really relevant in the U.S. market, largely because we do not build incrementally constructed core housing nor 'starter' housing that does not meet relevant codes." Still, their chapter discusses at least five other ways in which housing finance for the low- and moderate-income market in the United States might learn from the Third World. The first and most important lesson is that, in most financing schemes, savings comes first. According to Merrill and Temkin, this means "relying on borrower savings to establish credibility, provide collateral, and promote risk sharing." Second, risk-based pricing could allow banks to charge prices that cover the costs of smaller loans to poorer people, if those loans and people are indeed of unusually high risk. The main impediment to risk-based pricing in the United States appears to be fear of being labelled a usurer by the press and shelter advocates. Third, employers might automatically deduct loan repayments from paychecks, cutting costs and risk for lenders and thus making them more likely to go downmarket. Fourth, banks might hire new staff and train old staff to be willing to make small, unglamorous loans to poorer customers. Fifth, the supply of long-term funds for housing microfinance depends on a stable macroeconomy (especially low inflation) and a legal system that allow the perfection of homes as collateral; as Merrill and Tempkin explain, "in the majority of emerging nations, the main barriers to the greater availability of credit for housing are macroeconomic and systemic in nature." The United States has enormous advantages over the Third World in this regard.

g) Regulation. Developing countries tend to have large, dynamic informal sectors where regulation and taxes are largely absent. In the United States, regulation constrains not only microfinance for housing but also the potential for microfinance for microenterprise.[9] The constraints affect both microfinance lenders and microenterpreneurs.

For microfinance lenders, the chief regulatory constraints are laws that cap interest rates and thus limit potential profitability. Banks must publish annual percentage rates and, probably more importantly, they fear being known as as usurers; the press is quick to report apparent predators—banks, non-banks, or not-for-profits—who charge the poor more than the rich. Consumer protection has its place, but because the supply of microfinance to the poor costs more than the supply of traditional finance to the non-poor. Because profits matter for permanence, interest-rate caps limit the potential of U.S. microfinance. The record in the Third World suggests that interest-rate caps have often done more harm than good (Krahnen and Schmidt, 1994; Adams, Graham, and Von Pischke, 1984).

[9] Microfinance has not taken hold well in large and/or middle-income countries where government regulations (for example, on interest rates) might be enforced and/or where public development banks might crowd it out (for example, Argentina, Brazil, China, India, Mexico, and South Africa, with exceptions in Indonesia and Thailand).

For U.S. microentrepreneurs, the chief regulatory constraints concern taxes, licenses, and welfare rules (Dennis, 1998). Unlike most U.S. microenterprises, few Third-World microenterprises are formally registered or pay taxes. U.S. zoning laws preclude some types of home-based firms, and child-labor laws limit the use of children in the business. These laws ensure important protections, but they also reduce the returns to U.S. microenterprise. American microentrepreneurs, unlike their Third World counterparts, must keep accounts and guard against regulatory infractions and lawsuits, especially if they expand and hire employees.[10]

Licenses are required for three of the most-common types of microenterprise run by women in the United States: food service, child care, and beauty salons. Licensing protects the public, but, relative to the Third World where such requirements do not exist or are not enforced, they increase the cost of entry into microenterprise (Servon, chapter 8 of this volume). Even seemingly simple businesses can be complex in the United States. For example, a food vendor in the Third World could in practice go out on the street with a cart and start to sell. Localities in the United States would first require a license, an inspection, and a permit, if street vending is allowed at all.[11]

The design of welfare programs does little to encourage self-employment. Public assistance is subject to means-tests on financial assets, and this discourages personal saving (Powers, 1998).[12] Low levels of saving impair the ability to start a business and then to keep it going (Montgomery, Johnson, and Faisal, 2000; Bates, 1997; Holtz-Eakin, Joulfaian, and Rosen,

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[10] Taub (1998, pp. 61-2) relates how one woman worried about whether to buy liability insurance for her business that sold lotions.
[11] Licenses for taxis and the public monopoly on other forms of public transport also limit the U.S. potential of one of the sectors most-dominated by microenterprise in the Third World.
[12] In the wake of the 1996 welfare-reform law, most states greatly relaxed limits on financial assets and on the vehicle net worth, so asset-tests have less import now than they did in the past (Greenberg, 1999).

1994). Also, the Personal Responsibility and Welfare Reform Act of 1996 reinforces the movement of people from welfare to wage jobs. Time and effort invested in microentrepreneurship do not count against work-search requirements, and the new time limits on welfare ignore the lengthy gestation of most small businesses (Servon, chapter 8 of this volume).[13] Deductions from income limits are low, and deductions are often not allowed for the organizational costs of a new firm. Case workers have some discretion, but they are not always sure how to evaluate the claim that a person deserves continued welfare benefits while they work to start their microenterprise. By nature, entrepreneurship is unsupervised, and a case worker cannot know with certainty whether a mop and bucket claimed as a business expense for a cleaning microenterprise are really being used in the household. In short, this is another case where regulations that work for the majority turn out to hinder attempts to spread microenterprise in the United States.

3. Training and microfinance

The difficulty of microenterprise in the United States has contributed to a focus on training that is in sharp contrast to experiences in the Third World. The focus on training fits with the Third Way vision to equip the poor to compete in the marketplace. The Third World microfinance experiences, however, have few lessons to offer in the area of training. Most large, well-known Third World programs make loans but do not offer training, but most U.S programs offer only training or both training and loans.[14] As Servon notes in chapter 8, "credit is the

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[13] Dennis (1998) estimates that average gestation is about one year.

[14] The *1999 Directory* reports that about 30 percent of U.S. programs provided only training, about 8 percent only made loans, and about 62 percent did both. The *1996 Directory* reports that 27 percent provided only training, 6 percent only made loans, and 67 percent did both. Johnson (1998a) says that training takes precedence over loans in the United States. Of the four Third-

distinguishing characteristic of programs, but it is far from the most important thing that they do." In fact, some U.S. programs make loans at least in part because donors will then fund training (Servon, 1996 and 1994). The emphasis on training follows from the belief is that in the United States, human-capital constraints matter more than financial-capital constraints.[15] In the Third World, the common wisdom is that finance is the main constraint and that classes would too often waste borrower time and increase program costs. Is the United States so different?

Skills as a constraint. As argued above, microenterprise is often more complex in the United States. In Bolivia, a woman can watch someone sell oranges from a box on the sidewalk and then buy some oranges and sell them herself. Few U.S. microenterprises are so simple, and examples or mentors, although believed to be crucial for success (Aronson, 1991; Mokry, 1988), are few and less visible. Furthermore, many of the U.S. poor have access to microfinance through credit cards or other sources, so human capital may indeed eclipse financial capital as the greatest constraint on U.S. microentrepreneurship.[16]

U.S. entrepreneurs must be decathletes who excel in many tasks (Schreiner, 2000a). Not everyone, however, can come up with a business idea, produce a good or service, market it, deal with suppliers, keep the books, and manage a host of other activities. Bates and Servon (1998) argue that many of the poor lack the human capital (skills and experience) required for success in self-employment. Indeed, entrepreneurs with greater human capital—in terms of age, experience in entrepreneurship, or experience in a line of business—are more likely to succeed (Benus *et al.*,

World programs in Hung (chapter 5 of this volume), one offered training, whereas 64 percent of the U.S. programs required training before borrowing.

[15] Human capital encompasses skills from education and from experience and what Schreiner (1999a) calls *oomph*, the ineffable essence of entrepreneurship.

[16] Of course, human capital and financial capital are complements (Bates, 1996 and 1990).

1995; Drury, Walsh, and Strong, 1994; Evans and Leighton, 1989). Because skills matter so much, microenterprise programs naturally seek to impart them.

Who to train. Microfinance in the Third World often deals with business owners with at least one year of experience,[17] so they bypass the many small firms that fail soon after they start (Buckley, chapter 4). In contrast, training in the United States usually aims at start-ups. This reflects the hope that microenterprise will help people to exit from poverty, but it increases the skills gap to be filled, increases costs, and increases the number of trainees who never start a business or whose firms fail.

Bendick and Egan (1987) argue that evidence from large, national programs in Britain and France suggests that assistance to young-but-experienced firms is more effective than assisting start-ups: “Public efforts to assist entrepreneurs should not attempt to increase the number of business starts but instead should concentrate on reducing failures among those already operating” (p. 538). Likewise, Spalter-Roth, Soto, and Zandniapour (1994) argue that microenterprise training is likely to be most effective for those welfare recipients with self-employment experience and for those who are already self-employed. If the program’s focus is on start-ups, then inevitably training will have to play a large role in microfinance, necessitating higher costs and making much greater demands on staff. Although Third World experience has some lessons for the United States, the experience is less extensive in training than in lending, so U.S. programs will have to solve many problems for the first time.

[17] Important exceptions include the Grameen Bank and the network of village banks and other institutions that aim to create social transformation alongside income generation.

What to teach. It is not always clear what to teach. Programs might focus on general entrepreneurship, self-esteem/personal development, sector-specific issues, or long-term, on-call advice. Training seems more effective if rooted in specific issues that come up in real small firms. The simplest approach—guest speakers from local small businesses—may be inappropriate unless these speakers run firms similar to those likely to be run by the trainees.

The goal of general entrepreneurship classes "is to provide the practical knowledge to do the myriad of little things it takes to start and sustain an enterprise" (Balkin, 1992, p. 141). Drury, Walsh, and Strong (1994, p. xiii) explain that "training for entrepreneurship is fundamentally different from re-employment training. Its goal is not merely to provide business skills, but to help develop a new and viable organization." Beyond basic classes for skills common to all firms (such as tax management or accounting), microenterprise programs can hardly hope to teach the wide array of skills needed by different businesses, and it is not clear that they can do much to impart entrepreneurial spirit or perseverence (Bhatt, 2000). Evidence in Schreiner (1999b) suggests that the main effect of general entrepreneurship classes may be to warn potential entrepreneurs of the risks that they may face.[18] Good general classes may discourage small ventures more than they encourage them.[19]

[18] The widespread provision of classes, degrees, and even schools of entrepreneurship may reflect less their likely effectiveness and more the lure of the American Dream of small-business ownership and the pressure on politicians to "do something" for economic development.
[19] In an analysis of two microenterprise programs in California, Bhatt and Tang (forthcoming, pp. 9-10) note that "in some instances, the training provided was so generic and inappropriate that it was hardly any use to participants, who ultimately needed to evaluate whether their *specific* ventures had a good chance of making money in the marketplace. It is, for example, not very useful to force prospective borrowers who have hobbies instead of businesses to undergo mandatory training on financial-statement analysis or to listen to 'guest speakers', such as attorneys or investment bankers, talk about their life experiences. In fact, engaging participants in such activities probably does more harm than good because it distracts them from assessing the feasibility of their ventures."

This screening role is an important outcome, but it creates tensions with a second goal, building the self-esteem of participants. In chapter 9, Bhatt, Tang, and Painter highlight the tension between classes that focus on “making the participants ‘feel good’ about their business ideas” and classes that focus on skill transfer and on the assessment of the viability of a business plan. It may be difficult to create a positive experience for participants and yet still screen out those for whom an excursion into self-employment might be a major mistake. Moreover, self-employment classes may not be a cost-effective way to build self-esteem.

Sector-specific classes that teach the basics of professional child-care or food-service operations hold more promise (Sherraden, Sanders, and Sherraden, 1998). Although microenterprise programs may not be able to teach bakers how to bake, mechanics how to repair cars, or artists how to create, they can at least teach them how to deal with the red tape needed to get a license so that participants need not muddle through on their own.

Finally, some evidence suggests that long-term, on-call advice for problems as they come up can be more effective than up-front classes meant to immunize against anticipated problems (Schreiner, 1999b; Bendick and Egan, 1987). On-call advice is less costly, as problems that never come up are not treated, and people who never start a business are not trained.

In sum, useful training might orient participants to options both in and out of self-employment. It might serve less to impart skills than to make sure that trainees know what they are likely to face as small-business owners (Bender *et al.*, 1990). In that vein, Balkin (1989) proposes that microenterprise programs first help poor people to get more education, then to search for a wage job, and only last to attempt self-employment. Mangum and Tansky (1987) suggest that self-employment training include job training, given that self-employment does not always work out. According to Bhatt (2000, p. 107) “The focus of training and technical assistance needs to change from ‘completion’ and ‘graduation’ to assessing the feasibility of proposed plans for business start-up or expansion.” To do this, Bhatt proposes that training-cum-consultations focus on five key questions whose answers “do not require lengthy curricula and elaborate instruction schedules:”

- Does the idea make sense in business terms?
- Has the entrepreneur mistaken the creation of a product/service with the existence of a market for it?
- Can the market support the business’s projected sales?
- How long will it take for the business to break even?
- Does the loan applicant have the necessary resources to get by until the firm shows a profit?

Training as monitoring and screening. Training can play important roles beyond the imparting of knowledge. Business plans may also help to track self-employment effort (Dennis, 1998) and to indicate who is likely to be a successful entrepreneur. Welfare rules assume that all work effort will be in wage-employment in part because self-employment is difficult to verify; no paycheck from an employer proves that work took place. Without a natural monitor, people who receive public assistance as they start a small firm might be tempted to shirk. Microfinance offers two ways to signal self-employment effort. With classes, the signal is attendance and progress through a business plan. With loans, the signal is repayment. States have been willing to waive welfare rules for self-employed people monitored in these ways.[20] If classes and loans are

[20] Examples include Iowa (Raheim and Friedman, 1999) and the five states in the Self-Employment Investment Demonstration (Raheim, 1996; Friedman, Grossman, and Sahay, 1995).

mainly signals of commitment to self-employment, however, then is it possible to find a more efficient signal? How effective is training overall?

Does training work? Most programs and participants say that training is worthwhile. For example, Spalter-Roth, Soto, and Zandniapour (1994, p. 8) found that “the majority of participants in the micro-enterprise programs were enthusiastic about their need for additional training.” Few evaluations, however, look rigorously at the effects of training (Schreiner, 1999c; FIELD, 1998). Without the accountability sparked by the feedback of evaluation, improvements depend mostly on the good will of program staff. Advocates say that participants want training and that classes build human capital that has high returns even if self-employment fails (Friedman, Grossman, and Sahay, 1995). This may be true, but it also allows programs to continue to train, something that many of them did long before the advent of microfinance, something that may absolve them from the need to judge credit risk, and something that provides jobs for staff.

One simple check on the worth of training is whether participants will pay a small fee to attend. Another simple check is whether training is voluntary or mandatory.[21] Beyond these simple tests, microenterprise training in the United States should look to formal cost-benefit analysis or to its less-involved cousin, cost-effectiveness analysis (Schreiner, 1999c).

Is the United States different? For the most part, microfinance lenders in the Third World eschew training for four main reasons. First, they expect borrowers to know their businesses, most of which are relatively simple. Second, they fear that borrowers might blame failed projects on their training and thus feel justified to default on their loans. Third, good lenders are not necessarily good trainers.[22] Fourth, training is costly to supply.

These reasons may be less relevant in the United States. First, U.S. borrowers might have a greater need for training that can be standardized, such as for taxes and licenses. Lenders could know more than borrowers in these general-business areas even if borrowers know more, for example, about the specifics of how to sew or lay a roof. The full costs of such microenterprise training, like elementary education, probably cannot cover the full cost of supply with participant fees. Thus, it requires continued subsidies (Servon, chapter 8 of this volume), and so far donor funding in the United States has been available to subsidize training even when they choose not to subsidize loans. Second, U.S. microfinance lenders can motivate repayment by reporting delinquent borrowers to credit bureaux, although few have done this so far. Third and finally, the United States has an extensive network of training infrastructure already in place, for example in county extension services and community colleges. To cut costs and to take advantages of specialization, programs might link participants with existing sources of training (Bhatt and Tang, forthcoming). Thus, the issue in the United States may be less whether or not to train and more how to ensure low costs and high quality.

A natural question then is how, in the absence of prices, can programs ensure an innovative, efficient supply of training? No one has all the answers, but the limited experience in the Third World suggests three approaches.

First, programs should charge participants something, even if it is too little to cover costs. About half the U.S. programs surveyed by Langer, Orwick, and Kays (1999) did charge some fee

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[21] Few U.S. programs charge even nominal fees for training, and many, if not most, make training a prerequisite for access to other services such as loans.

for training and technical assistance. Fees can encourage participants to commit themselves more than they might in a free program (which they might view as required rather than chosen). Furthermore, it increases the cost of participation and thus increases the chance that participants will not settle for low-quality services.

Second, programs should measure and report the costs of training, and do so separately from the costs of lending (Rosenberg, Christen, and Helms, 1997; Inter-American Development Bank, 1994). Cost measurement can be painful, but it helps to focus attention on efficiency (Schreiner and Yaron, forthcoming; Von Pischke, 1996).

Third, in an experiment in Paraguay, vouchers promoted innovation and efficiency in the supply of microenterprise training (Schor and Alberti, 1999; Navajas, 1998). Not only did microentrepreneurs receive vouchers to redeem at registered providers of training, but the providers themselves were usually microentrepreneurs. Training was decoupled from loans, the entrepreneurs chose which classes to take and from whom, and the best trainers—as judged by the entrepreneurs themselves—made the highest profits. In essence, vouchers induced a market for microenterprise training, with subsequent incentives for quality, low-cost service.

4. Financial sustainability and social impact

Learning from international experiences requires re-visiting the main arguments and tensions that have animated microfinance discussions. The chief axis on which the issues turn is the trade-off between the pursuit of financial sustainability (that is, a state where profitability no

[22] For example, Bhatt and Tang (2000, p. 28) say that “microenterprise experiences from around the world provide few examples of good lenders being good trainers and vice versa”.

longer constrains permanence) and the pursuit of depth of outreach (that is, effects on poverty alleviation and community empowerment).[23]

This theme, and various responses to the tensions, arise in every chapter of this volume. A fundamental difference stands out between microfinance in the United States and in the Third World. In the Third World, at least some donors and large microfinance organizations espouse a single-minded focus on self-sustainability, and some organizations are self-sustainable, or very close to it (Buckley, chapter 4 in this volume). Many believe that the self-sustainability camp dominates most discussions of microfinance in the Third World. In the United States in contrast, very few (if any) donors or microfinance organizations intend to become self-sustainable soon or even believe that self-sustainability is possible. The discussion instead revolves around appropriate funding strategies and incentive systems to motivate efficiency and innovation—along with large social impacts for large numbers of poor people—without the help of a profit motive.

The tensions between financial sustainability and social impact illustrate a general challenge for the Third Way. The First Way focuses on social concerns, but paid less attention to economic incentives and market forces. The Second Way focused on the market, and paid less attention to the social consequences. The Third Way intends to use market forces to achieve social ends, and to use non-market interventions to enable the poor to succeed in the marketplace. The challenge is to design incentive structures that lead to outcomes that mimic the desired social.

[23] Morduch (2000a) and Schreiner (1999d) discuss the main issues in the debate.

The trade-off in principle. Given a lending or training technology, serving poorer people cost tends to cost than serving than less poor people (Conning, 1998). Even if the poor are more willing to repay loans, they are probably less able. Training is also costlier because poorer people tend to start with less human capital.

As poverty increases, cost increases, and so at some point, the benefit that a poor entrepreneur might derive from microfinance is smaller than the cost. If the poor entrepreneur were the only one who benefited from microfinance, or if society did not care more for the poor than for the non-poor, then the story would end here. Microfinance would be left to private firms, prices would cover costs, and microentrepreneurs would buy services if the benefits exceeded the price.

Microfinance, however, is seen as a possible tool of redistribution, and many would argue that microfinance could be socially worthwhile even without full cost recovery from clients.[24] Microfinance may also lead to positive spillovers. For example, some poor people start businesses so as to set a good example for their children (Sherraden, Sanders, and Sherraden, 1998; Friedman, Grossman, and Sahay, 1995). Likewise, a poor entrepreneur may hire others and thus improve the well-being in the local community. In general, successful business strengthens the neighborhood and the economy as a whole.

In sum, microfinance may have two types of benefits: direct benefits to poor entrepreneurs and indirect benefits that spill over to others. If the cost of the supply of microfinance borne by the poor entrepreneur exceeds the direct benefit to the entrepreneur, however, then she will not buy it, even if the sum of all types of benefits exceeds the cost of

[24] How exactly microfinance can best help the poorest is beyond the scope of this paper. The strengths and weaknesses of the two main paradigms (economic development and poverty

supply. In this case, society (typically via government) may choose to subsidize microfinance to reduce the cost borne by the poor entrepreneur. And, even without spillovers, subsidization can in some cases be justified on efficiency or distributional grounds (Morduch, 1999).

The optimal supply of microfinance requires answers to three questions. First, given that resources are scarce and that funds used for microfinance could benefit the poor in alternative uses, does the sum of the direct and indirect benefits indeed exceed the cost of supply? In answering this question, a second question must be asked: how valuable to society are the benefits that accrue to the poor? Are funds spent cost-effectively relative to alternative social investments? Third, if microfinance is worthwhile, then how can society ensure that the supply is efficient and that programs work hard to experiment to improve quality and reduce costs? As Buckley points out in chapter 4, even if an organization is not sustainable, "it is unquestionably a good idea to always try to use resources as effectively as possible."

Is microfinance worthwhile? Vinelli sums up the issue in chapter 10:

> "The ultimate questions are whether U.S. microfinance organizations in the United States are adequate instruments to leverage the skills and social capital of the poor in order to improve their living conditions, and whether these organizations are cost-effective. . . . The best way to answer the first question is to perform careful impact evaluations using control groups. The only way to answer the second question is to weigh the benefits of microfinance, derived from impact evaluations, against the social costs of supporting microfinance organizations."

To date, among the only explicit comparisons of the benefits and costs of microfinance are Khandker (1998) and Schreiner (1999d, 1999e, and 1997). The measurement of benefits is difficult and so far has left much to be desired (Adams, 1988), but better, more careful

alleviation) are discussed in Mosley and Hulme (1998), Johnson (1998a and 1998b), and Servon (1997).

measurements are not impossible (Morduch, 1999). If society is to allocate public funds well, then the microfinance field must take benefit-cost analysis seriously.

For now, rigorous work has not shown whether private provision works best, nor whether public provision is worthwhile. In the meantime, the assumption is that microfinance in the Third World is often worthwhile, or can soon be made so. In the long term, especially if microfinance remains heavily subsidized, society will require better proof.

Outreach. How many poor people use microfinance in the United States (breadth of outreach), and how poor are they (depth of outreach)? The available numbers are rough, but they suggest that few Americans use microfinance, although many clients (but not all) are poor.

The average number of clients (trainees or borrowers) in the 283 U.S. programs in Langer, Orwick, and Kays (1999) is about 200. The average for the U.S. programs surveyed in Hung (chapter 7 of this volume) is about 110. For comparison, the Grameen Bank of Bangladesh has more than 2 million members, and it competes with other programs operating at a similar scale. In 1996, Bolivia had about 8 million people and 200,000 microfinance clients (La Razón, 1997). U.S. microfinance programs come up far short by this measure.

U.S. programs serve both the poor and the non-poor (Servon, 1999). As a rough rule-of-thumb, loan size decreases as people are poorer, and Hung (chapter 7 of this volume) notes that the average group loan in his sample in the Third World is 30 to 45 percent of per-capita income but only about five percent in the United States. About 91 percent of the U.S. programs in Langer, Orwick, and Kays (1999) “either target low-income individuals or have assisted them directly,” and about half of these programs had some clients on welfare. Four percent of the programs serve only women, and about 40 percent have a client base of more than half women (so about 60 percent have a client base of more than half men). As their top goal, about 44 percent listed job creation/business development, and 29 percent listed poverty alleviation. In one large network, 87 percent of clients were non-white, and 40 percent were women (Himes and Servon, 1998). Among the seven oldest and best-known programs, two-thirds were non-white, and three-fourths were women (Servon, 1997; Clark and Huston, 1993). Bhatt, Tang, and Painter (chapter 9 of this volume) say that programs in their survey "have served a limited number of entrepreneurs, especially those who are low-income individuals. In addition, programs serving the poor have faced high loan-loss risks and transaction costs." Schreiner (1999a, p. 496) also argues that "most poor Americans who use microenterprise programs are not among the poorest. Rather, they have the most assets, the most years of school, the most skills and experience, the strongest support networks, and one or more wage jobs."

Of course, the breadth or depth of outreach does not reveal how much society values outreach. Discussions of the microfinance strategy would improve if assumptions were explicit about how best to trade-off larger, short-term gains for a few very poor people (the poverty-alleviation or relief perspective) against smaller, long-term gains for many less-poor people (the development perspective).

Efficiency and innovation. A program is efficient if it achieves a given goal with as few resources as possible. An innovation either increases what can be done with given resources or reduces the resources required to achieve a given goal.

Von Pischke (chapter 2 of this volume) suggests that the importance of commercialization is the chief lesson from the experience of microfinance in the Third World. The focus on commercialization rests on three assumptions. The first is that a profit motive will generate healthy incentives for efficiency and innovation and thus decrease costs and increase benefits. The second is that available subsidies are too small to provide microfinance to all who might benefit from it. The third is that many microenterprises benefit so much from microfinance that they are willing and able to pay prices that cover the cost of supply.

Do these assumptions hold in the United States? First, the profit motive does promote efficiency and innovation, but government and other donors might be able to provide equivalent incentives if they retract subsidies from microfinance suppliers who do not meet contracted performance goals that force staff to stretch beyond their comfort zones.[25] Also, beyond a handful of lenders in even fewer countries, few microfinance lenders in the Third World are truly profitable as yet. Profitability is probably even more difficult in the United States. Second, because the United States is richer and because the potential market is smaller, it might be able to subsidize all microenterprises, although this does not necessarily mean that it would be worthwhile to do so. That is, subsidization of unprofitable microfinance for a very large share microentrepreneurs simply is not possible in the Third World due to budget constraints (Rosenberg, 1994), even if such subsidized microfinance would be socially optimal; the United States has deeper pockets, so permanent, massive subsidization might not be impossible. Even if U.S. microfinance need not be profitable, measurement of profit (or losses) would still provide useful information (Buckley, chapter 4). Third, although most U.S. microenterprises could probably pay more for microfinance than they do now, higher prices will put microfinance

[25] In practice, government and donors have rarely enforced hard-nosed expectations. Also, the threat of loss of support may not motivate programs that expect to be able to move on to another type of project with other sources of support should microenterprise funds fade.

beyond the reach of some and decrease benefits for all, at least in the short term. In principle, the social benefits of microfinance may justify subsidies (Morduch, 2000a).[26]

Even though the worthwhileness of microfinance in principle may not require financial sustainability, profitability in practice is helpful in many ways. Defaults increase if borrowers believe that a lender is not permanent (and so cannot reward repayment in the present with further loans in the future) or if they believe that the lender will not punish them, as may happen when funds come from government (Bhatt and Tang, forthcoming; Gonzalez-Vega, 1998; Bates, 1995). Thus, permanence and private funds tend to boost repayment rates, and it seems unlikely that microfinance can be worthwhile unless almost all borrowers repay as promised.

In the end, what matters is not whether microfinance programs are run by for-profit firms with private resources motivated by self-interest or by not-for-profit firms with public resources motivated by the public good. What matters is efficiency and innovation and that microfinance makes the best use of scarce resources earmarked to assist the poor. Profitability matters only inasmuch as it affects these considerations.

Profits and depth of outreach. If financial sustainability matters, then it does so as a means to an end, not an end in itself (Schreiner, 1999d; Rhyne, 1998). The profit motive is a common and powerful way—but not the only way—to generate incentives for efficiency and innovation. In the short-term, however, the poor are both more costly to serve and less able to pay, so more profit also means less depth of outreach. As Vinelli (chapter 10 of this volume) points out, a blind focus on financial sustainability can lead to mission drift if a lender seeks

[26] Von Pischke (1991) notes that the market-failure wild-card is dangerous in practice even if correct in principle because it is often played for reasons other than to optimize social well-being.

profit not by working harder to make better, less expensive products but rather by searching for easier-to-serve clients.

Although profits and outreach are in short-term conflict, they may be long-term complements if the profit motive leads to innovations that cut costs (Schreiner, 1999d). Innovation can reduce trade-offs. For example, Ferguson and Haidor in chapter 6 argues that the outreach of microfinance for housing in the United States is constrained by profitability. They foresee that technology—in particular, credit scoring—will allow risk-based pricing to "facilitate non-traditional lending such as micro-loans for progressive housing. At first, U.S. advocates are likely to bemoan the higher rates on smaller loans to low-income families. . . . However, as in developing countries now, these modestly higher rates will be a small price to pay for the greater flexibility these households gain to match their income and changing needs to their housing."

Costs. U.S. microfinance programs have been much more open about costs than their Third World counterparts. Still, discussion is overwhelmingly weighted toward benefits. No U.S. microfinance organization is close to financial sustainability. For example, the seven oldest and best-known lenders spend about $1.50 per $1 disbursed (Edgcomb, Klein, and Clark, 1996). Costs in one large demonstration were about $2,000 per participant (Raheim, 1997), and rough estimates from data in Severens and Kays (1997) and in Langer, Orwick, and Kays (1999) put costs for a large sample of U.S. programs at about $2,000 per client in 1996 and about $1,300 per client in 1997.[27] One lender in Bhatt, Tang, and Painter (chapter 9 of this volume) spent about $3.60 per $1 disbursed, and average ratio of administrative cost per dollar disbursed for 16 Californian programs surveyed by Bhatt, Painter, and Tang (1999) was about 2:1.

[27] Schreiner (1999a) outlines the method used here.

Revenues do not cover these costs. For the lenders in Edgcomb, Klein, and Clark (1996), the ratio of revenue from interest and fees to operating costs was between 3 and 25 percent (reported in Bhatt, Tang, and Painter, chapter 9 of this volume). Likewise, for the most profitable (or least unprofitable) member of the most profit-minded network of U.S. programs, revenue covered 41 percent of operating expenses in 1995 (Bhatt, Tang, and Painter, chapter 9 of this volume).

The lack of profits stems from several factors. One is that program staff are often unwilling to charge interest and fees even below the legal limit (Bhatt, Tang, and Painter, Chapter 9 of this volume). Funders sometimes also cap interest rates (Bhatt and Tang, forthcoming). Programs, the public, and the press also often fail to realize that the "market" rate is a cost-covering rate and that costs differ across markets. Thus, they often believe that the cost-covering rate in the market for large blue-chip borrowers who are inexpensive to serve is the same rate that should apply to the different market of risky microentrepreneurs who are very expensive to serve. For example, Ferguson and Haidor in chapter 6 say that "rates that are substantially above those for large, long-term mortgages to upper-income households often continue to be viewed as unethical and produce bad press." Most lenders in Langer, Orwick, and Kays (1999) report annual interest rates between 10 and 12 percent, and none charge more than 18 percent, less than a typical credit card (computed by Bhatt and Tang, forthcoming).

High wages also contribute. Lending is labor-intensive, and training even more so. The United States, unlike many places in the Third World, lacks a ready supply of unemployed, college-educated people willing to work with the poor for low wages. Inexpensive, high-quality labor is crucial in the cost structure of the best programs in the Third World (Christen *et al.*, 1995; Rhyne and Rotblatt, 1994). Furthermore, U.S. programs are too small to reap economies of scale, and high delinquency drains funds through default and distracts staff from other work.

Perhaps most importantly, few U.S. programs see financial self-sustainability as an important goal (Bhatt and Tang, forthcoming). The likelihood that microfinance in the United States will not be profitable makes careful, credible cost-benefit studies all-the-more important.

Standards beyond sustainability. All the authors in this volume that deal with microfinance for microenterprise agree that profitability is not a reasonable expectation for U.S. programs. Bhatt, Tang, and Painter (chapter 9) say that among the 27 programs in California that they surveyed, "many programs are not sustainable due to operational inefficiencies. . . . These results can be explained by various social and economic circumstances that make it difficult for U.S. programs to apply successful Third World operational methods in reaching large numbers of poor microentrepreneurs at relatively low costs. . . . Policymakers in the United States must understand these unique social and economic conditions."

Vinelli makes a similar argument in chapter 10, saying that "it is unrealistic to expect very high levels of financial sustainability in U.S. microfinance organizations, regardless of the positive impact that these organizations may produce." He is careful to note that "this does not mean that microfinance is doomed to fail. But it does mean that it would be unrealistic and potentially damaging to present microfinance in the United States as a panacea that achieves social improvement at no cost."

Servon (chapter 8 of this volume) also believes that the standards that Von Pischke derives from Third World experience are not appropriate in the United States and have contributed to harmful myths. She says that "some of the focus on credit and the lack of recognition that programs need operating support comes from the confusion between U.S. microenterprise programs and the developing-world models that motivated the U.S. movement."

If the United States has deep pockets and if non-profit incentive structures can motivate efficiency and innovation, then the question of financial sustainability might be moot. But Himes and Servon (1998, p. 7), for example, expect that "the current flurry of interest among policy makers in the microenterprise strategy will not be sustained over the long term." Programs rightly worry about where they will get cash to pay future expenses. Servon reports in chapter 8 that "program directors and field experts across the board expressed the need for greater funds for operating support." In the same vein, 80 percent of programs in Langer, Orwick, and Kays (1999) listed "programmatic sustainability" as a very high priority, and 73 percent also listed diversifying and broadening their funding base as a very high priority.

Many programs are not permanent; Bhatt, Tang, and Painter report in chapter 9 that "more than 30 percent of the microcredit programs that were in operation in California in 1996 were no longer in existence in 1998."

5. Governance structures and appropriate incentives

If standards for U.S. programs should be different, then what should the different standards be? The challenge is to ensure that less-stringent or more-qualitative standards are truly more appropriate, and not merely masks for inefficiency or other weaknesses. Furthermore, even if profitability is unrealistic, programs must still be induced to work hard to be permanent, to maintain high rates of repayment, and to increase quality and decrease costs. In the absence of a profit motive, clear systems of incentives to reach efficiency targets—and credible threats to enforce them—become even more important. Without an assumption of altruism (the First Way) and without self-interested owners with a profit motive (the Second Way), the Third Way must find some mechanism to motivate the employees of donors, governments, and microfinance organizations, all of whom harbor some combination of self-interest and altruism.

As the search for appropriate standards and incentive structures continues, microfinance must continue to balance financial sustainability against social impact, at least in the short term. “Efforts to achieve efficiency should be supplemented with efforts to remain committed to produce valuable impacts in the communities” (Vinelli, chapter 10).

Likewise, Von Pischke states in chapter 2 that “The critical challenge is to get the incentives right in order to combine a sustained commitment to the target group with the quest for profitability. Too much emphasis at the board level on outreach tends to compromise sustainability. Too much emphasis on making money tends to jeopardize outreach and commitment to the target group.” For Von Pischke, the key is owners and/or board members who will somehow balance the two goals properly. The question is then how to design a governance structure that will determine the proper balance and then give owners or board members incentives to achieve it.

Markets are at the heart of the Third Way, but markets are not always kind to those who arrive with few resources. Thus, the Third Way leaves room for public intervention, not to supplant markets but rather to shift their incentive structures so that the self-interested pursuit of the private good will also improve the common good, with a preference for the poor. From bottom to top, the microfinance experience in the Third World suggests that success hinges on close attention to incentives. Microfinance works best when the individual actors involved have a self-interested reason to make it work.

For example, unless borrowers repay their loans as promised, microfinance is little more than a thinly-veiled cash-transfer program—a First Way solution. And although most borrowers who repay their loans probably do so more because they are honest than because they fear the costs of default, incentives that increase the cost of default and/or increase the benefit of repayment can only improve repayment.

Controlling Arrears. The bedrock of the success of microfinance in the Third World has been a web of incentives for borrowers to repay. These include peer pressure from members of joint-liability groups, the threat of repossession on chattel mortgages on household goods such as televisions or appliances, and the promise of future access to loans for those who repay as promised (Armendáriz de Aghion and Morduch, 2000).

Thus, the first step for a microfinance organization is to control arrears (Von Pischke, appendix, this volume), but U.S microfinance has struggled in this area. For example, Bhatt, Tang, and Painter (chapter 9 of this volume) also find loss rates of over 20 percent for four California programs. Likewise, seven of the oldest and best-known U.S. microfinance lenders had a 10-percent average annual loss rate (Edgcomb, Klein, and Clark, 1995). If U.S. microfinance programs cannot devise better incentives to ensure that almost all borrowers pay their debts as promised, they risk losing credibility as a worthwhile development tool.[28]

[28] U.S. microfinance programs have been unusual in their candor about arrears, and although they may have to exert more effort due to their frankness, accurate data is healthy because it creates pressures to find ways to control arrears. For comparison, the Small Business Administration (SBA) in the 1960s and 1970s made microenterprise Economic Opportunity Loans (EOL) to minorities in inner cities. Default rates in Boston, Chicago, and New York exceeded 70 percent, but the program continued because, according to Bates (1997, p. 170), "The SBA successfully covered up the fact, for nearly a decade, that the majority of all EOL loans to minority borrowers ended in default."

Microfinance lenders serve those whom the banks judge as too risky (Servon, 1999). This does not mean, however, blindly accepting high risks; rather, it means working to judge risk better than banks. Much of the challenge of U.S. microfinance is to devise ways to identify poor entrepreneurs whose true risk is overestimated by traditional underwriting techniques. This is a difficult challenge. Microfinance lenders must sort through self-employed people whose risk is highly dependent on their specific business and on their specific human capital and who often have imperfect credit records. Somehow, they must pick out the exceptions, the good risks who, at first look, appear to be bad risks. “Thus it is not surprising that many microcredit programs have a hard time identifying people who failed to qualify for a traditional bank loan, but may be qualified for microloans” (Bhatt, Tang, and Painter, chapter 9).

Encouraging innovation. The search for the required innovations is costly. Employees of microfinance programs are more likely to take time and exert effort if they are systematically rewarded for the search and the discovery of useful innovations. Microfinance lenders in the Third World often place most of the power and responsibility for the control of risk on the shoulders of loan officers and then pay them performance-based incentives (Churchill, 1999). For example, loan officers may get salary bonuses for keeping defaults under a specified percentage of the loan portfolio. The employees of the not-for-profits that run most U.S. microfinance programs may be less willing to participate in such an incentive scheme.

In private firms, the benefits of innovations accrue to the owners, who thus have self-interested reasons to pressure (and reward) employees to improve efficiency and quality. Not-for-profit organizations, in contrast, lack owners with a self-interested reason to pressure (and reward) innovative employees. Government and other donors may or may not make sure that microfinance pushes for constant improvement.[29] Of course, altruistic donors may pressure microfinance programs to improve because they care about the well-being of the target group, or self-interested donors may demand constant improvement because their own benefits and costs are somehow tied to the benefits and costs experienced by the target group. Still, it seems at least possible that the benefits and costs experienced by donors are only loosely connected to the benefits and costs that accrue to the target group.

Thus, the success of U.S. microfinance rests on a chain of incentives—for borrowers to repay as promised, for employees to make sure that borrowers repay as promised, and for programs to reward innovation—that ultimately depend on the incentives faced by donors. Beyond altruism, the incentives for donors depend, at least in the long term, on whether voters and taxpayers believe that support for microfinance is worthwhile. In the short term, self-interested elected officials and bureaucrats want programs that—at least in appearance if not also in fact—have big effects on the lives of people, that hide or diffuse costs, and/or that concentrate benefits on small groups (perhaps poor entrepreneurs, perhaps the employees of microfinance programs). For private donors, the incentives are different but still complex and potentially ambiguous. Although their mandate often explicitly includes the encouragement of innovation, the sanction for failure to fulfill that mandate is not always clear. There are still pressures for quick results, and often pressures to disburse quotas of funds per year. Again, measurement of costs and benefits (and explicitness about what can and cannot be measured) can improve information and thus allow all incentive structures to work better (Schreiner, 1997).

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[29] Von Pischke (Chapter 2 of this volume) says that donors rarely have strong reasons to provide healthy incentives. Servon (Chapter 7 of this volume) quotes a practitioner as saying that "legislators like to have successes and like to have endings." Bates (2000) describes some of the incentives within the U.S. Small Business Administration that stifle attempts to improve efficiency.

6. Savings institutions

A decade ago, this book would likely not have had “microfinance” in the title; instead, it would have been about prospects for “microcredit.” The shift in wording reflects the awareness that the “unbanked” lack access to more than just loans. In the United States, the recognition has meant adding training programs, while in developing countries, it has typically meant an increased focus on the provision of safe and convenient deposit services.[30] Experience in the Third World suggests that, especially for the poorest, saving is at least as important, if not more so, than loans in the effort to help households to accumulate resources. First, if households can generate adequate assets on their own, the need for loans is reduced. The bulk of evidence (*e.g.*, Berger and Udell, 1998, Bates, 1997) suggests that lack of savings constrains the start-up and expansion of small business more than does lack of access to loans. Second, savings provides a buffer against misfortune (*e.g.*, illness, business setbacks, or uninsured property loss). Third, the discipline of building up savings over time can yield important lessons for entrepreneurs. Fourth, funds within households tend to be largely fungible, and focusing just on financing for microenterprises misses much of how households need and use money. Funds earmarked for small businesses, for example, are more likely to be diverted to paying for other expenses when borrowers lack other resources (like savings) to address short-term contingencies.[31]

Still, for the most part, the papers in the volume have focused only on lending and training. Recognizing the place of savings requires questioning long-held assumptions.[32] The

[30] More recently, there has been a groundswell of interest in developing countries in ways to provide life insurance and, more ambitiously, health and property insurance (Brown, 2001).
[31] Buckley (chapter 4 in this volume) points out that movements in the past two centuries that resemble the current microfinance movement started with a heavy emphasis on saving services.
[32] This section draws in large part on Caskey (2000).

first is that poor households are too close to subsistence to save much—monthly expenses exhaust all resources. Evidence from the United States appears to support this conclusion for the subset of 10 to 15 percent of households who have no transaction accounts at any depository institution (the unbanked).[33] When asked why they lacked savings accounts, half of the unbanked respondents in a 1997 study commissioned by the U.S. Treasury indicated that they had insufficient funds (Booz Allen and Hamilton Shugoll Research, 1997).

The demands for financial services of the typical low-income household in the United States differ from those in the Third World. For example, in the United States, low-income households in principle have access to safe, liquid, remunerative deposit services. But in practice, costs and requirements may deter the opening of accounts. The "unbanked" tend to have difficulty maintaining month-to-month balances of around $500, the point at which banks often waive monthly maintenance fees for passbook or checking accounts. Low-balance account holders are also more likely to bounce checks and thus to incur other fees; the $25 to $35 cost of a bounced check can make the cost of the use of conventional bank accounts greater than the cost of check-cashing outlets—and a history of bounced checks greatly reduces the likelihood of eligibility for a checking account in the first place (Caskey, 2000). Wire transfers and payment services (for example, money orders to pay monthly bills) are also relatively more important for the U.S. poor.

Experience in the Third World has shown that the positive correlation between low assets and the lack of bank accounts is due to both factors operating at the same time: households with low assets have trouble maintaining an account, and second, households without access to convenient, flexible accounts have trouble building assets. Rutherford (2000) argues that poor

[33] Dunham, Scheuren, and Willson (1998) place the number of unbanked Americans at 30

households typically have the cash flow to make small, regular deposits that can add up over time to "usefully large" sums of money. In Bangladesh, Rutherford and Rubeya Islam, a housewife in Dhaka who had long experience running informal rotating savings and credit groups, put this idea to work in founding Safe*Save*. Program staff solicit savings from participants daily in their businesses or homes. Depositors may borrow against their deposits for any purpose (not just for microenterprise). Staff visits are feasible because most clients live and work in densely populated slums.

Providing similar door-to-door deposit services in the United States is apt to be too expensive and too insecure. But Caskey (2000) has proposed a potentially workable five-point strategy toward the same end: (1) Banks open low-cost "outlets" that are conveniently-located for lower-income households (for example, in discount stores) and that provide regular banking services as well as fee-based check-cashing, wire transfers, and money orders. These outlets should be small, safe, and friendly, following the seemingly successful model established by the Union Bank of California's "Cash and Save" outlets. (2) The outlets offer accounts with low minimum-balance requirements but no check-writing; instead, low-cost ($0.40 to $0.75 each) money orders are available. Thus, customers can pay bills, but the bank assumes no extra risk from bounced checks. (3) Special accounts, much like traditional "Christmas Club" accounts, are offered to help customers save in small, regular installments. The installments should be timed to coincide with income flows, preferably through direct-deposit arrangements. These special accounts are similar to Individual Development Accounts, which typically aim to help depositors save for medium-term purchases like education or housing and which feature matching funds provided by philanthropic organizations or government. But IDAs can be costly

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million.

(Schreiner *et al*., 2000).[34] The proposed accounts are a cheaper and more flexible complement to IDAs. (4) As with Dhaka's Safe*Save*, quick, deposit-secured emergency loans are available. And (5) partnerships are formed with community organizations to promote the services and provide appropriate training for interested customers.[35]

Creating outlets and developing low-cost, low-requirement savings accounts should be feasible for many banks interested in serving a broader community.[36] This is encouraged by the federal Community Reinvestment Act of 1977, which requires banks to channel a portion of profits into local community development.[37] And the federal Community Development Financial Institutions Fund has so far provided over $300 million to encourage efforts. Pennsylvania and several other states are also providing tax credits, matching funds, and other incentives to spur banks to expand in low-income communities. The result has been a doubling of assets under management of Community Development Financial Institutions since the start of the program, to over $5.5 billion by 2000.

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[34] The U.S. experience with Individual Development Accounts (Sherraden, 1991) suggests that the ability and willingness of the poor to save depends in part on incentives and institutional structures. IDAs are low-cost, low-requirement passbook accounts held by banks but linked to financial education through community not-for-profits. Deposits by the poor (typically those under 200 percent of the federal-poverty guideline) are matched (often at a rate of 2:1) if used to purchase a home, pay for post-secondary education, or finance a microenterprise. Withdrawals for other purposes are possible but are not matched. IDA staff encourage savers to make regular deposits. In a demonstration at 14 sites across the United States, the average IDA participant in an average month deposited about $25, and the average participant made a deposit in 7 out of 12 months (Schreiner *et al.*, 2001).

[35] Fondation, Tufano, and Walker (1999) suggest that church groups might be useful collaborators with banks.

[36] Details here are from Tannenbaum (2000).

[37] Since 1995, banks can get Community Reinvestment Act credit for financial support of microfinance institutions and banks working in low-income communities. Bhatt, Tang, and Painter (chapter 8 in this volume) find that about 23 percent of the funding of microfinance organizations in their survey comes from banks, many of which are seeking to meet their mandated community-development obligations.

Still, there remain substantial barriers to full-service banks in low-income communities in the United States.[38] One is that some state welfare programs have means tests that diminish incentives to accumulate assets (Powers, 1998, and Servon, chapter 8 of this volume), although requirements have been greatly relaxed in the wake of the 1996 welfare reform legislation. Another is that non-profits that wish to offer deposit services would have to operate in partnership with fully-regulated banks, and some donors are uncomfortable with subsidizing a private bank. A third is that potential customers lack experience with and trust in commercial banks—and that commercial banks lack an understanding of the potential market (Caskey, 1994b). None of these barriers seems insurmountable, and expanding access to a full menu of financial services will be a large step forward for low-income communities.

7. The promise of microfinance in the United States

Microfinance embodies much that attracts policymakers and practitioners who work to expand opportunities for low-income Americans. In particular, microfinance offers a way to help low-income clients find new livelihoods while moving away from cash-transfer programs associated with the traditional welfare system. Thus, it fits squarely with the Third Way approach adopted by the United States under Clinton and by Britain, France, and Germany.

In principle, success stories from Asia and South America should be replicable in the United States, and this hope has driven donors and activists. In practice, however, establishing microfinance in the United States has proved difficult. Many of the programs described in the present volume face unexpected costs, find low demand for their services, and fail to reach substantial scale.

[38] Some evidence suggests that many people choose to be unbanked (Doyle, Lopez, and

Among the earliest supporters of U.S. microfinance were Bill Clinton and Hillary Rodham Clinton, but, eight years after promoting the establishment of the Good Faith Fund of Arkansas, Hillary Rodham Clinton (1997, p. ix) equivocates in surveying the recent landscape. She writes:

> . . . given the smaller scale of the self-employment sector in our nation, and the costs associated with providing the technical assistance that businesses need to succeed in our highly competitive market and legal system, microenterprise programs in our country will clearly look different than those in the Third World. And success will be measured differently as well–less in terms of the economic self-sufficiency of microenterprise institutions, and more in terms of the cost-effectiveness of microenterprise as a strategy for reducing poverty and building our economy.

The tempered tone reflects recognition that the goal driving many microfinance advocates in developing countries—achieving the complete financial self-sufficiency of programs—has remained out of reach in the United States. The excitement about financial self-sufficiency is ultimately tied to concern with impacts on poor households in low-income countries. With full financial self-sufficiency, it is argued, programs can untether themselves from donor funding, seek commercial financing, and grow to serve tens of millions more people than would otherwise be possible (Morduch, 2000a).

The strong push to improve financial results in developing countries has led to the neglect of the development of frameworks with which to build microfinance as a cost-effective (but subsidized) poverty-alleviation strategy (Morduch, 1999 and 2000b). This chapter has described some of the required pieces of such a framework. Advocates for microfinance in the United States argue that profitability should not be expected here, but the field has yet to convincingly

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Saidenberg, 1998; Bond and Townsend, 1996).

demonstrate that it can be efficient and can generate social impacts that would justify the costs of on-going subsidization. This critical tension must be faced if the field is to move forward.

Acceptance of the possibility of a greater diversity of approaches (some of which may include ongoing subsidization) is slowly emerging in developing countries, but not quickly enough to provide guidance for U.S. programs. Non-profit programs in the United States will have to take the lead in the development of better ways to provide clear and appropriate incentives to staff and customers. In addition, new ways will have to be found to monitor social and economic impacts in a timely, transparent way. Woller *et al.* (1999) and Schreiner (1999c) show that there is still far to go on this score in the United States, particularly with regard to the use of control groups in making inferences, but there are ample methodological lessons to be learned from evaluations of ongoing experiments with welfare reform, school vouchers, and job-training programs.[39]

There is also need for greater realism with regard to what microfinance can and cannot do (Servon, chapter 8 of this volume). Microfinance will never be *the* solution to U.S. poverty. Bates (1997, p. 207) concludes that "scholarly studies have failed to produce hard evidence that entrepreneurship in the United States today is an effective strategy for bootstrapping one's way out of poverty," and the papers in this volume offer little additional evidence to counter that view. Even if microfinance is effective for those who choose to participate, the size of the microenterprise market in the United States remains very small. Vroman (1997) and Dallinger (1989) suggest that microfinance may help about 1 in 100 displaced workers become self-employed who otherwise would not have, and, according to Schreiner (1999a), the ratio for people on public assistance may be closer to 1 in 1,000. Even with effective, universal microfinance, the most common routes out of poverty will remain acquiring a good wage job and acquiring more human capital.

Greater realism also requires openness to a diversity of approaches to assist low-income households and communities reach their potential. Microfinance may fill important niches in this regard. The microenterprise strategy has generally not been targeted toward the "truly disadvantaged," but it has engaged low-income individuals with motivation, basic education, some relevant business experience, and a support network of family and friends that provides an informal safety net. As Servon (1997, p. 166) concludes: "The programs studied do more to help those who exist at the margins of the mainstream economy than those who are cut off from the economic mainstream." But these are often important groups, and addressing their needs can help reduce the chance that they will slip backward.

For microfinance to make further headway in the United States, it is necessary to push on a number of simultaneous fronts. First, there is a need to look for technological improvements in cost-effectively judging the risk of loans to the self-employed poor. In the Third World, this has been done largely via joint-liability groups and cash-flow analysis for individual loans. In the United States, though, joint-liability groups have had less success, and the use of business plans and coursework as an indirect tool to screen for risks has been inefficient. Potential approaches include credit scoring (Schreiner, 2000b) and the use of landlord references, savings records and escrow accounts, proof of bill payments, and symbolic chattel mortgages (Bhatt, Tang, and Painter, chapter 9 of this volume). Second, there is a need for greater efficiency. This includes ways to streamline training, provide appropriate incentives to staff, and expand marketing. Third, technical standards need to be improved. Many microfinance practitioners have no special

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[39] In an important first step, Servon and Doshna (2000) compare the cost per job of

knowledge or experience in lending. Their energy and willingness to learn on the job have given a critical jump-start to many programs, but mature programs require strengthened financial expertise, management experience, and professional information-management systems. Fourth, methods for timely, transparent, and inexpensive social-impact evaluations need to be developed, and issues surrounding cost-effectiveness have to be confronted regularly and openly. Fifth, partnerships with commercial banks should be explored where possible to create low-cost savings accounts and to provide access to inexpensive wire transfers and money orders.

Given the diversity of contexts, achieving the promise of microfinance in the United States will likely stem from a diversity of approaches. In developing countries, the rush to establish a unified set of "Best Practices" has come with both costs and benefits, and microfinance leaders should take care not to let premature standards dampen innovation. As Vinelli argues, "a 'one-size-fits-all' model discourages experimentation, innovation, and learning, an ironic fate for a movement that grew out of these values" (Vinelli, chapter 10). Von Pischke's recognition of a diversity of approaches in his catalogue of Best Practices (appendix, this volume) is an important step toward expanding conversations. Microfinance can play a role in the continuing struggle to equalize opportunities in the United States, but the current record has been disappointing when viewed in the light of Third World successes. This is still very much a time for experimentation, refinement, and evaluation.

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microenterprise programs with the cost per job of other traditional interventions.

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