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# An exploration of the practice of microfinance and its potential application and resulting implications in the United States

Ryan D. Oestreich

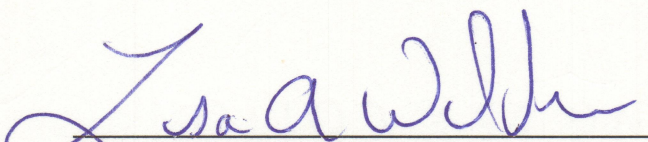
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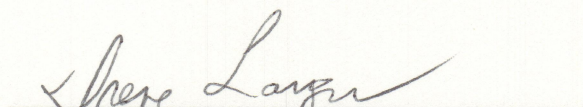
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Lisa A. Wilder, Ph.D.



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David A. Martin, D.A.



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Irene Langran, Ph.D.

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Signature of Author: Ryan D. Oestreich Date: 05.05.2008

Printed Name of Author: Ryan D. Oestreich

Street Address: 1739 Meyer Way

City, State, Zip Code: Jonison, PA 18929

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An Exploration of the Practice of Microfinance and its Potential Application and  
Resulting Implications in the United States

by

Ryan Oestreich

Senior Honors Thesis

Department of Economics and Business

In partial fulfillment of the requirements for the

Bachelor's Degree with Honors

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Microfinance is quite unique in the way that it seems to defy the status quo and question the way that business has traditionally been done around the world. It challenges common perceptions of for-profit businesses as merely profit seeking entities rather than socially minded ventures. It challenges common perceptions of commercial lending practices and the potential to profitably serve people at the bottom of the pyramid. Finally, it challenges common perceptions of the role of business and government in the economic development and security of people with little income. Microfinance, despite its name, has the potential to make a macro-impact in the lives of many people; more than half of the world's population lives on less than \$2 per day, the internationally defined poverty line, making its market potential enormous. How efficient are financial markets if over half of the world's population, including many within the United States, is not served?

The recent turmoil in the economy of the United States was caused in large part by the utilization of inappropriate financial services targeting the poor. Sub-prime mortgages were seen by many as a way for poor individuals and families to afford to buy a home. As rates began to adjust upward on adjustable rate mortgages (ARMs), foreclosures began to increase in number. In August of 2007, the number of residences being foreclosed on rose by 36% over the previous month (Bajaj). Foreclosures for the month totaled 243,947 nationally, or



one in every 510 households. The so called “mortgage meltdown,” created primarily by defaults on sub-prime mortgages, caused a tightening of credit and lending standards and a receding economy. Although the U.S. financial market infrastructure is the envy of much of the world, there are still problems that are difficult for it to deal with, principally the problem of how to profitably and sustainably offer appropriate financial services to people of very limited income.

The microfinance movement began with an economics professor named Dr. Mohammad Yunus in Bangladesh. Dr. Yunus noticed that the traditional commercial banks in Bangladesh would not lend to people of very limited means due to a fear that the loans would not be paid back. Bangladesh, like many developing countries, has a large informal or underground economy within which many families sustain themselves not through traditional employment, but through their hard work and entrepreneurial spirit. Without formal work and a documented income, banks preferred not to serve the impoverished informal economy. Realizing a market opportunity, Dr. Yunus started the Grameen Bank Project in 1976 to investigate the feasibility of offering small loans to entrepreneurs excluded from the commercial banking system. The idea was an immediate success with over 97% repayment of loans and visible social gains.

There is opportunity to replicate the success of the microfinance business model to serve low-income entrepreneurs from anywhere in the world, including



highly developed countries such as the United States. In Section I, I will discuss the current financial system in the United States and its inability to serve individuals of low income, thereby indicating that there is a market within which microfinance can operate. In Section II, I will discuss the potential application of microfinance as a realistic and profitable option for business lending in the United States. In Section III, I will discuss the social gains that can be achieved through successful implementation of microfinance in the United States. I believe there is a market opportunity in the United States in which microfinance can operate profitably while delivering significant financial, political, and social gains.

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## Introduction and Review of Current Literature

Microfinance is a relatively new and vibrant field of study. Although it's relatively new, I would like to acknowledge some existing research that has already been done in the field. A particularly interesting study was done by Ian Callaghan, Henry Gonzalez, Diane Maurice, and Christian Novak of Morgan Stanley. Their work, entitled "Microfinance: On the Road to Capital Markets" was published in the *Journal of Applied Corporate Finance* on March 27, 2007. The authors recognize the need for capital in the process of alleviating poverty. As a major investment bank, Morgan Stanley reflects on the role the bank can play to leverage its strengths with microfinance. Greater utilization of capital markets including the securitization of microfinance loans into tradable securities is the role the authors envision for Morgan Stanley.

Great research has also been done in comparing issues facing the successful implementation of microfinance in the United States as compared to the developing world. Mark Schreiner and Gary Woller published an article in the *World Development* journal entitled "Microenterprise Development Programs in the United States and in the Developing World" in which favorable and unfavorable conditions are compared and analyzed with regard to their affect on microfinance. A noteworthy barrier to success for microfinance in the United States is that, unlike many developing countries, most vital purchases in the



United States are not transacted from microenterprise firms. Additionally, the authors note that the innovation of group lending in developing countries as a mechanism for decreasing the cost of enforcing loan repayment has not been successfully transferable to the United States for four main reasons. First, social capital among low-income households in the United States is weak; Americans tend to be less collective and more individualistic. Second, poor individuals in the U.S. are a much more diverse group and face different struggles making group-based lending difficult. Third, microfinance institutions don't use joint liability loans because it is not culturally acceptable in the United States to assume the debt of a defaulting borrower. Lastly, groups are difficult because, credit is already offered to poor people in the U.S. via credit cards, as long as their credit history is clean. The American sense of independence as well as the country's well developed financial markets, although good qualities, make it necessary to adapt the successful model for microfinance developed in Bangladesh to the unique needs of low-income Americans.

Additional research has been done to come up with a system of ratings for microfinance institutions. Begoña Gutiérrez-Nieto and Carlos Serrano-Cinca published an article entitled, "Factors Explaining the Rating of Microfinance Institutions" in the *Nonprofit and Voluntary Sector Quarterly* in 2007. This system of ratings is similar to the rating system that agencies such as Standard & Poor's,



Moody's and Fitch use to evaluate and rate companies and the risk associated with them. As investors use the company ratings assigned by the previously listed agencies to decide in which company to invest, so too can donors use the microfinance ratings system to decide in which company to donate. Difficulty arises when trying to rate the social impact of these microfinance. Arguably, social goals are a major part of the mission of microfinance institutions and adequate means of measuring the achievement of these goals is important to the ratings process.

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**I. Does the current financial system in the United States leave low income families out of favor with respect to availability of funds?**

The current financial system in the United States leaves many low income families without access to an efficient loanable funds market. Without available access to the commercial lending market, low income families must rely on either loan sharks who charge usurious rates or their own, often negligible, savings with which to make purchases or investments. According to researchers at Morgan Stanley, "what such people would appear to need more than anything is opportunity—opportunity that, as in the case of many businesses, often takes the form of access to capital" (Callaghan 115). In Bangladesh and other developing countries, microfinance is used by banks and lending institutions to make loanable funds available to those low income families who are denied access to funds by traditional financial institutions. The success of the program led many to consider the implications of implementing microfinance programs within developed economies such as that of the United States. Microfinance may offer a profitable and therefore realistic option to open access to financial markets for low income families which may offer them a way out of poverty, away from reliance on social programs, and toward self sufficiency.



Access to the credit market is important because it allows entrepreneurs with limited resources the ability to start a business and earn a living. Businesses often require a large initial investment to purchase the capital required to operate the business. This is commonly called the business's startup or overhead costs. Some business owners are able to finance these initial overhead costs with their own money, known to the business as owner's equity. Financing through owner's equity is important because it symbolizes the owner's financial stake in the business and shows potential future creditors that the owner has a serious commitment to the wellbeing of the business.

Many entrepreneurs look to the Small Business Administration (SBA) as a source for the business's additional capital needs. The SBA was created in 1953 and operates as an independent agency of the federal government. It offers a number of programs aimed at helping small businesses succeed and compete effectively. Recognizing the importance of access to capital, the SBA is a popular source of funds to entrepreneurs. However, its status as a government agency does not mean it has relaxed lending standards.

The high standards that must be met by applicants seeking loans from the SBA prohibit many low income entrepreneurs from being able to access capital. The SBA evaluates loan applications by a criterion which it refers to as the "5 C's of Credit" which are: (1) Capacity, (2) Capital, (3) Collateral, (4) Conditions, and



(5) Character ("The 5 C's of Credit"). Many of these five criteria are extremely difficult for low-income borrowers to meet.

Capacity to repay is of highest importance to the SBA. Three years of financial statements, including business cash flow, balance sheets, and income statements, are requested to help configure reasonable timelines for repayment and to assess the probability of successfully receiving payments. The means to assess this are unfavorable to borrowers with incomplete or inadequate financial information and little or no history of credit, as past payments to creditors are used to predict success with future loan repayments.

Capital refers to the owner's equity investment in the business. As the SBA states, "if you have a significant personal investment in the business you are more likely to do everything in your power to make the business successful" ("The 5 C's of Credit"). The trouble with this for low-income borrowers is that they are expected to already have a large investment in their business. Microentrepreneurs, by definition, have little extra money to invest; they may have only their time to invest, but time is not money when one is poor, so it is not considered capital.

Collateral is considered the second source of loan repayment behind cash flows from the business. According to the SBA, "adequate collateral is required as security on all SBA loans" ("Credit Factors"). In the event that a borrower's



business performs poorly and is unable to meet its debt obligations, the SBA wants a guarantee that it can receive full repayment of their money. Collateral relates directly to capital, if the business owner has a large capital investment in the business, the business is likely to have a large amount of collateral to pledge to guarantee a loan. Without capital, as many microentrepreneurs are, there is little likelihood of having adequate collateral.

The conditions of the loan, such as what it will be used for, are also considered before an application gets approved. Many microentrepreneurs would need to use the loan proceeds to pay for capital required to operate the business, since they lack the funds to purchase such capital on their own. This is a worthwhile use for funds, but indicates the obvious lack of capital within the business. Such factors as economic climate, industry growth, and other factors that affect business success will also be analyzed. The microentrepreneur has a better chance to receive a favorable review in this category than in any of the preceding ones since money is not the main consideration.

The last criterion used by the SBA to review a loan application is the character of the applicant. This is a subjective assessment of whether the applicant is believed to be, according to the SBA, "sufficiently trustworthy to repay the loan" ("The 5 C's of Credit"). The education, job training, and experience in business of the applicant are used to determine character. Whether



a microentrepreneur with little money or collateral is considered sufficiently trustworthy to repay may prove difficult in the eyes of a lender.

Microfinance institutions have more lenient credit requirements than the SBA does. In Bangladesh, microfinance loans were uncollateralized loans, but in the United States there are both collateralized and uncollateralized loans. Collateral is preferable but not required; co-signers or co-borrowers can be used in place of or along with a pledge of collateral. Microloan officers are willing to work with the potential borrowers to negotiate the terms of the loan. ACCIÓN USA posts their business loan application on their website and it is only one page long, front and back. The simplicity of the application facilitates the lending process for potential borrowers.

The application is broken up into seven brief sections, (1) Personal Information, (2) Business Information, (3) Loan Request (maximum \$25,000), (4) Credit History, (5) Financial Information, (6) Collateral, and (7) References. Personal information includes information about the potential borrowers' identity and living situation. Business information is basic including business name, industry and contact information. Boxes are provided to select the quality of the financial records that were kept, ranging from professional records to no records. Unlike the SBA, there is no requirement to keep three years of professional quality financial records. The loan request leaves only one line to



describe the use for the funds. Details are discussed with the loan officers and catered to each borrower's needs. Only two questions are asked of the borrower's credit history, which are whether the borrower is current on home payments and whether the borrower has any tax liens placed on his or her business. The financial information section requests simple monthly figures such as business sales and expenses, personal income and expenses, and the balances and payments made on debt. There are lines at the bottom to pledge collateral and to list references. The application is brief, simple, and allows microentrepreneurs to confidently apply for a loan without the prohibitively demanding and intimidated process of applying to the Small Business Administration. ("Business Loan Application")

In addition to microfinance institutions, the informal economy in the United States may offer assistance in the form of intra-family loans to some borrowers turned away by the SBA, but due to its small scope it will not significantly reduce the demand for microfinance. Friedrich Schneider published a paper for the World Bank entitled "Size and Measurement of the Informal Economy in 110 Countries around the World" in which the informal economies were compared on a country to country and region to region basis. A particularly meaningful statistic that he collected noted that the informal economy in Bangladesh made up 35.6% of the country's gross national product between 1999



and 2000 (Schneider 8). In the United States, the informal economy made up only 8.8% of the gross national product (Schneider 18). The difference is quite striking; the proportional size of the informal economy in Bangladesh was 400% larger than that in the United States. Intra-family loans are part of the informal economy and the United States has the smallest informal economy in the world, significantly limiting the opportunity for intra-family lending to make a major impact.

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## **II. Does the system of microfinance present a profitable and therefore realistic option in the United States?**

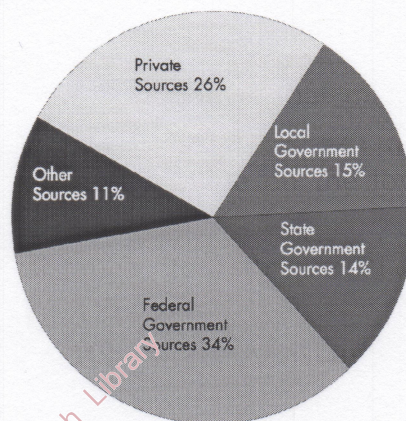
For microfinance to gain acceptance in the United States it is not enough to prove that there is a need and a demand for it; lenders must also believe that they can meet that need profitably. For institutions whose sole purpose is to offer microloans, operating profitably for them would require their entire microfinance operations to make a profit. However, for large diversified financial services firms which serve people with a range of incomes, operating profitably for them would not necessarily require their microfinance operations to make a profit; if they operate successfully to raise the income levels of their borrowers they stand to profit from them in the future by selling them traditional financial services such as savings accounts and investment products. Indeed, many microfinance institutions (MFIs) get some of their funding from large commercial banks who recognize that microentrepreneurs are not un-bankable but rather "pre-bankable" and may represent future bankable clients for them.

Many MFIs in the United States operate as not-for-profit businesses. According to the Inter-American Development Bank, "the introduction of private for-profit institutions will improve the market for microfinance service provision while at the same time making it more competitive" (Luna 8). Unfortunately,



simply changing the registration of an MFI from not-for-profit to for-profit won't actually make the business profitable. The irony of the situation is that many MFIs, like the clients whom they endeavor to serve, can't survive on the low income they generate and require public assistance to survive. For microentrepreneurs, public assistance takes the form of Temporary Assistance to Needy Families (TANF), a federal government funded welfare program. For MFIs, public assistance takes the form of subsidized loans and grants from charitable foundations, commercial banks, and the federal government.

MFIs utilize many different sources of funding to obtain the money they need to operate. According to the Association for Enterprise Opportunity (AEO), the trade association for the microfinance industry, MFIs receive funding from all levels of government, federal, state, and local, in addition to private sources of funding. The largest source of funding for the microfinance industry is the federal government which accounts for thirty-four percent of funding. Many governmental agencies contribute funds for microfinance including the Small Business Administration, the Treasury Department and the U.S. Department of Health & Human Services. The second largest source of funding for the microfinance industry comes from





private sources such as banks, churches, and businesses which account for twenty-six percent of funding. Hewlett Packard and COVAD communications recently made donations in cash, products, and services for MFIs. Funding will likely not last forever, and while it strengthens the ability of MFIs to operate, the mere presence of funding may weaken the resolve of MFIs to improve their efficiency and prevent a reliance on funding. ("Sources of Public Funding" 5)

One of the biggest challenges to the long-term viability of MFIs in the United States is financial self-sufficiency. On this topic, it is impossible not to draw further parallels between MFIs and the low-income individuals whom they serve. It is often stated that welfare recipients have less incentive to find work to provide a steady income stream because they already have a steady income stream from the government. That same income stream is now being made available to MFIs and it may lessen their drive to become self-sufficient. According to a journal article entitled "Making Microcredit Work in the United States: Social, Financial, and Administrative Dimensions" published by Nitin Bhatt and Shui-Yan Tang in *Economic Development Quarterly*, there are three problems that threaten the success of microcredit programs in the United States:

First, most programs do not make enhancing self-sufficiency a priority and therefore remain almost entirely dependent on outside subsidies. Funds for capitalizing microcredit programs are often obtained at concessional rates or, in some cases, acquired as grants from foundations... Second, operating and administrative costs of microcredit programs, especially in terms of staff salaries and basic



infrastructure, are much higher in the United States compared to many developing countries in which such programs are most successful. The administrative expenses associated with running microcredit programs in the United States are much higher, making movements toward financial sustainability challenging... Third, most microcredit programs in the United States do not charge interest rates and fees that can cover their risks and administrative cost structures (Bhatt 234).

The sustainability of MFIs is a major concern for the industry because future funding is uncertain. According to AEO, the Bush Administration has proposed the elimination of the SBA Microloan Program in Fiscal Years 2005 and 2006 as well as the elimination of the SBA Program for Investment in Microentrepreneurs (PRIME) in Fiscal Years 2002 through 2006 ("Sources of Public Funding" 2). Due to diligent advocacy efforts by AEO and recognition of the importance of microfinance by the U.S. Senate Committee on Small Business and Entrepreneurship, the SBA Microloan Program and SBA PRIME have been continued. Perhaps the blessing behind the threat of the elimination of funding is that the microfinance industry will recognize the temporary nature of public assistance to the industry and endeavor to build more efficiency into their operations.

MFIs have made great strides to become increasingly efficient over the past decade and are working toward self-sufficiency. According to ACCION USA, which is the largest MFI in the United States, "the operational efficiency of credit led organizations has... been improving over time" (Burrus 6). In 1998, the



median operational cost, meaning the cost to the MFI to lend \$1, was \$2.33; in 2003 the cost was reduced to \$0.44. This means that lending costs were cut more than 81% over 5 years, an average reduction in lending costs of 12.6% per year.

Even with such improvement in efficiency, MFIs in the United States are still unable to sustain themselves without financial assistance; revenue generated from lending activities is still not sufficient to cover operating costs. According to ACCION USA's President and CEO Bill Burrus, "ACCION New York, the oldest of the ACCION programs, achieved a level of self-sufficiency in 2004 of 63%" (Burrus 11). As of 2007, their level of self-sufficiency has increased to 76%, according to past ACCION Vice President Jordan Pollinger (Pollinger).

Efficiency alone is not enough to guarantee self-sufficiency; the interest rate charged on the loan plays an important role as well. There is much disagreement among MFIs about the appropriate interest rates to charge low-income borrowers. On one hand, low-income borrowers are riskier to lend to and warrant higher interest rates to make up for the possibility of default. On the other hand, some view microfinance loans not as business transactions but more as social transactions to offer assistance to low-income borrowers as a means to escape from poverty, thereby warranting lower interest rates.



### Interest Rates and Fee Structures for 189 U.S. Microcredit Programs

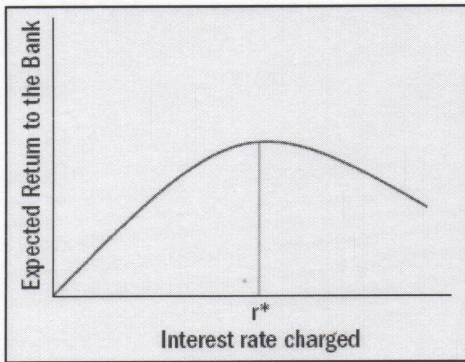
	<i>Mean</i>	<i>Standard Deviation</i>	<i>Minimum</i>	<i>Maximum</i>	<i>Fees (%)</i>		
					<i>Yes</i>	<i>No</i>	<i>Not Reported</i>
Individual lending interest rate ( <i>n</i> = 146)	10.53	2.44	2	18	38.4	48.6	13.0
Group lending interest rate ( <i>n</i> = 43)	12.03	3.19	2	18	34.9	53.5	11.6

SOURCE: Data obtained from Aspen Institute's Self Employment Learning Project and authors' calculations.

As the above table (Bhatt 234) shows, whether a loan is being made to an individual or to a group, the interest rate charged on the typical loan varies greatly. Interest rates for individual and group loans ranged from as low as two percent to as high as eighteen percent, a range of disagreement of sixteen percent. The maximum rate charged of eighteen percent is nine times higher than the minimum rate charged of two percent. This demonstrates the variation and lack of uniformity in the lending habits of the microfinance industry.

The interest rate charged by microfinance institutions directly affects their ability to become self-sufficient. Unusually low interest rates do not permit the lender to recover the costs associated with providing the loan. Unusually high interest rates increase the likelihood that the borrower will be unable to make the loan payments and will be forced to default, affecting the profitability of the lender. The graph on the following page ("Finance for All?" 31), taken from a World Bank publication, demonstrates the delicate balance that exists between the expected return to the bank and the interest rate charged on the loan.





The interest rate charged on the loan also has an effect on the actions of the borrower, known as moral hazard. Moral hazard is a double-edged concept, depending upon whether it is being applied to the borrower or the creditor. When applied to the borrower, it signifies an allocation of capital to projects that will decrease the likelihood of successfully repaying the loan. When applied to the creditor, it signifies the incapability of the lender to prevent such hazardous activities by the borrower. According to the World Bank, "higher interest rates lead to moral hazard, that is, they induce firms to undertake riskier projects with lower probability of success but higher payoffs when successful" ("Finance for All?" 31). Moral hazard reduces social gains by decreasing the profitability of the lender as well as decreasing the likelihood of commercial and financial success by the borrower. Potential jobs from projects funded by companies for which moral hazard is a problem could be eliminated if borrowers and creditors act inappropriately.



### III. Would this system create social gains in the United States? If so, for whom.

If microfinance can be successfully implemented within the United States it has the potential to create substantial social gains for not only those directly involved, but for virtually every citizen of the country. It can fulfill political objectives for both Democrats and Republicans, no easy task in the politically divided landscape that guides the politics of the day. Traditionally, Democrats have spent more money on social programs and safety nets such as welfare programs for those in poverty. On the other side of the aisle, Republicans traditionally support private sector initiatives and the efficiency of the marketplace to solve problems with which they believe the government shouldn't involve itself. David Bornstein makes a similar point in *The Atlantic Monthly*:

Grameen is a political chameleon: it has the ability to affirm beliefs that both conservatives and liberals hold dear. From the right Grameen can be seen as an entrepreneurial institution that makes the case for less government; from the left it appears to be an enlightened social-welfare program that argues for the value of government involvement. Some see Grameen as an example of reinvented government. Muhammad Yunus disagrees. He sees his bank as an example of reinvented capitalism. In fact, he calls it a 'socially conscious capitalist enterprise' (Bornstein 45).

The political landscape in Bangladesh that inspired Bornstein's comments is not dissimilar from the political landscape nowadays in the United States. Being a



"political chameleon," a term that Bornstein used to describe the Grameen bank, may be a key success factor for obtaining federal funding in the United States. Funding for social programs such as microfinance institutions that are included in the Federal Budget must be ratified by a majority in the Senate. It is difficult to get majority approval for social programs that only serve the political objectives of one party. The mass appeal of microfinance within both major political parties is quite important to ensure funding for the program into the future.

A letter to World Bank President Robert Zoellick was recently signed by many members of Congress pressuring him to invest more of the Bank's resources in microfinance. Support for the bill came from not only democrats and republicans, but Independents as well, proving there is support for microfinance in the United States at all points on the political spectrum. "Signers include the leading Democratic presidential candidates Senators Hillary Clinton (D-NY) and Barack Obama (D-IL) and top Republican on the Senate Foreign Relations Committee, Richard Lugar (R-IN)" ("Members of Congress"). Other notable signers include Chuck Schumer (D-NY), Barbara Boxer (D-CA), Orrin Hatch (R-UT), Bob Bennett (R-UT), James Inhofe (R-OK), and Joe Lieberman (I-CT). Currently the World Bank allocates only approximately one percent of its resources to microfinance. The signers of the letter hope to pressure the World



Bank into doubling its current allocation of resources toward microfinance to at least two percent. ("Members of Congress")

The government already funds welfare programs aimed at providing assistance and work opportunities to needy families and individuals, a goal very similar to that of microfinance. The "Personal Responsibility and Work Opportunity Reconciliation Act" was passed by Congress in 1996; with its passage, the Temporary Assistance for Needy Families (TANF) program was founded. TANF put a cap on the amount of time a family could receive federal assistance in an effort to promote work and self-sufficiency rather than reliance on the government for income. A needy family may receive funding for a total of only 60 months, and may not receive funding for more than 24 months successively (United States. Congress. 30).

TANF superseded the previous federal government social welfare programs known as Aid to Families with Dependent Children (AFDC), the Job Opportunities and Basic Skills Training (JOBS) program and the Emergency Assistance (EA) program ("Fact Sheet"). The JOBS program was meant to promote education and job training to assist welfare recipients in attaining employment. From 1988 to 1996 while it was active, welfare recipients were put into one of three groups:

The first was a JOBS program that emphasized the rapid acquisition of employment (the "labor force attachment" approach); the second was a



JOBS program that emphasized longer-term training and education (the "human capital development" approach); and the third was the traditional AFDC (control group) ("Job Opportunities").

The labor force attachment approach put an emphasis on job placement, while the human capital development approach put an emphasis on job training. According to Child Trends, a social science research organization, the human capital development approach produced positive results, especially with regard to the children's cognitive school readiness tests. On the other hand, the labor force attachment approach produced negative results with regard to the children's behavioral outcomes.

Without the JOBS program, there is a void in job training programs that target welfare recipients. Additionally, TANF limits the amount of job training that welfare recipients can personally pursue and use to receive benefits. Under the law, most welfare recipients are limited to a combined six weeks to complete any "job search and job readiness assistance" activities (United States. Congress. 28-29). According to the Association for Enterprise Opportunity (AEO) with regard to the effect of welfare reform on the microfinance industry it claims, "new barriers were put in place, such as time limits on TANF benefits and a strong emphasis on job placement, both of which mitigate against the slow process of learning about and starting a business" (Sources of Public Funding" 7). Forcing rapid job placement may cause high job turnover if workers are not



satisfied with their new jobs or think that with some additional training they could get better jobs. Job turnover and unemployment will cause income fluctuations and may create unstable family environments.

Many microfinance institutions in the United States offer job training either as a prerequisite for getting a loan or as a service to complement a loan. They can help to fill the void in job training that was left unfilled upon the passing of the TANF welfare reform. Many microfinance institutions make loans directly to welfare recipients in an effort to alleviate poverty and promote economic self-sufficiency. In serving the lowest income entrepreneurs in the country by providing access to capital and job training, microfinance institutions can offer an alternative to dependence on the taxpayer financed welfare system.

Successful implementation of microfinance as a widespread tool for economic development can reduce the cost of the TANF welfare program while alleviating poverty and improving economic self-reliance among the poor through business ownership. The Aspen Institute's Microenterprise Welfare to Work (WTW) Learning Assessment conducted a study of the economic impact of microenterprise development. The study measured three parameters: (1) increases in income, (2) progress out of poverty, and (3) business survival. The results of the two-year study found that median household income rose 87% from \$10,114 to 18,952. Average income contributed to the family solely from the



microenterprise was an average of \$8,104. The percent of the participants receiving TANF welfare declined from 94% at the beginning of the study to 25% toward the end. The median household assets of participants increased by \$1,075; this may seem small, but it represents a 253% increase to those low-income families with few assets to their name. As assets build, they may be eligible to apply for a traditional collateralized loan from the Small Business Administration. The number of participants who owned their own businesses increased by more than 76% over the length of the study and the business survival rate was in line with that of small businesses in general. Net worth grew by an average of 34%. Microfinance appears to be a successful and potentially sustainable way to alleviate poverty and increase economic self-reliance as compared to federal welfare programs such as TANF. ("Microenterprise Development" 6)

While TANF assists poor families through temporary income supplements, it is more costly to U.S. taxpayers than microfinance and offers no long-term solution to alleviating poverty. In fiscal year 2007, \$16.5 billion was made available to the TANF program ("Fact Sheet"). According to the CIA World Fact Book, the estimated population of the United States in July of 2007 was 301,139,947 (United States. Central Intelligence Agency). Rounded up to the nearest dollar, that means that the cost of sustaining the TANF welfare program



in 2007 was \$55 per person, or \$275 dollars for a family of 5 people. Federal funding for microfinance programs was much lower. In fiscal year 2007, through the SBA MicroLoan Program \$20 million was made available for lending capital and another \$13 million for technical assistance. Through the SBA's Program for Investment in Microentrepreneurs (PRIME) another \$2 million was made available for technical assistance. Total government funding for microfinance through the SBA in 2007 was \$35 million ("Key Microfinance Development"). Rounded up to the nearest tenth of a cent, that means that the temporary cost of microfinance programs in 2007 was \$0.117 per person, or \$0.585 dollars for a family of 5 people.

Aside from the disparity in costs, a key to the promise of microfinance is that federal funding is temporary. The goal of microlending, as with any lending, is to recover one's costs while collecting interest over the period of the loan. Microlenders have become increasingly sustainable in the United States; many in other countries, such as Compartamos ("Who's Making Money") in Mexico and Grameen in Bangladesh actually make a profit. If microfinance gains wider acceptance in the United States and succeeds in becoming sustainable, the federal government can scale back funding for welfare programs like TANF and put the \$16.5 billion of taxpayers' money to better use.



## **Executive Summary and Concluding Comments**

I believe it is evident from this study that there is a significant market opportunity present in the United States in which to offer formal microfinance services. The Small Business Administration simply does not offer loans that cater to the needs of low-income microentrepreneurs; the process is too complex and it excludes many potentially successful borrowers from applying. Microfinance institutions should capitalize on the gap evident in the Small Business Administration's offerings to build an efficient and effective model to deliver capital to entrepreneurs of limited means.

Self-sufficiency should be the goal of microfinance institutions moving into the future. This can be achieved by consolidating the number of MFIs to allow for economies of scale in operation, because it is typically the largest lenders that are the most efficient. Appropriate interest rates must be charged as well. Microfinance is a socially-conscious business, but it is a business nonetheless. To charge too low or too high a rate is unprofitable. Low rates don't cover the lender's costs of administering a loan and high rates produce the opportunity for moral hazard. Mohammad Yunus commented that, "my own experience has convinced me that microcredit interest rates can be comfortably under the cost of funds plus ten percent, or plus fifteen percent at the most" (Daley-Harris 29). This is important to provide formal uniform lending



standards. The diversity of interest rates being charged, ranging from two percent to eighteen percent, is too inconsistent to be taken seriously.

Politically, microfinance has achieved broad appeal by engaging in socially-conscious development work typically advocated by those on the left of the political spectrum while also encouraging free market solutions and less government involvement as typically advocated by those on the right of the political spectrum. Government funding is still available, although the Bush Administration had endeavored to severely limit it; however, microfinance institutions are becoming increasingly self-sufficient over time and are requiring less and less assistance from donors.

The benefits to society from microfinance are broad and significant. Microfinance offers a ladder for entrepreneurs at the bottom of the pyramid to climb. This development and poverty reduction technique will stimulate business growth as well as limit the amount of taxes to be used for welfare programs provided by the government. This money can be returned to taxpayers, used to pay down the national debt, invested in the country's infrastructure and education, and countless other possibilities.



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