MICROCREDIT: AN INSTITUTIONAL DEVELOPMENT OPPORTUNITY

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Abstract

The development of microcredit programs provides an opportunity to strengthen local institutions. Research has focused on the design and management of microcredit programs without enough attention to the institutional environment in which microcredit programs operate. Theory offers a framework for understanding the importance of linkages between microcredit programs and local institutions. These linkages lead to sustainability. Broadly defined, sustainability refers to a net positive flow of benefits to the local community. Microcredit programs embedded in local institutions have the best hope of becoming sustainable.

Introduction

Microcredit programs provide an opportunity to build sustainable local institutions. While much has been written about the design of microcredit programs and their impact on people's lives, little has been done to place the role of microcredit in an institutional perspective. But there is a body of institutional development theory that can be applied to microcredit (Leonard, 1982; Uphoff, 1986; Esman and Uphoff, 1988; Cernea, 1993; Ostrom, 1993; Howes, 1997). Two theorists, Elinor Ostrom and Norman Uphoff, among others, have contributed substantially to what we know about the role of institutions in effective economic development. Drawing from both economic theory and practical experience, these writers established development policy frameworks useful in designing programs to help the poor. Uphoff examines the advantages of various institutional arrangements in the design of development programs, while Ostrom uses economic concepts to explain the benefits of developing local institutions. While much of the theory has evolved from the study of developing countries, lessons learned apply to microcredit programs in the United States as well.

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The conventional wisdom holds that programs to help the poor should be sustainable. But achieving sustainability is a particularly difficult problem in crafting economic development strategies. Microcredit programs can only evolve into sustainable institutions if they are linked, or partnered with local institutions: churches, post-secondary schools, local governments, credit unions, banks, established nonprofit organizations, service organizations, and job training programs. Microcredit programs operating without linkages to local institutions are less likely to be sustainable.

Just how "sustainability" is to be defined is a knotty problem. Broadly defined, sustainability is in direct opposition to quick fix or ad hoc options addressing a particular problem for a short period of time. All too often, quick fix solutions end up embedded in the lengthy catalog of government programs. Most of us have a pretty good idea of what sustainability is not. Sustainability is not achieved if programs do not meet the needs of the people that they are designed to help. Programs are not sustainable if their costs cannot be met over a long period of time. Without a commitment to maintaining, evaluating, and improving programs, sustainability cannot be achieved.

Sustainable programs are well-designed, in terms of operations and institutional relationships, and allowed sufficient time to demonstrate a positive effect. A great deal of research has focused on the design of microcredit programs. The size of the loan, the interest rate, the term, the use of peer group v. individual loans, to name the most prominent issues, occupy a sizeable portion of the literature (Snow and Buss, Forthcoming). The relationship of microcredit programs to existing institutions as an important variable in achieving sustainability has been neglected.

Sustainable Microcredit

Microcredit programs become sustainable institutions when net benefits to the community exceed total costs. Benefits accrue to the community when new businesses are successful and incomes increase. Microcredit fills a niche that banks do not always fill. Commercial banks are unable to economically administer microcredit programs. Neither are they in the business of training entrepreneurs. Without a credit report and a track record of business success, the poor do not look like good credit risks to commercial lenders. High costs and high risks combine to deter banks from entering the microcredit market. To take up where the market leaves off, microcredit programs generally have two objectives. First, they allow people access to small amounts of capital that would otherwise be inaccessible and, second, they provide a training ground for entrepreneurs, some of whom may expand their businesses to a point where they can utilize commercial sources for working capital.

Microcredit programs must access the appropriate clientele to accomplish their mission. However, outsiders with a desire to help the poor perform no better than commercial bankers. They do not know the local market for microcredit. To develop this information, they will incur both high costs and high risks. But linkages to local institutions can reduce costs and risks for micro-lenders. Except for those too poor to have any connection to local institutions, most of the poor are connected to local institutions in some form, even if it is only through the welfare office.

Local institutional development theory emphasizes the aspirations and know-how of individuals who, ultimately, make up the strength of a nation's economy and political structure. This, in turn, strengthens local communities (Ostrom, 1993). Microcredit sponsors present abundant anecdotal evidence (and some empirical evidence) of their ability to help the poor. What has not been demonstrated empirically is the importance of linkages between microcredit and other institutions in the United States, although there is some literature that deals with programs linking microcredit and local institutions in developing countries (Churchill, 1997; Malhotra and Fidler, 1997; Pederson and Kiiru, 1997). Theories of development stressing strong local institutional capacity predict a strong correlation with sustainability.

The rule for linkages to local institutions is simple: find institutions having comparative advantages (Uphoff, 1986). Institutions meet human needs. The closer the institution to the individual, the stronger its comparative advantage. Local leaders and the peer group of the microcredit clientele, through their relationships in local institutions, can identify the best candidates for microcredit programs. Churches, vocational schools, community colleges, fraternal organizations, service clubs, granges (in rural areas), neighborhood organizations and associations are examples of local institutions with potential comparative advantage.

Sustainable microcredit programs must be embedded in the network of existing local institutions. They will become recognized avenues out of poverty. When a microcredit program becomes sustainable, net social benefits will be positive (Ostrom, Schroeder, and Wynne, 1993: pp. 13-14). That is, operating and capital costs will be exceeded by reduced welfare costs, increased household income, and possible reductions in other, less quantifiable, social costs. This does not necessarily mean that there will be no need for subsidies. A program might become financially sustainable, yet fail to achieve its original goal of reaching the poor. Analysts for the World Bank and USAID, however, tend to stress recovery of costs to achieve financial sustainability as a major microcredit goal (Yaron, 1998; Christen, Rhyne, Vogel, and McKean, 1995). Officially, however, these organizations stress more than just financial viability when they deal with the concept of sustainability. For example, USAID notes that "sustainability mandates the greater involvement of individuals and communities in the decisions that affect their well-being" (USAID's Strategies for Sustainable Development, n.d./1998). ACCION International, a pioneer in microcredit, stresses financial viability as well, but the organization still relies heavily on external support (ACCION, 1997).

Financial viability is not a concept that should be ignored. To the extent that financial viability alone is used as a definition of sustainability, however, one may be led astray from the concept of sustainability and the proper role of microcredit in economic development. It is the overall benefit to individuals and the community as a whole that ought to be taken into account. Sustainability, then, is a concept intertwined with institutional development.

An Institutional View of Microcredit

Uphoff (1986) defines the term *institution* as a "complex of norms and behaviors that persist over time by serving collectively valued purposes." Simply put, people interact with institutions because their needs are met. The identification of institutions that meet poor people's needs is the key to understanding their comparative advantage. *Comparative advantage* is used in a manner consistent with the definition used by economists in trade theory. A nation has comparative advantage when it has the ability to deliver satisfactory goods and services less expensively than other nations. An institution, then, enjoys a comparative advantage when it can deliver satisfactory services less expensively than other institutions.

The primary advantage of local institutions is *time* and *place* information, knowledge about the circumstances and challenges faced by the poor. (Ostrom et. al, 1993). While large organizations such as commercial banks and centrally located government agencies possess expert knowledge in the social and behavioral sciences, they lack a complete understanding of the needs of the poor. Without time and place information, organizations risk program designs that do not meet the needs of those they intend to serve. For microcredit, the risk is an initial flood of capital to high-risk borrowers, resulting in a disincentive to save, high defaults, and program termination. The very people who were to be helped may be harmed (Albee, 1996). But local institutions dealing with poor people possess information that banks and government agencies cannot easily obtain or find too costly to produce. They are able to adapt to the needs of poor people. Some examples follow.

Working Capital

Cambridge, Massachusetts-based Working Capital is utilizing savings clubs brought to the United States by West Indies immigrants as a base for some of its microcredit activities. Club members are already familiar with saving and lending in the club format. The savings clubs, sometimes called Rotating Savings and Credit Associations (ROSCAs), have their origins in African village culture. They are a familiar vehicle for financing a variety of needs: individuals bring savings to weekly meetings and a member receives the weekly savings as a loan. The member repays the loan by bringing the required contribution to each meeting. The right to borrow savings accumulated at each meeting rotates among the ROSCA members. The leader of the ROSCA is a prominent village leader who enjoys social benefits from leading the ROSCA. Individuals are able to rely upon the ROSCA to provide the discipline necessary to make sure their neighbors repay loans (Ardener, 1995). Using the clubs imported to the United States as a base, Working Capital can add entrepreneurial training and infuse capital for business development. Working Capital uses the comparative advantage of the clubs to build new institutions (Jeffrey Ashe, Executive Director, presentation at Suffolk University, February 11, 1998). This has been done in Africa as well. In South Africa, the Get Ahead Fast Foundation utilizes ROSCAs as intermediaries in making loans (Churchill, 1997).(1) The Kenyan Rural Enterprise program also uses ROSCAs as intermediaries (Pederson and Kiiru, 1997).

Working Capital has come to rely on its partnerships for client recruitment (Goldstein-Gelb, 1998). In Boston, Working Capital has a partnership with an existing program established to provide training and education services to female entrepreneurs, the Center for Women and Enterprise (CWE) (Jennifer Bennett, CWE, personal communication, August 20, 1998). Dumas (this issue), describes CWE as a strong institution with ready-made ties to potential female entrepreneurs. The partnership between Working Capital and CWE is a natural. It reduces transaction costs for Working Capital by reducing the risks and time involved in recruiting clients. Since CWE specializes in training, it avoids the costs of starting a microcredit program.

ACCION International

Partnerships exist at ACCION International as well. ACCION, which began operations in Latin America in 1961, now operates its programs in several American cities: Albuquerque, Chicago, El Paso, New York, San Antonio, and San Diego. In El Paso, ACCION partners with several local institutions, including:

- University of Texas at El Paso,
- El Paso Community College,
- Small Business Development Center,
- Small Business Administration,
- Urban Community Services,
- Service Corp of Retired Executives (SCORE),
- Local churches,
- Chambers of Commerce,
- City of El Paso,
- El Paso Association of Banks.

These relationships are both formal and informal (Carmen Contreras, Chairman and CEO, ACCION El Paso, personal communication, 11-24-98). While these institutions are not run by poor people, they are embedded in the local community where services are provided. To the extent that these institutions have already invested in obtaining time and place information, they have the potential to reduce transaction costs for ACCION. The partnerships also create vertical and horizontal linkages in the community. These organizations will help ACCION by providing clients, financial services, marketing, etc. ACCION will help the community by delivering microcredit programs that existing organizations lack the expertise to deliver. For example, ACCION El Paso's office is a satellite location for the Small Business Administration and the Service Corps of Retired Executives. Borrowers, and non-borrowers who pay a fee, may join an ACCION El Paso membership organization and thereby gain access to resources for business management (Burrus and Stearns, 1997).

The Importance of Social Groups

Institutions, using Uphoff's definition, refer to more than formal organizations. To the extent that the criteria of norms, behaviors, and collectively valued purposes apply, kinship and peer groups can serve as institutions. Within ACCION, there is some evidence that the success of programs utilizing the peer group-lending model depends on existing networks of borrowers, people that already know each other. (Himes and Servon, 1998: 51). This suggests that outreach, connecting to at least some markets, can be achieved through the group lending design prevalent in microcredit programs. It also means that the risk of adverse selection – lending to someone who will default – can be reduced. People who already know each other have an advantage in making lending decisions. The peer group reduces transaction costs by acting as a combination credit bureau and collection agency. However, Burrus and Stearns (1997: p. 28) report that creating peer groups in the United States can sometimes be very difficult due to a lack of common institutional ties among potential borrowers. The group model must attempt to create a common bond through adoption of institutional values, but the bond may be fragile. As a result, the group lending model coexists with lending to individuals. For individual loan applicants, personal references are required.

In a 1994 (p. 13) update of an on-going evaluation, the Mott Foundation found that group lending models had lower operating costs and default rates than models using loans to individuals, although borrowers in the peer group programs tend to borrow less. This makes sense because entrepreneurs tend to borrow more than they need. Peer group members may convince them otherwise.(2) Theory tells us that the Mott Foundation's findings make sense. Better decisions can be made because group members have time and place information. They are knowledgeable, or become knowledgeable, about the capabilities of other members. Group members also have an immediate interest in repayment by other group members. The risk of default has been assumed by the peer group institution.

Peer group interaction can also be used to transmit technical information. Group members learn a great deal about the projects that other members undertake. They have first hand information about the area, the person, and the potential for a group member to make an idea pay off. But they do lack business management knowledge and skills. The group is an ideal vehicle for disseminating information. Working Capital has developed a curriculum for entrepreneurial training and distributes it for use within its own peer groups, although some professional supervision is required (Goldstein-Gelb, 1998).

Implications

For Working Capital and ACCION, sustainability is not guaranteed by linkages with institutions possessing comparative advantage, but the potential for sustainability is improved when risk and operating costs are reduced, thus increasing potential net social benefits. A microcredit program that is to be sustainable must utilize or link up with at least some of these institutions. The reverse is also true. Agencies wishing to effect social changes through entrepreneurship development can link up with organizations specializing in microcredit. Welfare to work programs, then, can use microcredit institutions as ready-made vehicles to move people off of welfare. Linkages can be both horizontal and vertical. Horizontal linkages refer to partnerships with organizations at the same level – local or national. Vertical linkages refer to partnerships with organization at different levels, i.e., partnerships and/or contracts with government agencies or foundations.

The Mott Foundation, which has been funding microcredit for over a decade, has recently awarded several grants to help welfare recipients become self-employed and to improve access to markets for microenterprise products (Mott Foundation, 1998). A triad of linkages among the 1) the Mott Foundation, 2) state and local government agencies, and 3) nonprofit organizations is the result.

There are other examples of linkages. In Boston, the federally designated Empowerment Zone (EZ) offers several microcredit programs as a part of an overall strategy to reduce poverty and increase entrepreneurship (Snow, Forthcoming). The Small Business Administration Micro-Loan Demonstration Program, administered by Jewish Vocational Services, and the Boston Local Development Corporation Micro-Loan Program are offered in the EZ through a one-stop capital shop, a place where small businesses can access several loan programs (*Boston Enterprise Community Performance Report 1995-1996*, *Boston, Massachusetts consolidated plan for 1995: Executive Summary*). Microcredit and management training are also provided by Working Capital and the Center for Women's Enterprise. The Service Corps of Retired Executives provides counseling to potential borrowers. In one location, a person wanting to start a microenterprise can be linked to governmental (federal and local), nonprofit, and service organizations. Government sponsored economic development efforts are being implemented through vertical linkages with locally based nonprofit organizations. Local organizations are linked horizontally both through contracts and through the one-stop capital shop.

Other Vertical Linkages

Local institutions can also be strengthened through vertical relationships with other institutions, commercial and nonprofit. While commercial banks are unable to enter the microcredit market directly, they are able to provide some services more efficiently than small nonprofits. Banks can disburse loans and manage accounts. Bank Boston, for example, provides these services to Working Capital. Banks also provide credit lines to microcredit programs. ACCION, for example, utilizes some twenty-eight commercial banks in its U. S. operations. Banks, in this way, can access the poor without incurring high transaction costs. Microcredit programs are the link between commerce and poor people. By acting as suppliers of start-up and working capital to microcredit, banks are also able to demonstrate compliance with the Community Reinvestment Act (Burrus and Stearns, 1997).

Nonprofits capitalized by foundations and banks can provide secondary markets for bundled microcredit loans, thus increasing capital available for lending. Microcredit loans are *packaged* into securities and sold to investors. The proceeds become available for lending. In this way, microcredit lenders do not have to wait for loan repayments to continue to make loans. The investors in the packaged loans become the creditors. ACCION New York recently did this through the nonprofit, Minnesota-based Community Reinvestment Fund (CRF). Loans totaling $272,500 were purchased by CRF and remarketed to investors (CRF, http://www.crfusa.com/about/sellers.html). Social investment funds also provide secondary markets for microcredit loans. These funds are willing to accept lower than market returns. For example, the Calvert Social Investment Fund (CSIF) invests "1% of fund assets at below-market rates in non-profit intermediaries to support microcredit, low-income housing and small enterprise development in the U.S. and overseas" (ACCION, http://www.ACCION.org/world).

Designing Institutional Linkages

Entering a new market is challenging for any organization, nonprofit or for profit. For microcredit, theory provides some guidance as to how entry can be achieved. The level of intervention from outside the locality— effectively the design of programs—is dependent on local capacity to deliver a product or service (Uphoff, 1986). Market entry may occur through assistance, promotion, or facilitation. Where local institutions are strong and possess community linkages, outside intervention may take the form of **assistance**. For example, the Mott Foundation has provided funding to The Northwest Michigan Council of Governments to expand an existing pilot microcredit program that will contribute to economic development and offer a welfare-to-work option (Mott Foundation, 1998). Where local institutions are weak, however, outside intervention may take the form of **promotion**. Nonprofits or government may have to convince the leaders of local institutions to utilize microcredit programs to accomplish their goals. In assistance mode, impetus for intervention may come from the bottom up and simply require some outside technical expertise, or resources, to help locals do what they wish to do. In promotion mode, impetus for intervention comes from the top down. National government officials or NGOs convince locals of the need for a good or service and then help them develop the capacity to deliver it. In either case, it is the work of establishing linkages that is the key to sustainability. In between these two extremes is a facilitation mode where local interest is supplemented by help in developing program models and finding a clientele.

The role played by ACCION International comes close to the **promotion** mode of implementation. ACCION implements new programs by establishing independent affiliates. Following market surveys and capital mobilization, a board of business and community leaders is selected to provide accountability and leadership. Ties to local community groups are also sought. ACCION plays a role in developing an organization that is linked to the community, then allows the new affiliate to operate independently. While ACCION stresses its program model for delivering microcredit in its literature, one should not downplay the importance of early attention to establishing "supportive institutional relationships" in entering new markets (Burrus and Stearns, 1997).

Conclusions

An appropriate vocabulary of development is important to the study of development policies. It will affect the decisions that we make. Take the term "sustainability." To evaluate the sustainability of microcredit appropriately, we must first define the term. Sustainability is not the same thing as financial viability. Few, if any, microcredit programs operate at a level where they do not need donor capital or services. Microcredit programs are not a substitute for capital markets. They are an introduction to capitalism for those who cannot yet access the market. Sustainability is not synonymous with an increase in wealth, either, although that is certainly one of the goals of microcredit. True economic well being kicks in when borrowers graduate to commercial sources of capital. At this point, they are truly independent. Sustainability is about creating institutions that can provide a positive flow of benefits for as long as they are needed. If people are using the program and graduating to commercial sources of credit, then the program is successful, and sustainable. Effectively, the sustainable program will become embedded in the local community. The support of other institutions and the success of its past clients will recommend it. People will use it and benefit.

Through an understanding of comparative institutional advantages, microcredit programs can be integrated into the network of existing and evolving institutions that, together, facilitate the capacity of local communities to develop economically. Institutional theory predicts that strong local relationships will contribute to successful, sustainable programs. Some research appears to indicate that this is so, as well. But far more research is needed. Research, with justification, has focused on the lending side of program design, with some studies examining outcomes for users. Without including institutional relationships in research designs, we are missing a key variable, especially important for those who wish to replicate microcredit programs.

Notes

1. In both cases the microcredit program delegates authority to make lending decisions and collect loan payments to the ROSCA. This is efficient because the ROSCA already has experience in managing loans among its members. Loans from the mocrocredit program, however, must be used for entrepreneurial activities

2. The Mott Foundation research does not indicate whether or not group members had known each other prior to participating in the groups

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