MICROENTERPRISE AND PATHWAYS OUT OF POVERTY

Pursuant to Section 7019(e) of Division K of Public Law 115-141, the Department of State, Foreign Operations, and Related Programs Appropriations Act, 2018, which incorporates, by reference, the requirements of Senate Report 115-152, the U.S. Agency for International Development (USAID) submits this report on microenterprise and pathways out of poverty. The underlying provision in Senate Report 115-152 reads as follows:

Microenterprise and Microfinance. Not later than 120 days after enactment of the Act, the USAID Administrator shall submit a report to the appropriate congressional committees on the extent to which microenterprise and microfinance programs have demonstrated sustainable improvements in the lives of the very poor or of those who are slightly above the poverty level in developing countries. The report shall further address, based on the latest evidence, the most effective approaches to economic empowerment of the poor in order to provide sustainable pathways out of poverty in such countries.

Introduction

USAID has played an integral part in the development of microfinance, which is now a sustainable industry that provides a growing number of financial services to individuals, households, and microenterprises. In 2016 alone, 1,160 formal microfinance institutions (MFIs) served more than 132 million people.[1,2] As MFIs have become largely self-sustaining with capital from deposits from clients, impact investors, and capital markets, USAID has shifted the type of activities it funds to address other constraints to greater financial-inclusion and economic opportunity for the poor and very poor.

Through decades of experience and evaluation, USAID has learned that traditional microfinance is only one piece of a larger puzzle. To alleviate poverty sustainably, additional interventions are required to generate economic growth and create jobs. These include access to a variety of appropriate financial services across all levels, the creation of an enabling environment that fosters the formation and growth of firms, and improved access to knowledge on how to identify and pursue business opportunities. Together, these interventions create an array of economic pathways for individuals as employees of growing firms, as business-owners that provide products and services, or as sole proprietors.

We have also learned that the most-appropriate set of financial services and other interventions differs depending on the target population. For households classified as very poor, savings is the most important financial service, combined with tools and assistance to help smooth incomes when earnings are inconsistent (such as in smallholder farming), and build resilience to keep families from sliding deeper into poverty. Access to credit, however, is most beneficial for firms that are more growth-oriented, such as micro, small and/or medium-sized enterprises (MSMEs). Evidence and experience suggest that USAID can help create jobs and achieve greater development impact by expanding our focus to growing MSMEs.

Evidence on Microenterprise Programs in Improving Lives of the Poor

The very poor live below the international poverty line of $1.90 per day. They typically have few, if any, productive assets, skills, or incomes to sustain a livelihood. Children and families face a greater incidence of malnutrition and insufficient access to clean, potable water. Numeracy and literacy rates are frequently minimal. Under such conditions, even small debts—most frequently used to meet immediate consumption needs—can easily become a significant burden that push a family deeper into poverty.[3] For example, should sustenance crops fail and families take out a loan to purchase food, they will need to apply any income they are able to earn towards repaying the debt, instead of acquiring new seeds that could improve their food security. Access to savings is more important than credit, and social safety nets are critical.

The poor live on approximately $1.91 to $5.50 per day, and become micro-entrepreneurs because they need to make a living when jobs are not available. The vast majority of these "necessity" microenterprises are in sectors with low barriers to entry, high competition, and razor-thin profit-margins. Such microenterprises are very difficult to expand. Examples include selling goods by the roadside, operating a rickshaw, selling trinkets or water to tourists, and selling crops from smallholder farms to traders at the farm gate with little to no market price information. With such low profit-margins, achieving the scale necessary to pay interest rates on loans and increase take-home income is limited. Studies indicate that only 17-38 percent of poor households borrow from an MFI.[4,5,6] For those that do, borrowers often take out loans to protect existing subsistence occupations (such as to procure seeds when crops fail), to meet healthcare needs, and for immediate consumption, rather than to invest in new technologies, productive assets, or hiring labor.[7,8] For these populations, building resilience and preventing a slide deeper into poverty as a result of a shock is critical. Evidence indicates that access to a broader set of financial tools does more to alleviative poverty for both urban and rural poor. MFIs and others have already started to do this by providing more access to savings and insurance-like products to respond to their clients' needs beyond self-employment.

Activities that focus only on direct **microfinance support to microenterprise** have limited impact for two main reasons. First, microenterprises do not operate in isolation. They interact with other firms of varying sizes, both directly and indirectly, and are part of imperfect market systems with more-complicated challenges. Second, because the growth of most microenterprises is limited (*i.e.* those born of necessity), they do not create jobs and alternatives to self-employment. In the developed and developing world alike, when given a choice, most people prefer a job.

The evidence shows alleviating poverty requires sustained economic growth. What we have learned over many decades is that, while providing direct financial services to the poor is important, ultimately we must help the poor gain access to that part of the private sector that leads to increased employment and greater economic opportunity. In emerging markets, **small and medium enterprises (SMEs)**[9] create four and five new positions. It is this growth and job-creation led by SMEs that helps poor and very poor households escape poverty the most.[10] Therefore, a sole focus on microenterprise limits our development impact.

Evidence on Key Approaches used in Microenterprise and Other Programs

The Graduation Approach has been successful in improving the lives of the very poor. It provides multifaceted and concentrated interventions, including direct consumption assistance, life-skills training; access to a savings account; access to health information and care, followed by skills-training around a selected livelihood; and transfer of a related productive asset. One study of evidence from the graduation approach showed increased consumption, income, and savings. The study found that even two years after the programs ended, households saw experienced expanded self-employment activities, diversified out of agriculture and livestock, reduced casual labor, and increased consumption.[11] Only once these populations meet certain criteria and "graduate" are they prepared to benefit from traditional microcredit services.

Community Savings Groups (CSGs)[i] increase financial inclusion for the poor and the very poor. CSGs are a means through which members collect their savings regularly into a communal pool. The group then selects a member capable of generating financial returns to the group to receive a loan from the pool. Basic financial literacy is a significant component of these programs. CSGs provide the poorest and most-remote populations a means to save and borrow smaller amounts than MFIs could affordably offer, because the transaction costs for MFIs to accept such small savings deposits from many individuals can be higher than the value of those deposits. In addition, interest rates for loans through CSGs can be lower than those of MFIs because they are local and based on existing knowledge of peers, whereas MFIs need to pay for loan officers' travel and time to conduct due diligence. CSGs have been successful in building resilience and expanding access to finance at the bottom of the pyramid,[12] and are part of many development programs across technical sectors, including health, education, water, and agriculture.

---

[i] CSGs have many names, including Village Savings and Loan Associations (VSLAs), Rotating Savings and Credit Associations (ROSCAs), and Savings and Credit Cooperatives (SACCOs).

Access to Savings is the most-important financial service for the poor and the very poor. It is the least costly, fosters self-reliance, and provides an entry point to other financial services. It also provides a means to smooth variable-income streams, save for school fees and health expenses, increase spending on children's education, and improve self-discipline and consumption choices when incomes peak. Savings also enhance overall resilience and risk-management.[13]. USAID programs expand access to savings through CSGs, and support regulatory frameworks for MFIs, credit unions, banks and digital platforms to provide these services.

Access to Credit can help poor households address an immediate health need, or acquire appliances and other consumer goods that improve their quality of life (although it can be harmful to the very poor, who benefit the most from access to savings, as previously stated). For women, evidence has found that, in some cases, microfinance has enabled increased bargaining power at home, greater control over financial decisions and assets, and improved self-worth and esteem.[14] Firms that are more ***growth-oriented*** benefit most from increased access to credit.[15,16] Such firms are more likely to use a loan to improve their productivity, and generate revenues significantly beyond the cost of the loan, which results in increased net incomes. For most microenterprises, the potential to generate revenues that greatly exceed the cost of the loan are limited, as is potential to increase incomes considerably.

Digital platforms leverage the broad reach of mobile networks—especially among the rural poor—to form the foundation for an increasing array of digital financial-service offerings from MFIs, banks, telecommunication firms, investment funds, the public (via crowd-sourcing), and others. A growing body of evidence demonstrates that **electronic payment services**, such as cell-phone banking and mobile money, not only make financial transactions more affordable, efficient, and transparent, but also equip individuals—especially women—to be resilient in the face of income shocks, and give them greater control over their financial future.[17,ii] There are also a growing number of social enterprises that provide energy and clean water on a **pay-as-you-go** (or "pay-go") basis through digital payments. Such services can have benefits over user-owned systems because use (and cost) can vary with income—unlike those financed with a loan. Fur thermore, a pay-go model does not shift maintenance burdens to households.

In addition, digital platforms enable individuals and businesses to **save** by offering secure locations to store money, and reduce the costs associated with savings, such as bank fees, the risk of theft, and transit time.[18,19] They are a means through which households can **acquire information**, such as weather forecasts, farming tips, or commodity prices at the central market, so they can better negotiate with traders at harvest time.

Training in financial literacy and skills—including life skills and basic technical and business management skills—are important factors to keep households from sliding backwards in the event of an unforeseen economic shock. Financial-literacy programs include basic numeracy, and instruction on how to use savings, credit and other financial services to manage financial resources effectively to improve financial well-being. Agricultural-extension services are an example of sector-specific technical training that can improve a household's financial stability. Business-management training includes topics such as basic planning and the diversification of livelihoods as a risk-mitigation strategy.

Insurance and insurance-like products, tools, and platforms can ease some of the burdens of poverty, and help build resilience. Traditional microfinance has had some positive impact in this area, but is insufficient to help poor households cope with larger shocks like major natural disasters, which require more substantial safety nets. USAID and others have started to experiment in this area, by building insurance into other products with positive results. Examples include bundling debt insurance into the cost of a loan, so families are not burdened with debt should the primary earner die before repaying, and increasing use of improved seeds by farmers relying on rain-fed agriculture through provision of replacement seeds should the rains be delayed. There are both cultural and commercial viability challenges to providing insurance for the poor in developing countries. Insurance is often an unfamiliar concept; and for families with limited assets in higher-risk occupations (like rain-fed agriculture), the cost-benefit is not obvious—even when the insurance is affordable (which is not often the case).

Another need is for programs that support the development of tools and financial services specifically designed for major disasters—not only at the household and firm levels, but for the MFIs and financial institutions that

---

[ii] Note: narrowing the gender digital divide is fundamental to achieve full impact of these technologies.

support them, often affected by the same disasters that increase the vulnerability of their clients. **Liquidity facilities** and **catastrophic insurance** help to spread risk and speed recovery in the event of a large disaster.[iii]

Economic Empowerment and Sustainable Pathways out of Poverty

The Organization for Economic Co-operation and Development (OECD) defines "economic empowerment" as "the capacity of women and men to participate in, contribute to, and benefit from growth processes in ways that recognize the value of their contributions, respect their dignity and make it possible to negotiate a fairer distribution of the benefits of growth." The evidence we have gathered thus far suggests that economic empowerment requires two fundamental approaches. The first is to increase the resilience of the poor and the very poor by smoothing consumption, increasing their food security, and enabling them to withstand shocks. The second is to generate the sustained economic growth that will enable populations to increase incomes and realize their full potential through access to opportunities and jobs.

Traditional microenterprise and microfinance activities are primarily beneficial to building resilience. Economic growth to reduce poverty sustainably requires change on a more systemic level to foster the open and free markets where women, men, and businesses can make choices and thrive—as consumers, laborers, suppliers, and citizens. At the heart of these markets are the SMEs that not only create much-needed jobs, but also provide the products and services that improve the lives of the poor and the very poor, such as off-grid energy systems; sanitation services; the delivery of clean water, health care, and products; and agricultural inputs. They are the distributors and shop owners who sell sanitary napkins, vaccines, mosquito nets, eyeglasses, bicycles, irrigation systems parts, mobile-phone cards, and soft drinks to customers in remote areas. They are the firms that purchase raw materials and other goods from micro-entrepreneurs and poor households, such as grain mills and exporters of artisanal goods.

In healthy markets, the vendors and multiple companies compete for customers, suppliers and workers, which not only increases the availability of goods and services for the poor, but brings down prices, encourages the development of new products and services that better serve them, and increases incomes. Well-functioning markets that support economic empowerment and create pathways out of poverty require an effective enabling environment for micro-, small-, and medium-enterprises (MSMEs), support for enterprise development, reduced red tape and regulatory burdens on business, and access to finance.[iv] USAID can and does support MSMEs in many ways—both directly and indirectly—to drive economic development and alleviate poverty based on the latest evidence.

Enabling Environment for MSMEs

A healthy enabling environment reduces the cost and time to set up a business and obtain permits, increases the speed of doing business, and reduces transaction costs and barriers of entry into markets.[20] **Property rights and rule of law**—such as for enforcing contracts—are fundamental. In addition, economies need robust **financial markets** and solid **financial-sector infrastructure** to enable the pooling of savings to support productive endeavors. Multiple studies confirm that financial sector development is strongly associated with economic growth.[21] A strong financial sector includes a breadth of available financial actors[v] and instruments; robust regulatory institutions; and reliable systems that enable transactions at low costs. USAID's role in establishing **credit bureaus**, supporting **collateral registries**, and building **payment and trading systems** have been important factors in the development of financial systems in partner countries.[22]

Digital, trade, and e-commerce platforms are newer innovations that have potential to enable more MSMEs in developing countries to reach new markets—including by acquiring equipment and other goods from U.S.-based firms. Examples of USAID-supported activities include: the Association of Southeast Asian Nations (ASEAN) Single-Window initiative, which is enabling trade and trade financing between ASEAN member countries; and the creation of dedicated exchanges for SMEs, such as the Ghana Alternative Market (GAX), to

---

[iii] Examples include catastrophic bonds and USAID programs such as the Indonesia Liquidity Facility After Disaster (ILFAD), which is an example of a multi-prong strategy to build systemic, institutional and household resilience after a major disaster.

[iv] Other elements, such as basic education, health and adequate infrastructure are also critical to developing markets.

[v] Such as banks, credit unions, investment banks, insurance companies, trust companies, brokerage firms, and pension funds

help connect investors to promising companies in emerging markets.[vi]

Enterprise Development

The countries in which USAID works do not have the same level of enterprise-development services as the United States and other developed countries. Incubators and accelerators are nascent, if they exist at all. Few municipal and national governments have programs like those of the U.S. Small Business Administration, with its networks of Small Business Development Centers, Export-Assistance Centers, and Women's Business Centers. Nor do they have programs like those of the U.S. Department of Agriculture, which provides extension, research, and financial services to farmers. These services are not only important for the **technical assistance** they offer regarding how to manage a business, but also for the development of soft skills, such as in communications and negotiations, which are equally critical to success and fostering robust markets.

Firms must be able to obtain and use new technologies, innovate, and access markets and market information to participate fully in local, regional, and/or global economies. USAID has supported enterprise development in many ways. USAID has worked to start, expand, and modernize **extension and advisory services** in presence countries for decades. In addition, the Partnering to Accelerate Entrepreneurship (PACE) program[vii] has supported incubators, accelerators, financiers, and capacity-builders.

Access to Finance

Lack of access to finance is among the top barriers identified to the growth of firms in developing countries, and is particularly acute for MSMEs.[23] However, as companies grow, their financial needs become more sophisticated. Credit is important for working capital (also called operating expenses), as well as for acquiring productive assets (capital expenditures). There is a gap between what friends, family, and MFIs can provide and what banks and other investors are willing to finance, especially for larger and longer term capital expenditures. This gap is known as the "missing middle." USAID employs many approaches to bridge this and other gaps in the financial system, which are critical to achieving economic empowerment.

The Agency also continues to support the expansion of financial services across the spectrum, including by building the capacity and reach of MFIs, banks, and other financial intermediaries to increase access to payment services, savings, credit, and insurance to foster financial inclusion of the poor, as well as finance that builds pathways out of poverty. Guarantees, sector-focused lending toolkits, and digital platforms are some of the techniques used to accomplish these objectives. In addition, USAID utilizes other financial products and techniques, such as revenue-based lending or unsecured credit, supply-chain financing, leasing, trade finance or factoring to help MSMEs smooth cash flows and access credit when things like high collateral requirements and obtaining technologies are barriers to access. Such techniques allow MSMEs to hire additional staff and grow at a faster rate.

Conclusion

Based on the evidence we have gathered thus far on microenterprise and microfinance, USAID is shifting our approach to include interventions that address multiple challenges simultaneously, such as using the Graduation Approach and building inclusive market systems. USAID is confident that greater impacts on poverty alleviation can occur by expanding the focus from only microenterprises to including MSMEs, enabling and leveraging market forces to the greatest extent possible, and reducing regulatory burdens, to create sustainable pathways out of poverty for the poor and very poor.

[vi] Ghana Alternative Market (GAX) https://gse.com.gh/market-product/gax

[vii] https://www.usaid.gov/PACE

ANNEX: EXAMPLES OF MICROENTERPRISE PROGRAMS FUNDED IN FISCAL YEAR 2017

Digital Finance in West Africa. USAID has enabled digital financial services to extend the reach of formal financial services to hard-to-reach communities and the very poor. Technical assistance to the Central Bank of Liberia led to the passage of agent banking regulations in June 2017, which enabled financial institutions to offer services in communities that are distant from bank branches. USAID support helped the Bank of Sierra Leone to launch a regulatory "toolbox" to foster greater investment and innovation in Financial Technology (FinTech) products useful for microenterprises and consumers. USAID also provided technical assistance to four mobile-network operators (MNO) across Liberia and Sierra Leone to improve the quality and liquidity of networks of mobile money agents. Despite significant operational constraints faced by each provider, by the end of the project, each MNO had a customized "toolbox" to put into place best practices for managing agent networks.[viii]

Cacao for Peace in the Republic of Colombia. In Sierra Nevada de Santa Marta, Colombia, an area that has suffered for more than 50 years from conflict and the production and trafficking of narcotics, local and indigenous populations have started the transition to growing cacao as an alternative to coca. However, many lacked the technical knowledge and business strategies to build sustainable cacao farms. In 2016, USAID began a program with the Foreign Agricultural Service of the United States Department of Agriculture to strengthen Colombia's key public and private institutions involved with cooperative research, technical assistance, and extension education in the cacao sector. This project provides access to technical assistance on a regular basis, and began a Bootcamp for trainers in November 2016. The project's 101 participants of varying ages and ethnic communities will help build the foundation for sustainable extension services for cacao as well as contribute to peace in the region.[ix]

Village Savings-and-Loan Associations (VSLAs) in the Federal Democratic Republic of Ethiopia. For many households in Ethiopia, poverty, vulnerability, and food insecurity are the norm. Since 2012, the Pastoralist Area Resilience through Improved Market Expansion (PRIME) Project works to address this challenge with a system-strengthening approach to build human capital, access to markets, and economic resilience in the lowland regions of the country. PRIME helps women and other impoverished people through its VSLAs program, which requires members to regularly contribute savings to the group's pool. The group then selects a member microentrepreneur capable of generating financial returns to receive a loan from the group. PRIME also works with many partners to foster the development of market systems and to build capacity in nutrition and managing livestock and natural resources.[x]

Partnering for Innovation in the People's Republic of Bangladesh. Less than one percent of crops are reaped mechanically in Bangladesh. Reapers are too expensive for smallholder farmers to purchase although they can reduce labor costs in harvesting rice and wheat by 90 percent and on-farm crop losses by 10 percent. As a result of a USAID partnership, The Metal, a mechanized-cultivation company in Bangladesh, works with local microentrepreneurs to lease reapers or provide them on a fee-for-service basis to smallholder farmers. Over an 18-month period, 4,000 smallholder farmers purchased reaping services from these firms and The Metal established six machinery hubs, hired 32 staff, and trained 700 local service providers.[xi]

[viii] The Digital Finance in West Africa activities were part of broader, multiyear agreements: The U.N. Capital Development Fund received $480,000 for Sierra Leone and $342,000 for Liberia; and Strategic Impact Advisors received $1,599,740 for both Sierra Leone and Liberia.

[ix] Cacao for Peace is a joint USAID—USDA five-year program that started in 2016. FY2017 USAID obligations were $47,297.

[x] PRIME is a Cooperative Agreement implemented between 2012 and 2017 with a project budget of $52,972,799 – a portion of which support microenterprise as part of the programs larger Feed the Future objectives.

[xi] The Partnering for Innovation partnership with The Metal was implemented by Fintrac and included USAID support in the amount of $399,953.

ENDNOTES

[1] Convergences. (2007, September 4). *Microfinance Barometer 2017*. Retrieved from Convergences.org: http://www.convergences.org/wp-content/uploads/2017/09/BMF_2017_EN_FINAL.pdf

[2] International Finance Corporation. (2018). *Microfinance*. Retrieved from International Finance Corporation - Financial Institutions: https://www.ifc.org/wps/wcm/connect/Industry_EXT_Content/IFC_External_Corporate_Site/Industries/Financial+Markets/MSME+Finance/Microfinance/

[3] Banerjee, A., Duflo, E., Glennerster, R., & Kinna, C. (2015, January). The miracle of microfinance? Evidence from a randomized evaluation. American Economic Journal: Applied Economics, 7(1), 22-53. Retrieved from https://www.aeaweb.org/articles?id=10.1257/app.20130533.

[4] Banerjee, A., Duflo, E., Glennerster, R., & Kinna, C. (2015, January).

[5] Banerjee, A., Karlan, D., & Zinman, J. (2015, January). Six Randomized Evaluations of Microcredit: Introduction and Further Steps. *American Economic Journal: Applied Economics,* 7(1), 1-21. Retrieved from https://www.aeaweb.org/articles?id=10.1257/app.20140287

[6] Beck, T. (2015). *Microfinance - A Critical Literature Survey.* Independent Evaluation Group. Washington, DC: The World Bank Group. Retrieved from http://documents.worldbank.org/curated/en/588931467993754857/Microfinance-a-critical-literature-survey

[7] Karnani, A. (2007).

[8] Beck, T.

[9] http://www.worldbank.org/en/topic/smefinance

[10] Mueller, B., & Chan, M.-K. (2015). Wage labor, agriculture-based economies, and pathways out of poverty. Washington, DC: United States Agency for International Development. Retrieved from http://pdf.usaid.gov/pdf_docs/PA00KDMT.pdf

[11] Banerjee, A., Duflo, E., Goldberg, N., Karlan, D., Osei, R., Pariente, W., . . . Udry, C. (2015, May 15). A multifaceted program causes lasting progress for the very poor: Evidence from six countries. Science Magazine, 348(6236), 772-789. Retrieved from http://science.sciencemag.org/content/348/6236/1260799

[12] Karnani, A. (2007). Microfinance Misses its Mark. *Stanford Social Innovation Review*, 34-40. Retrieved from https://ssir.org/articles/entry/microfinance_misses_its_mark.

[13] Cull, R., & Morduch, J. (2017, November). Microfinance and Economic Development. Policy Research Working Paper 8252. Washington DC: World Bank Group. Retrieved from http://documents.worldbank.org/curated/en/107171511360386561/Microfinance-and-economic-development

[14] Karnani, A.

[15] Banerjee, A. (2013, August).

[16] Banerjee, A. et. al. (2015, January).

[17] International Bank for Reconstruction and Development. (2016). World Development Report 2016: Digital Dividends. Washington, DC: The World Bank Group. Retrieved from http://www.worldbank.org/en/publication/wdr2016

[18] Ibid

[19] Banerjee, A., Karlan, D., & Zinman, J.

[20] Karlan, D., Lakshmi, Ratan, A., & Zinman, J. (2014, March). Savings by and for the poor: A research review and agenda. The Review of Income and Wealth, 60(1), 36-78. Retrieved from https://www.ncbi.nlm.nih.gov/pmc/articles/PMC4358152/pdf/roiw0060-0036.pdf

[21] Petra Valickova & Tomas Havranek & Roman Horvath, 2013. "Financial Development and Economic Growth: A Meta-Analysis," William Davidson Institute Working Papers Series wp1045, William Davidson Institute at the University of Michigan.

[22] USAID Interviews

[23] Teima, G., Berthaud, A., Bruhn, M., De Castro, O., Joshi, M., Mirmulstein, M., & Onate, A. (2010). Scaling-up SME access to financial services in the developing world. Washington, DC: The World Bank Group. Retrieved from http://documents.worldbank.org/curated/en/669161468140035907/Scaling-up-SME-access-to-financial-services-in-the-developing-world