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Microequity and Microfinance

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Summary. — This paper examines the work of the Village Enterprise Fund, an US nongovernmental organization, in East Africa as a case study in "equity" based microfinance in low-income countries. Many small businesses established in high-income countries rely on some form of equity capital to fund the startup phase and much of the growth of the business. The success of startup grants and equity financing in high-income countries suggests that this method might also be applicable in low-income countries. Using the work of the Village Enterprise Fund as an example, the paper argues that startup grants and equity finance are useful and appropriate in addition to the more common loan-based approaches.

Key words — Africa, Kenya, microfinance, microenterprises, small business, poverty

1. INTRODUCTION

Many scholars have argued that microenterprise development can be an effective means of assisting the poor in developing countries (e.g., Bornstein, 1998; Johnson & Rogaly, 1997, p. 1; Zeller & Sharma, 2000, p. 144). Microenterprises have the potential to create employment, especially given that, in Africa, for example, the agricultural sector has a limited ability to absorb new job seekers (Mead, 1994, p. 1881). Within the past few decades there has been a dramatic increase in the number of programs that provide capital to the poor to start microenterprises. This capital has largely been provided in the form of loans, despite the need for a diverse array of financial services for the poor, including grants. As Eversole (2000, p. 48) notes:

> by continuing to offer only a limited range of microfinancial services, suitable to certain kinds of businesses, we ignore and perhaps even discourage the rich diversity of microenterprise activities.

This paper argues that "microequity" finance, in the form of small business startup grants, may in some cases be preferable to microcredit programs that provide small loans. The concern in this paper is with grants given by a microequity institution to entrepreneurs in developing countries, rather than grant support for the microfinance institutions themselves. [1] Many small businesses established in developed countries rely on some form of equity capital to fund the startup phase and much of the growth of the business. The success of startup grants and equity financing in developed countries suggests that this method of microenterprise finance might also be applicable in developing countries. Microequity is comparable to venture capital in that the decision-making process, about whom to fund, is similar in both cases. Both venture capitalists in the developed world and grant-giving agencies in developing countries aim to target their support to entrepreneurs who are most likely to succeed in business. Unlike venture capital, in which the financier receives a share of the enterprise's profits, "microequity" as used in this paper refers to the provision of grants by external

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agencies to potential entrepreneurs in developing countries, without any expectation of a share in the ownership or profits of the business. Microequity providers seek to increase social equity—the social equity of the local community and its sustainability and independence from continued overseas aid. Social equity is concerned with addressing the gap between rich and poor, reducing social inequality, and promoting security and economic prosperity (Cambridge Sustainable City, 2001). By combining social equity and business, grant-making institutions are a kind of social enterprise (Dunford, 2000).

Most important, grant-based finance may be able to reach the very poor. [2] This paper examines the relative advantages of credit and grant-based approaches, and discusses the example of the Village Enterprise Fund (VEF), an NGO that makes small grants to entrepreneurs in Kenya, Uganda, and Tanzania.

2. MICROENTERPRISES

(a) *What do microenterprises need?*

Microenterprises are firms with fewer than five employees; they are typically unregistered and do not pay taxes. To be successful, microenterprise entrepreneurs must possess managerial skills, knowledge of markets and prices, and the technical ability to create their product. Simple vending businesses require general managerial skills but little technical ability, whereas manufacturing businesses such as furniture making require an additional knowledge of the craft. Furthermore, the entrepreneur must have sufficient capital to finance the startup costs of the business, plus access to additional capital to fund further growth: "it is the lack of capital that most frequently keeps a person from becoming self-employed" (Sonfield & Barbato, 1999, p. 3). Ability and capital are both necessary if the business is to be successful and is to provide an income for the entrepreneur and his or her family.

(b) *Financing microenterprises*

There are several possible sources of capital that the poor can theoretically access to fund a microenterprise. One is *self-financing*. In a self-financed business, the owner saves his or her own earnings or borrows from relatives. This is not always possible, however. The poor, living on a subsistence income, may be unable to save. This is especially true in times of natural disaster or social upheaval, when many people have lost all of their assets. Even among the poor who can afford to save, a lack of savings institutions makes savings difficult (Otero & Rhyne, 1994, p. 28). In his study of microenterprises in Madagascar, Zeller (1994, p. 1896) noted that friends and relatives may provide much short-term capital. This assumes, however, that friends and relatives have money to lend.

A second possible source of capital is local *moneylenders*. The poorest and most vulnerable borrowers often have little or no collateral to put up for a loan; this increases the risk to the lender. For this reason, moneylenders will often refuse to lend to the very poor. For example, Buckley (1997, p. 1084) observed that in Malawi "there was a general feeling that moneylenders would not lend to the poorest members of a community but only to those who could offer some form of surety such as a member of the family with a wage income or a particular asset." Moreover, moneylenders' interest rates are often prohibitively high, making them an undesirable source of credit for many. Sometimes these interest rates can be as high as 20% *per day*.

A third possible source is *commercial banks and other lending institutions*. These are problematic for the very poor. According to Zeller and his colleagues at the International Food Policy Research Institute, "the majority of the poor in developing countries lack access to formal credit" (Zeller, Schrieder, von Braun, & Heidhues, 1997, p. 62). There are three major reasons the poor cannot access formal credit: a scarcity of investment capital in developing countries, the need to be near a bank branch to access services, and the inability of the poor to assume the risk of repayment if the business venture fails. Commercial banking barely penetrates most rural areas (White & Killick, 2001, p. 69). Even if the poor own land, it is often not possible to use it as collateral, because of ambiguous or unrecorded traditional title or because of regulations prohibiting the use of land as collateral (Yaron & Benjamin, 1997). As Hulme and Mosley note in their major work, *Finance Against Poverty*, "the poor cannot afford to take risks, hence they avoid doing so as far as possible" (Hulme & Mosley, 1996, vol. 1, p. 182). Banks and other lending institutions