

# POLICY MEASURES TO PROMOTE THE USE OF MICRO-CREDIT IN EUROPE FOR SOCIAL INCLUSION

## EXECUTIVE SUMMARY<sup>1</sup>

### **"Micro-credit can play a role in social inclusion if the environment is right"**

Socially excluded people often have inadequate access to financial services. Lack of access to finance is an important barrier for people who would like to become self-employed; a barrier that micro-credit aims to overcome. Other related barriers to self employment such as inadequate social participation and/or access to government services and insufficient normative and cultural integration can be addressed through provision of related services: mentoring and coaching, assistance with administrative procedures and regulations, filling of forms, creating access to government institutions<sup>2</sup>, etc.

FACET, EVERS & JUNG and nef did this study on policy measures to promote the use of microcredit as part of the Commission's Community Action Programme on social exclusion. This thematic study has used transnational comparisons to identify and analyse the most effective policy measures in the area of access to microcredit and related combinations of services (training, advices, peer support, networking, saving facilities...) for self-employment or micro enterprise projects of people facing poverty or social exclusion.

This study identifies policy measures that make the environment more "self employment friendly". It seeks to identify bridges and barriers between the social welfare system, employment/enterprise system and financial system that exist, can be abolished or be built.

The countries included in the study are seven Member States (the Czech Republic, France, Germany, Poland, Spain, Sweden and the United Kingdom) and the accession country Romania.

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<sup>1</sup> This is the executive summary of a study conducted in 2004 by FACET BV, nef (the new economics foundation) and EVERS & JUNG for the European Commission DG Employment, Social Affairs and Equal Opportunities unit E/2.

A copy of the full report including a detailed description and analysis of the policies in each of the eight countries can be found on the EU's social inclusion web site at: [http://europa.eu.int/comm/employment\\_social/soc-prot/soc-incl/index\\_en](http://europa.eu.int/comm/employment_social/soc-prot/soc-incl/index_en).

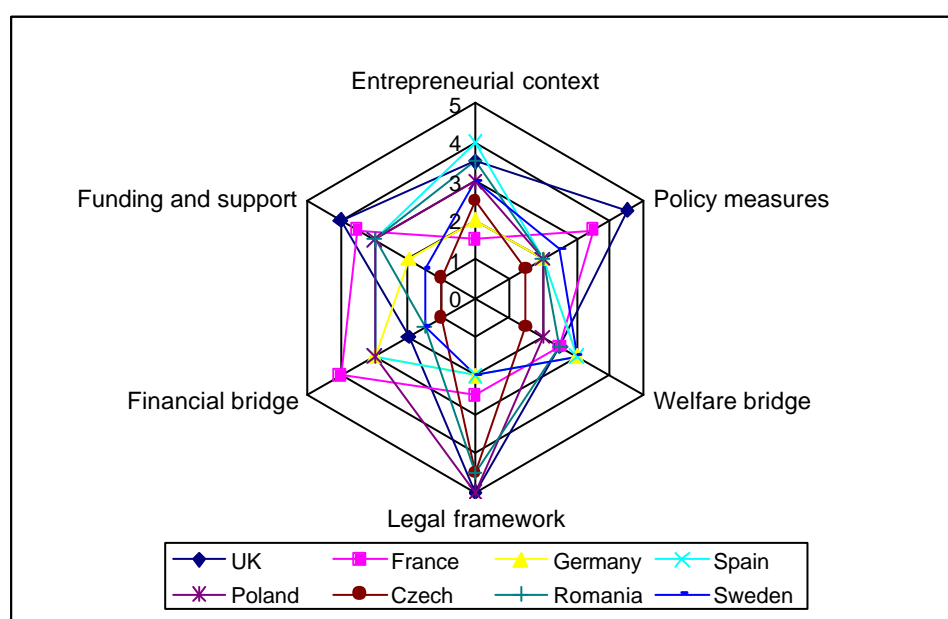
<sup>2</sup> Street(UK), First Step (Irl) and Adie (F) employ "bureaucracy experts" to assist the self employed in developing their activity

The research team did a quick scan in these countries along six factors that determine the extent to which a specific country has a self-employment friendly environment. The key factors identified are:

1. Entrepreneurial context: How entrepreneurial is the society and how much does it support its entrepreneurs?
2. Policy environment for micro-enterprises: Are there policy measures that promote self-employment in general, and for socially excluded in particular?
3. Welfare bridge: How developed is the system for taking people from unemployment to employment (including self employment)?
4. Legal framework for micro-finance: Is there a supportive legal framework for micro-finance services?
5. Financial bridge: Are mainstream financial services available for excluded groups and self-employed?
6. Funding and support for micro-credit providers. Is micro-credit supported through direct and sustained funding?

The study identified a large number of effective or promising policy measures that support social inclusion through self-employment with the help of micro-credit to facilitate this process. There was not one leading country but rather bits and pieces to learn from each of the eight countries studied. The research aims to bring those pieces together for sharing and mutual learning and as a resource for building bridges. Public and private organisations that make the best use of it can build bridges for an increasing number of welfare recipients who want to realise their entrepreneurial ambitions in an increasingly dynamic and inclusive European Union.

The findings for each country were scored, calibrated and presented in a radar diagram. The graph represents the main outcome of the study.



## **Entrepreneurship actively promoted and considered a viable option for a wide range of people**

Ideally, entrepreneurship is viewed as an option for every individual that has the ambition to start his/her own activity. This includes women and men, migrants and residents, young and old alike. This diversity in entrepreneurship is actively promoted through the national curriculum for school children and students and becoming an entrepreneur is an option for all. There is a culture that self-employment is as respectable as wage employment and business failure does not mean the end of an entrepreneurial career.

Policy measures that foster entrepreneurship are:

- Awareness programmes to promote self-employment and entrepreneurship as an alternative for wage employment. Awareness can for example be raised in schools, university and social welfare, tax and employment agencies.
- Reduction of legal, fiscal and administrative barriers related to self-employment: special (favourable) regulation for micro-enterprises, tax and social security holidays, and easy business registration.

Some examples that show how the entrepreneurial context can improve:

1. In Poland, the Czech Republic and the UK entrepreneurship training is an integral part of the school curriculum. In addition, entrepreneurship is being promoted amongst young people through projects with "fictitious companies".
2. In Germany, a new word – the ICH AG ('Me, the public shareholder business') – spread the notion in society at large that self-employment is a viable and valuable option for one's career. As a consequence, the demand for the related support scheme of the employment agency has dramatically increased.
3. In Poland, a loan scheme to university graduates diminishes unemployment for university leavers because the option of entrepreneurship is actively promoted.
4. In France, the regional authorities tested a system with lower VAT for private construction and home & garden services to foster the transition of informal entrepreneurs into the formal economy.
5. In the UK, tax officers were seconded to Street (UK) (a micro-finance institution) to see and interview clients who struggle with the transition from the informal to the formal economy. One of the aims was to change attitudes among tax officials that people working in the informal economy are not 'benefit cheats and tax dodgers' but people who try to make enough money to get by.

## **Micro-enterprise acknowledged as a priority area for social inclusion and supported through appropriate policies**

Ideally, each country would have a variety of public, NGO and private sector initiatives to support the creation and development of micro-enterprises.

Ideally policy measures would promote:

- Business support that is clearly targeted to micro-enterprises.

- Access to finance regardless of loan size and bank history but filtered with criteria around motivation and capacity to repay a loan.
- The development of market-oriented services for the smaller segments of the market.

Policy measures that support micro-enterprises include:

1. A decrease in the compliance requirements and administrative burden for micro start-ups and provision of business advice through flexible Internet and telephone based support desks. Support for one-stop, temporary specialised assistance for creation of micro-enterprises.
2. Loan funds run by specialised NGOs or banks focusing on micro-enterprises. In the past, many funds failed to be revolving. However, better design<sup>3</sup> could increase the success rate of public authority interventions if no other actors are willing to take the lead.
3. A government that highlights the importance of access to financial services and affordable credit as a means of tackling poverty through self-employment. A focus on making the environment for small business more conducive is essential. The combination of research, support for funds and public and private agencies that focus on self-employment and political backing at high level are equally important.

Some examples that show how to improve policy measures that support micro-enterprises:

1. Reduction in administrative procedures and requirements for micro-enterprises like the "plan Dutreil" in France
2. Support programmes for non-financial services delivery to start-ups (mentoring, training). The telephone seems to be a good support instrument for sole traders, start-ups and micro-enterprises. There is one national scheme in the UK ([www.bdl.org.uk](http://www.bdl.org.uk)) and one regional one in Germany ([www.firmenhilfe.org](http://www.firmenhilfe.org))
3. A straightforward referral system for potential micro-entrepreneurs from social welfare, employment and micro-enterprise support organisation.
4. In all European countries initiatives to improve the *E-Government* – government services accessible through the internet – also benefit the (micro) entrepreneurs. One-stop internet sites that assist entrepreneurs in compliance, registration and subsidy requests like available in France are good examples.

### **Welfare benefit recipients move smoothly into self-employment**

An ideal welfare bridge will activate but not force the unemployed to become self-employed (pull rather than push) and offer realistic opportunities combined with support. Potential self-employed people control the timing of their transition and their decision to pursue self-employment.

Ideal policies would:

- Provide financial support during the transition period,

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<sup>3</sup> A list of success factors for the design as interest rates on market level or efficient external selection has been collected in the handbook *Finance for Local Development: New Solutions for Public-Private Action*, London 2001 (Evers, J., Fisher, T., et al).

- Give access to non financial business support services and advice during the transition process,
- Allow gradual steps in matching enterprise income with welfare benefits,
- Have the possibility of a 'nothing to lose' approach and a return into the benefit system with related benefits if the enterprise venture fails,
- Filter the potential candidates to prevent 'free riders' and 'falling riders' to start a business venture without being patronising.

Policy measures that support a smooth transition are:

- Income bridges that give enough time to test the income generating capacity of the activity
- Collaboration between social welfare and employment/enterprise system to monitor closely the individual who moves from benefits to self-employment with smooth transition between different sources of income
- Active labour market policy (incentives to work and penalties for the unwilling) that includes incentives for self-employment and gives equal weight to self-employment as an option out of unemployment
- Awareness programmes and incentives for employment bureaux' staff to offer self-employment as an equal alternative for wage employment flanked with appropriate tools to identify entrepreneurial capability/potential
- Provide "financial and business literacy" courses to social welfare workers
- Support for research in each Member State to understand social exclusion and the people at risk of poverty in view of their possibilities to become self-employed
- Programmes that assist people at risk of poverty to address barriers like inadequate social participation, insufficient cultural and normative integration, material deprivation and lack of social rights as precondition for self employability

Some examples of policy measures that build welfare bridges are:

The most advanced European model is the Irish system where people get income support on a decreasing scale during a period of four years, and there are no barriers or penalties if the person wants to return to the benefit system in the case that the enterprise fails. This transition period allows people to test the income-earning capacity of their enterprise.

Other schemes we found but that are less ideal are:

1. The German Ich AG is good in decreasing support steps (three steps of one year each) but it lacks any kind of filter or combined non-financial support. The design of the scheme still has to be developed to prevent free rider effects but the start is promising for building bridges through transition periods.
2. The UK Government is trying to tackle the disincentives to leave the welfare system through tax credits and test trading periods. However, take-up is low due to poor flexibility. Test-trading period is shorter than in other countries.
3. The French ACCRE system is strong as it can be combined with a support scheme (EDEN) and has been in existence for a long time and is therefore

widely known. The transition period where welfare benefits continue to be paid is limited to six months, up to 12 in exceptional circumstances.

### **The legal framework aims for access to finance for all**

In an ideal world, the European and national regulators would consider “Access to finance for all” a goal that is as important as “Safeguarding the savers’ interests through the supervision of the financial sector”. Apart from mainstream commercial banks, there are legal possibilities for alternative financial institutions whose objectives are to create access to micro-finance for low-income groups and marginalised people.

Policy measures that promote an enabling legislative framework are:

- Specific legislation for micro-lending if a niche is clearly defined and as long as the organisations are not in unfair competition with mainstream financial sector operators
- Reduced capital requirements for micro-credit institutions and adapted to the specific characteristics of micro-credit (by amendment to banking directive to open eyes of national regulators)
- Favourable fiscal status of micro-credit institutions serving specific purposes or groups (tax waivers or incentives)
- Ease possibility to attract (commercial) sources for micro-lending
- Adequate protective private law to prevent indebtedness.

Some examples of policy measures that create a favourable legal framework:

1. The Polish and UK models of bank regulation are both very liberal and therefore pose no obstacles to micro-finance. However, we see the lack of usury regulation as being harmful in the light of consumer protection.
2. This model could be completed with a regulation similar to the German one: The heights of interest rates are limited by a usury law that forbids to charge more than the double of the average interest rate in the sector (real estate, loans, e.g.), or exceed the average interest rate in the sector by 12 percent points or more.
3. The French bank regulation opened a special window to do micro lending. The window is designed to allow micro-lenders to provide the first small (hence most risky and most expensive) credit to a starting entrepreneur on the basis of risk sharing with the mainstream financial sector. This credit provision is not replacing a bank service but on the contrary, prepares potential clients for bank finance.

### **Micro-finance enhances access to mainstream financial institutions**

In an ideal world there would be a variety of financial institutions, each of them effective for its target group and product. The regulatory environment and public authorities’ willingness to support the “Access to finance for all” agenda, makes innovative financial institutions interested in developing products and delivery systems that contribute to social inclusion. Examples of products are bank accounts for the homeless, pension schemes for the poor or micro-loans for enterprise growth or migrant entrepreneurship.

Policy measures that strengthen links between micro-finance organisations and banks are:

- Risk sharing loan instruments (financial bridges) whereby banks can test credit worthiness of self employed client
- Tax incentives for investors (banks) supplying funds to micro-credit retailers
- Outsourcing of activities related to the loan transaction (credit analysis, business plan preparation and analysis, business monitoring,...), to (subsidised) micro-enterprise support organisations
- Sharing of office premises
- Cross-selling of services

Some examples of policy measures that build financial bridges are:

1. The Spanish saving banks have developed special units for micro-finance within the mainstream banks. Caixa la Catalunya has a special not-for-profit unit, La Caixa has specialised loan officers within general branches.
2. The UK Government identified specific ways in which enterprise in deprived areas and access to basic banking services for the socially excluded could be improved. Some of the recommendations have been implemented within mainstream operations (banks offering basic bank accounts), while others have been taken forward by the voluntary sector through the establishment of new institutions (e.g. setting up CDFIs).
3. In the Czech Republic, the EBRD has provided support to the Raiffeisen Bank to develop a product for micro-business.
4. In France the three micro-lenders Fonds Initiative Réseau, Fonds France Active and ADIE have built financial bridges for the self-employed starting from disadvantaged backgrounds. Banks refer clients that they cannot lend to themselves to micro-lenders and at the same time banks take over graduating clients that have repaid in time.
5. In Finland, the micro-lending operation of the public body Finnvera finances micro-clients but hands them over to banks if they have repaid and grown.
6. In Germany, some saving banks have started to co-operate with local not for profit start up support centres to develop and disseminate micro-loans. The central refinance bank, KfW currently develops a good practice manual and window to refinance specific products for such co-operation.

### **Funding for micro-finance is long term and a mix of different instruments**

Ideally the cost of micro-finance will primarily be covered from financial operations. However it must be acknowledged that this is not realistic in Europe. Fragmented demand for micro-loans, the need for additional non recoverable services and interest rate caps set at low levels are just some factors that impede micro-finance providers' ability to become self sustainable. Public sources and grants complement self-generated income on a performance basis to cover costs of specific services to specific clients. The aim of subsidies is to build bridges between the person at risk of social exclusion and mainstream institutions. Once the bridge is built, the subsidy disappears.

Policy measures that promote diversified funding instruments for micro-enterprises and that strengthen partnerships between micro-enterprise support organisations are:

- Tax waivers for investors in start-ups
- Reduction of taxable income for people that provide business support services to start-ups
- Conducive tax regime for donations to activation programmes or financial institutions targeting people at risk of poverty (CDFI's in UK and MFI's elsewhere)
- Promotion of risk capital instruments for micro-enterprises
- Research to deliver recommendations on how governments can best support micro-enterprise support organisations to strengthen efficiency and effectiveness
- Links between micro-enterprise support institutions and social welfare institutions for client referral

Some examples of policy measures that encourage funding and support for micro-finance:

1. Fundusz Mikro, the Polish micro-lender with currently 8,000 active clients, started to be profitable in year three and was fully sustainable in year four. Interest rates are around 20 per cent, default rate is under 5 per cent and a \$20 million interest free donor investment has enabled the organisation to accumulate capital that enables Fundusz Mikro to obtain commercial loans. The donor set clear goals but gave freedom in implementation.
2. The Northern Ireland (UK) micro-lender Aspire has a margin of around 11 per cent between loan loss rate (7 per cent) and interest rate charged (18 per cent) to cover part of the transaction costs. It competes successfully with regional subsidy schemes that provide free funding on the basis of quality services delivery.
3. In France, the micro-lender ADIE's recent agreement with Paribas, an international bank, is an interesting example of private partnerships: Paribas refinances the portfolio for a specific interest rate, it takes over a share of the risk and pays part of the transaction cost through a grant of 10% of the amount lent. Such a finance package encourages efficient and effective lending.
4. Un Sol Mon, a foundation of Caixa Catalunya – Spain's fifth largest bank, founded a micro-lending department to pilot micro-loans for self-employment and inclusion of people without guarantees. In three years the number of loans has increased steadily. The interest rate of 6 per cent (annual) covers by now the loan loss risk (4.6 per cent) and starts to cover a growing share of financial and transaction cost.
5. DMI, a national micro-lenders' association in Germany started in autumn 2004 to pool donor money in a central fund that will refinance MFI portfolios. The centralised refinance scheme will conduct quality controls, through an appraisal and licensing scheme for the micro-lenders.

## Concluding remarks

The European Union aims to make its economy more dynamic and inclusive. In order to do so, it needs to address the joint issues of unemployment and inactivity (people receiving welfare benefits without the option of integrating into the economy). Micro-credit can be a valid tool in facing the poverty alleviation challenge, especially in getting unemployed people out of the welfare system through self-employment and micro enterprise development. Micro-credit can also help to increase poor people's participation in the economic and political processes of society. Collaboration between the welfare systems, the employment agencies, the micro enterprise development services and the financial system is crucial for the success of this strategy. This means a radical shift in approach from simply selling a specific financial product to merging financial products, business support services and the relevant environmental factors into an integrated approach taking into account the reality faced by many disadvantaged groups or persons. Innovative policy measures are needed to break the walls between the welfare system, the employment system and the financial system. The European Commission supports Member States' exchanges and mutual learning in this important field.

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*The contents of this publication do not necessarily reflect the opinion or position of the European Commission, Directorate-General for Employment, Social Affairs and Equal Opportunities.*