

Washington and Lee University

# Microfinance in the Rockbridge Area?

An Exploration of Microfinance's Potential to  
Fight Poverty in the Washington and Lee

Community

Washington and Lee University

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## Introduction

Poverty is real in the Rockbridge Area. A key lacking capability for those at or near the poverty line is sufficient employment. In the current economy, now more than ever, the Rockbridge Area needs jobs. Existing businesses are cutting hours, leaving many underemployed. Homemakers are entering the workforce to combat the falling household incomes, swelling the ranks of the unemployed in this area. The Department of Social Services was approach by 2,000 people in February 2010, for assistance in meeting basics needs. Expansion is far from the mind of local bankers, who describe the current commercial lending market as the worst in 40 years. A business that wanted to start or expand, potentially creating jobs, would have to be rigorously vetted by a bank standard few can meet. The credit deadlock makes organic recovery almost impossible without some kind of intervention.

Could microfinance help the poor in the Rockbridge Area? In developing countries, lending smaller amounts of money to poor entrepreneurs has taken the poverty-reduction community by storm. Microfinance's poster program, the Grameen Bank in Bangladesh won the Nobel Peace Prize in 2007 through its founder, Mohammed Yunas. There is preliminary evidence that providing financing to poor entrepreneurs stimulates the local economy in all the right places so that the area's poverty organically decreases. Due to the appearance of wide banking access, among

other reasons, microfinance has yet to become widespread in the US as an anti-poverty measure.

Whether or not microfinance could efficiently help the poor of the Rockbridge Area is a complex question that begins with the poor. My paper explores the facet of poor citizens from the perspective of laborers. Not all the poor are capable of a normal full-time job, but many poor are stuck in a minimum wage job without a chance for a higher wage. These are the people microfinance could initially help.

A brief description of the Rockbridge Area economy follows, mostly so the reader can flesh out an economic map of the area and understand its strengths and weaknesses. The section on the economy helps explore the underlying question of financing for small businesses. Small business cannot help the poor if they cannot get financing to start and operate. Expanding the credit market is microfinance's niche, but it is only necessary if there is a gap in the current credit market.

The next section explores first-hand the Rockbridge Area credit market through conversations with a few local banks. Bankers outline their individual lending policies, which though different, share a common theme of conservative investments in established businesses. Though brief, the overview shows clearly the lack of a credit market for smaller ventures without a substantial existing supply of human or monetary capital.

Next is outlined a program that is essentially microfinance in the Rockbridge Area—Buena Vista’s microloan program. Though small in size and scope, the impact of this program so far highlights microfinance’s potential and limitations for helping low-skill workers in the Rockbridge Area.

### **Labor Force**

The wage data for the Rockbridge area, provided by the US Census Bureau is sobering. While there are many affluent members of the community, around 30% make less than \$15,000 in annual wages and an additional 47% make between \$15,000 and \$40,000 in annual wages.<sup>1</sup> The roughly 3200 people that make less than \$15,000 in wages should be of great concern. While some might have additional benefits, such as health insurance, these benefits cannot be large for essentially a minimum wage job. According to the Census Bureau’s 2008 CPS data, 72.5% of Virginia residents making less than \$15,000 a year do not have private health insurance.<sup>2</sup> Furthermore, most minimum wage employers do not offer benefits, from Blue Sky Bakery, which cannot afford them, to Wal-Mart, which does not provide a particularly affordable plan.<sup>3</sup> Mike Clark at Rockbridge Bank estimated that 75% of workers in the area work for an hourly wage, suggesting that many of these low wage workers are expectedly hourly employees.<sup>4</sup> Caron & Martin (2009) provided the current definitive research the magnitude of

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<sup>1</sup> US Census data,

<sup>2</sup> <http://www.census.gov/cgi-bin/broker>

<sup>3</sup> Harlan Beckley (personal communication, March 2010)

<sup>4</sup> Michael Clark (personal communication, February 2010)

poverty in the Rockbridge area, and I do not aim to recount their results in much detail. Suffice it to say, poverty is real in this area some of which is due to the low-paying jobs held by roughly one third of the local population.

The most basic economic wage function would intimate that these 3200 workers are low-skill workers, who do not possess the motivation or skills to make a higher wage. According to Jean Dunbar, who runs a construction business along with her husband, low skill labor is a real problem in this area. “My husband has been frustrated time and time again by not being able to find people who want to work hard and get ahead in the construction business,” she said.<sup>5</sup> Though Ms. Dunbar’s opinion is anecdotal, she does make an important point. Slackers and unmotivated workers will always deserve a low wage, and there is undoubtedly a contingent of the low-wage workforce who is not motivated to make a way for themselves. There is no way of knowing how many workers are “deserving” of this low wage and I do not focus my analysis on them. Rather, my focus is on the many low-wage workers that are willing to work hard but lack the skills or opportunity to earn a higher wage.

### *Literacy*

The more pressing concern is those who lack the skills needed to earn a higher wage, namely literacy. In Ms. Dunbar’s experience, illiteracy is sizeable problem in the Rockbridge Area workforce that hinders the health of the economy and the well-being

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<sup>5</sup> Jean Dunbar (personal communication, March 2010)

of the community. The National Center for Education Statistics (NCES) provides estimates of basic prose literary skills (BPLS) by county throughout the US as recent as 2003. In Virginia as a whole, 12% of adults lack basic literacy skills, certainly leaving room for statewide improvement. Lexington (10%) Buena Vista (13%) and Rockbridge County (13%) do not seem particularly far from the norm, until the sample size is considered. There is enough data for the State of Virginia to place the 95% confidence interval of illiteracy between 10 and 15 percent. The confidence interval for the Rockbridge Area, due to a smaller sample size, is between 5 and 20 percent, suggesting the problem of illiteracy could be much worse than average. Furthermore, the NCES data is based off estimates by statisticians, not by a full research study of literacy in the Rockbridge Area. Ultimately, statistics on literacy suggest that illiteracy is common (1 in 10 residents) at best, and could be a very serious problem.

### *Education*

A related method of estimating workers' skills is educational attainment, which signals to employers and researchers a worker's skill. Rockbridge County, in which the Social Science Data Analysis Network (SSDAN) includes Lexington and Buena Vista, greatly improved its educational attainment from 1990 to 2000, the data of the most recent census data (see chart below).

### Educational Attainment in Population 25 Years and Over, 1990-2000

	1990		2000	
	Number	Percent of Total	Number	Percent of Total
<b>Total Population Age 25+</b>	12,404	100.00%	14,556	100.00%
<b>Less than 9th grade</b>	2,589	20.87%	2,149	14.76%
<b>Some high school, no diploma</b>	2,109	17.00%	2,078	14.28%
<b>High school graduate*</b>	4,047	32.63%	4,708	32.34%
<b>Some college, no degree</b>	1,544	12.45%	2,261	15.53%
<b>Associate degree</b>	515	4.15%	638	4.38%
<b>Bachelor's degree</b>	837	6.75%	1,486	10.21%
<b>Graduate or professional degree</b>	763	6.15%	1,236	8.49%

The sobering side of the story is the large and persistent number of relatively uneducated residents in the Rockbridge Area. Roughly 30% of the population has less than a high school education and half of that number (15%) has less than a 9<sup>th</sup> grade education. Furthermore, in the modern economy, often a high school education alone is not enough to command a high-skill wage. To the extent that this is true, up to 60% of the Rockbridge Area population could be considered low-skilled. It is important to note that the 2008 data that estimates wage earners is different from the 2000 Census numbers that estimate total residents of the Rockbridge area. While there is no data

comparing the wage level to education level in the Rockbridge area, from a theoretical perspective there is little question many of the low-wage workers are also low-skilled.

### *Skill Sets among the Low-Skilled*

Lack of hard skills among the low-skilled is a persistent problem in the Rockbridge Area. Meredith Downey, head of the Rockbridge Department of Social Services described the under-employed as lacking hard skills. “Skills are lacking in our area: we need training for electricians, plumbers, and HVAC technicians,” she said.<sup>6</sup> Those with at least a high school education are typically able to take these classes, but there is little formal training for these practical skills in the Rockbridge Area. What Ms. Downey does see are women with training in cosmetology or a six-week course to be a nursing assistant. Neither of these jobs pays particularly well, but they are the options currently open to an underemployed worker looking to develop hard skills.

The regional Workforce Investment Board, which covers the Shenandoah Valley from Winchester to Roanoke, received a \$5 million grant to create green jobs. The grant, which comes under the most recent economic stimulus package is set to provide “green” training for 1000 workers and eventually provide 800 “green” jobs. An obvious barrier, according to Ms Downey, is the current lack of a “green” industry in this area, adding layers of complication to the job creation process. I was concerned that this training might end up helping the richer poor—those who have more education already

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<sup>6</sup> Meredith Downey (personal communication March 2010)



but are having trouble making ends meet in a tough economy. Ms Downey agreed this was a concern, but said that “If they [the minimum wage workers] were able to get the training, they’d be able to benefit from these new jobs.”<sup>7</sup> While she is right about the training opening doors, whether or not the poorest of the poor will actually benefit is an open question. More research is necessary into the potential for green jobs in the Rockbridge Area and the supporting services, such as loans, that these businesses might need.

### **Economy of the Rockbridge Area**

Based on my anecdotal research, the Rockbridge Area economy can be described in the following way: a rural community with a bit of manufacturing that happens to have three colleges in the center. The universities skew the cultural and monetary inequality of the area, creating a unique twist on the typical rural community.

Without Washington and Lee, VMI, and Southern Virginia, Lexington and the Rockbridge area would be rural homes with a manufacturing presence. Occasionally a few tourists might pass through, but by and large the community would be rather provincial. Buena Vista, as it is currently, would be the typical town of the area: small, with older buildings and locally owned stores. Real estate prices throughout the county would probably be lower, translating to lower cost of living.

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<sup>7</sup> Ibid

The universities add a unique element to the economy that is unusual for rural Western Virginia. The approximately 4,000 students bring the need for additional seasonal services and add outside money to the economy. More importantly, the professors, administrators, and affluent students introduce a set of demand tastes and preferences. A Buena Vista, blue-collar type town would never have a street full of upscale restaurants and boutiques. This cultural inequality adds an additional demand for services. To be blunt, there are restaurants for the affluent and for the blue-collar. Each socio-economic class really does have its own service sector, from hotels, to laundry mats, to grocery stores. The affluence is able to support more cultural events, such as Lime Kiln, which adds to the appeal for retirees. Lexington offers a unique appeal of a small town with enough wealth to embrace its historical roots that has enough of the right services for a semi-wealthy retiree. As a result, the Rockbridge area has more than its fair share of retirees, who increase the demand for real estate, driving up the average price.

This real estate appreciation in turn appears to attract outside investors, who look to Rockbridge area real estate as an investment source. The result is, according to one member of the downtown Lexington business community, much of downtown Lexington is owned by out-of-towners. Local businesses are forced to lease and even if successful can rarely buy the “profitable lease” from the owner at an affordable price. I visited the commissioner of revenue's office to see if I could find any evidence for this

claim. When I explained that I was looking for a way to research the number of non-resident commercial property owners in Lexington, a worker assured me there was no way. "All we have is the information on the deed. We have no way of knowing if the holding companies are local or out-of-town because almost all of them have an out-of-town address, even if the owner is local."<sup>8</sup> The most conservative conclusion is that there is at least one absentee commercial property owner and no one should be surprised if there are more.

Assuming their presence on some level, absentee owners bring two negative shocks to the Rockbridge Economy. A significant part of the cash generated by local businesses immediately enters an envelope destined for another part of the country. Even as business profit on paper, only a portion of it can be injected back into the local economy. Secondly, business owners relegated to leasing have difficulty generating equity in their business. Mike runs Blue Sky Bakery, one of the busier lunch spots in Lexington, yet he has trouble building equity in his business. "All I have are the clients and the sign," he said. Selling his business without an actual building would greatly reduce its price on the open market, hurting his chances of eventually exiting comfortably.<sup>9</sup>

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<sup>8</sup> Anonymous worker at the Lexington Commissioner of Revenue (personal communication April 2010)

<sup>9</sup> Mike (personal communication, February 2010)

The data from the US Census Bureau paints a less vivid picture of the Rockbridge economy, but provides much evidence to support what the naked eye conjectures. There are about 11,200 jobs reported throughout this area, with the highest job concentrations in the Lexington and Glasgow. Chart 2, (available in the appendix), breaks down these jobs by industry.

The size and nature of the industries are not a real surprise given what one observes driving through the area. The largest sectors are Education, Manufacturing, Food Services, and Retail Trade. Perhaps the most surprising is that the Agriculture sector only provided the area with 74 jobs in 2008, dismissing the idea of Rockbridge as a farming community with a few colleges. Interestingly, Meredith Downey was skeptical of these low agricultural numbers when I discussed them with her. She felt that agriculture was a main source of minimum wage jobs in the area, though she did not have any hard data.<sup>10</sup> One possibility is that many agricultural positions are unreported, explaining the low reported job numbers and high apparent agricultural employment. Whether these apparent uncounted farm laborers are a result of bad data or the informal economy is impossible to discern. Rather, future researchers should be aware the existing data does not tell the area's complete economic story.

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<sup>10</sup> Meredith Downey (personal communication, February 2010)

It should be noted that both the number of jobs and the numbers employed by each industry are relatively inelastic from year to year. The local economy does not appear to be growing or shrinking in terms of workers or businesses.

### *Low Wage Employers*

Low-wage employers are the section of the economy that connects most directly with low-wage workers. There is no good data on which companies provide minimum wage jobs. Meredith Downy, head of the Rockbridge Department of Social Services did think that many of them were locally owned. Her off-the-cuff list of low-wage employers included motels, restaurants like Burger King or McDonalds, and lumber yards. Obviously, the handful of national supermarket chains like Wal-Mart and Kroger form their own category of low-wage employers. She also pointed out that construction work, while technically not a low-wage job is seasonal, drastically lowering the average yearly wage.<sup>11</sup> The Horse Center also provides jobs that are not necessarily minimum wage, but are also seasonal.

The central issue for this paper surrounding the labor force is the relationship between small businesses and low-wage, low-skill employees. If small businesses are an efficient way to provide low-skill workers quality jobs, these businesses should be heartily pursued for the area's economic development.

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<sup>11</sup> ibid

There is some evidence that the current low-wage employers are local businesses. Meredith Downey observes that many of the low-wage employers in the area are locally owned franchises.<sup>12</sup> Fast-food restaurants are usually franchised, meaning a local owner has some oversight over the operations and treatment of employees. Motels also are often franchised to a local owner, who in turn hires a housekeeping and maintenance staff.

These local businesses are usually not the small businesses that microfinance-type programs try to help, so I do not include them in my final analysis. Medium-sized local businesses, integral to the Rockbridge Area, have different needs. They are often large enough to have access to commercial lenders and can pursue financing through traditional means. More importantly low-wage, low-skill labor needs a different reaction from established medium-sized businesses—the opportunity to eventually make a higher wage. The logistics behind this policy are beyond the scope of this paper, which focuses on the potential of microfinance to help small businesses provide good jobs to low-skill workers.

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<sup>12</sup> Ibid

## **The Role of Banks**

My research focuses on the commercial lending policies of banks for the following reason: commercial lending provides liquidity and capital for the local businesses that drive the Rockbridge Area economy. Encouraging the growth of local businesses is a key component to economic health—local businesses create local jobs for residents, bringing wages into the community. Additionally if the business is locally owned, the profits stay in the Rockbridge Area.

All businesses need some kind of capital and many need loans of some kind. Credit is the lifeblood of many businesses. If a business has access to a favorable line of credit, it is able to weather hard times and profit from good economic times. If a small business cannot easily get a loan from a bank—from professional lenders—it will have a hard time surviving and growing. While there are other important components of the Rockbridge economy and the roles of banks, this paper focuses on small business lending—the American equivalent to microfinance.

## **Lending Policies**

Before judging or applauding local banks' attitudes towards small businesses and entrepreneurs, it is essential to understand the goal and duties of a commercial banker. A commercial banker wants to lend money. The more money he lends *and is paid back* the more profitable he and the bank will be. Banks make their profits from interest rates on loans and fees. Bankers want to lend to business they believe will

successfully repay the loan and they work hard with qualified clients to tailor suitable loans.

In the Rockbridge area, in the current economy, there is an overwhelming emphasis on being paid back. Banks put all potential clients and their businesses through a rigorous background check to find answers to the many unknowns of a loan: macroeconomic factors, local economy, and business plan to name a few. The three local banks I interviewed described the following criteria as standard for assessing the risk of potential business clients.

#### *Experience*

The borrower's experience using the loan, from flipping homes to opening a restaurant, plays an integral role in determining risk. Wachovia looks for 1-2 years of experience in the specific line of work requiring the loan before lending to small businesses.<sup>13</sup> While perhaps not having a hard and fast rule, other banks certainly take a potential borrower's experience into a consideration. A more experienced business person with a verifiable track record almost always reduces loan risk by reducing the unknowns in a loan.

#### *Business Plan*

No matter how much experience a potential borrower has, banks will not consider lending without an adequate business plan. Banks want to see the goals and

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<sup>13</sup> Randy Shomo (personal communication, February 2010)



expectations of potential clients in the business plan. The quality of the plan also indicates the seriousness and practicality of the business owner's mentality in approaching the venture. Whether the potential client is a start-up or an existing business, the local banks want to see a clear plan for how the debt is going to further the generally sensible overall goal of the business.

### *Cash Flow*

Wachovia, one of the more active lenders in Lexington, swears by cash flow as benchmark for measuring a loan's risk. Borrowers must demonstrate either by previous financial statements or through a thorough business plan, their ability to generate enough cash to repay the loan on time. Adequate cash flow essentially ensures the bank will not have to foreclose, or go through any other messy methods of recovering its investment. According to Joe Boatwright, cash flow, or ability to repay, has become the gold standard for banks in the current economic downturn. He said "It used to be that if you were making a \$100,000 loan to someone and they had \$1,000,000 in the bank you'd loan to them on the spot. Now the banks care about whether or not you have the cash flow—the ability to pay the loan back from some kind of income."<sup>14</sup> Wachovia is a prime example of this shift. They used to be fine with taking real estate, for example, as collateral. If the borrower defaulted, they'd have the property to sell to recoup their

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<sup>14</sup> Joe Boatwright (personal communication, March 2010)

loss. Today, Wachovia has no interest in potentially getting a farm in Natural Bridge.

They want to get their money back and not have to deal with any sort of hassle.<sup>15</sup>

### *Collateral*

While cash flow has recently risen to prominence as a precursor to getting a loan, collateral-based lending is still alive in Rockbridge. Carter Bank and Trust, for example, a small bank in southern Virginia and North Carolina prefers to lend based on real estate. Kathy Cummins, the Assistant Vice President, says Carter feels comfortable making collateral loans based on real estate because they have always done it that way. She quickly added that they would never make a loan simply because enough real estate was posted. They would have to believe the loan was actually a good idea.<sup>16</sup> Her response illustrates the typical—and proper attitude—toward all these lending requirements. The requirements are important, but the loan will not be made unless the loan officer is confident it will be repaid.

### *Personal Finances*

The financial analysis done by the lender is not limited to the businesses current assets and past record. Banks also judge the applicant's personal credit score and credit history to determine his or her trustworthiness to receive a small business loan. A bad credit score often flags a potential borrower as an unnecessary risk. Rockbridge Bank collects data from potential borrowers on their personal finances: physical assets, debts,

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<sup>15</sup> Randy Shomo (personal communication, February 2010)

<sup>16</sup> Kathy Cummins (personal communication, February 2010)

savings, and so on. Furthermore, almost all lenders require a personal guarantee. The borrower must contract to pay the loan out of his or her own pocket if the business cannot. Randy Shomo explained this policy best. "If a business owner doesn't trust his idea enough to put his own bank account on the line, why should I trust his idea?"

### **The Lending Gap: The Potential for Microfinance**

Since the Rockbridge Area is relatively small, the banks have a somewhat paradoxical attitude to lending. On the one hand, citizens look to them to provide all types of banking services and loans so they must be willing to provide almost kind of financial service. On the other hand, the banks will often have one or two officers to

handle all these different services, making these vice presidents quite literally a jack of all trades and a master of none. These bankers are very aware of the limits of their expertise and often, self-consciously or not, gravitate toward a certain kind of loan.

Carter Bank and Trust, for example, focuses on commercial real estate loans, while Mike Clark at Rockbridge Bank is even more specific, targeting commercial real estate loans in excess of \$1 million.<sup>17</sup>

All of the banks speak of small loans as anything less than \$250,000 and none of them target these loans. While they are willing to lend less than \$250,000, there are two barriers. It is not profit maximizing to seek out smaller loans. Most loans require relatively the same amount of time and resources to assess the risk, irrelevant of size.

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<sup>17</sup> Michael Clark (personal communication, March 2010)

Since interest and fees are based on percentages of the total loan amount, bigger loans bring the banks more profit. In order to fulfill their responsibilities to banks and their shareholders, loan officers in the little time they have to seek out clients, must seek out the bigger potential loans.

As a result, there is more of an incentive to develop an expertise with bigger loans, increasing the efficiency of the market for loans in excess of \$250,000. Thus, as with most market failures, the root of local entrepreneurs' difficulty getting loans comes from imperfect information. Banks do not have enough expertise in sole proprietorships and start-ups, making loan officers feel less comfortable assessing their risk. Wachovia is more than willing to make small loans to qualified start ups, but Randy Shomo said he would certainly tap into the expertise of another banker. "We're a small bank and I handle everything from mortgages to retirement planning. I just don't have the expertise needed to assess a start-up. I'd bring in one of my colleagues from Roanoke to help judge the risk."<sup>18</sup> SunTrust would follow a similar pattern of outsourcing the expertise because they do not have an in house commercial loan officer, but work with potential clients through one of their larger branches in another location.

The way all banks almost always hedge the risk of smaller loans (<\$250,000) to small businesses is through the programs of the Small Business Administration and the USDA's Business and Industry Program for Rural Areas. Both organizations will

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<sup>18</sup> Randy Shomo (personal communication, February 2010)

guarantee a loan for a qualified business, contracting to pay back the lion's share of the loan if the business defaults.

The United States Department of Agriculture (USDA) has two important programs designed for economic development in areas with less than 50,000 people. The first, the Business and Industry Program, is essentially a service to banks. If a bank wants to make a loan and wants a guarantor, it can approach the USDA. Joe Boatwright, the representative for northwest Virginia, explained the program like this. "If a bank wants to make a loan but the risk is too high, they'll come to us. If we approve the loan, the USDA will pay the bank 80 cents on the dollar for any losses they incur up to \$5 million dollars."<sup>19</sup> In exchange, the borrower pays the USDA 2% of the total amount guaranteed plus a service fee. This kind of loan insurance essentially protects the bank and allows borrowers who might typically be denied a loan to get one.

The target though, is loans much bigger than a local entrepreneur would need. Mr. Boatwright told me about a potential \$5 million loan to start a movie theatre in Waynesboro. "This fellow has plenty of money personally, he just doesn't have an existing movie company. He's a start up." Later Mr. Boatwright added, "there's little to no risk of us actually having to pay [because of a defaulted movie theatre loan]. He has

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<sup>19</sup> Joe Boatwright (personal communication, March 2010)

enough personal assets to cover the loan so there's no chance we'd have to pay."<sup>20</sup> There is no question the B&I program provides liquidity to the local economy, but it is initiated by banks and is generally for larger loans. The smallest loan currently on Mr. Boatwright's desk was for \$280,000.

The USDA's Rural Business Enterprise Program has a completely different focus—it is tailored to help small businesses that need a smaller loan for working capital or equipment. Their two programs currently in this area are essentially two sizes of the same program. The Intermediary Relending Program (IRP), the smaller of the two programs, establishes revolving loan funds controlled by the community to lend to emerging businesses. For example, the City of Buena Vista was recently given a \$99,500 grant through IRP to make loans to local businesses. Buena Vista established a board that makes and oversees the loans, but must get final approval from Mr. Boatwright's office.

The larger program is the Rural Business Enterprise Grant (RBEG) which provides a community board with a proven track record, often with IRPs, to make more and larger loans. The Staunton Creative Community Fund is currently applying for an RBEG grant after successfully using IRPs. The Fund would be able to lend to any private business or non-profit in the community with less than 50 employees and less than \$1 million in gross projected revenues.

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<sup>20</sup> Ibid

*The Lending Gap: Justifiable Choice or Market Failure?*

With one exception that is discussed below, entrepreneurs wanting to start companies face large, but not insurmountable, hurdles to get commercial loans from banks. Even Cornerstone Bank, a self-described community bank, does not lend to just anyone. Scott Steele, chief commercial lending officer, said that Cornerstone would not lend to an entrepreneur without a clairvoyant plan and capital. “We’re not a venture capital firm; we’re a bank so we lend to people who are already in business.”<sup>21</sup> Banks are not designed to support small start-ups: they have a responsibility to their shareholders to make profitable loans, not take large risks at total loss. The world economy as a whole makes a distinction between banks and venture capital; the Rockbridge economy should be no different. Rockbridge Area stakeholders should not expect local banks to do the work of a venture capital firm or angel investor.

The process of small business lending in the Rockbridge Area has components of a market failure, but one that is not without reason. Because there is a lesser level of expertise, commercial lenders can have asymmetric information about any component of the above lending criteria, with the exception of income and tax statements and credit scores. Because banks know their own lack of expertise, it is possible they place more emphasis on these quantifiable components. As a result, businesses with a less-than-

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<sup>21</sup> Scott Steele (personal communication, April 2010)

stellar history can appear a worse investment than they actually are— asymmetric information.

Based on my brief anecdotal research, I believe there is potential for a Rockbridge Area bank or lender to make profitable loans to small businesses that currently do not have access to favorable credit. If this lender can develop some kind of expertise in small businesses, it will be able to better evaluate the projections of local small businesses. There are two caveats that must be noted: not all businesses who want a loan will get one. Some loans are not a reasonable risk even if the lender understands them perfectly. There will still be businesses that cannot get loans, but hopefully it will be for good reason. Secondly, it will be just as difficult to make these small loans profitable. As mentioned earlier, smaller loans do not have as much profit as larger ones—hence the specialization away from the former.

Fortunately, the additional business for banks from businesses that need smaller loans can make those loans attractive. Scott Steele said that even if they did not make much profit from the fees on a \$50,000 loan, they would still want it. “We might not make much on the loan itself, but if we were able to get their deposits, merchant banking, and provide credit card services to the business we’d consider it a success.”<sup>22</sup> For some banks, gaining a satisfied and faithful client is worth providing loans that do not have outstanding profit potential. To the extent that banks have this attitude toward

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<sup>22</sup> Ibid



small businesses, they will be eager to provide loans to qualified borrowers regardless of size.

### **Microfinance in Action: Buena Vista's Revolving Loan Fund**

Buena Vista's micro loan program, the Revolving Loan Fund (RLF), is micro in every sense of the word. They received their \$99,500 grant from the USDA in the fall of 2007 and have made 6 loans so far. Each of these loans, per the USDA's policy for a new micro loan program, is for \$15,000. Despite its newness and small size, the program seems to eliminate market failure for small business and start-up financing in Buena Vista. Their policy and attitude toward small businesses is positive and inclusive. Below I describe their operation.

The Micro Loan program is the brainchild and project of Tim Reamer, Buena Vista's Economic Developer. He worked with Joe Boatwright of USDA to get the initial grant in August of 2007 to fund the program. The process of funding loans, as established by the USDA and Mr. Reamer, is as follows.<sup>23</sup>

When a business owner or entrepreneur approaches Mr. Reamer about a loan, usually by phone, he invites the interested party in for an interview and asks them to bring a copy of tax returns from the previous three years and any other information about the business. At present, RLF does not advertise, but Mr. Reamer believes Buena Vista is small enough for word of mouth to be sufficient so far. When I spoke to him

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<sup>23</sup> Tim Reamer (personal communication, March 2010)

about potential changes to the program, he did express interest in generating more publicity for the program. If the potential borrower is a start-up, Mr. Reamer asks to see personal tax returns from the previous three years. He also has the applicant fill out a loan application.

The nine-page loan application is very similar to applications from banks. Any person who owns a 20% or greater stake in the business must fill out an application. The first section is a personal income statement of assets and liabilities, listing specifically personal investments, sources of income, real estate holdings, mortgages, unpaid taxes, to name a few. Borrowers must personally guarantee the loan and the RLF wants to accurately assess the risk of lending to these individuals.

The second half of the application is about the business itself, assuming it already exists. RLF wants to see a list of current funders and amounts, because it will not fund more than 75% of a project's total cost. Applicants are asked to list the businesses liabilities and describe their products and competition. Finally they must discuss their most recent year of sales by size and pattern.

RLF asks most businesses to develop a business plan and works with them to put in writing their ideas and objectives. Applicants also have the resources of the Small Business Development Center in Weyers Cave in addition to Mr. Reamer's personal assistance. Despite the support, Mr. Reamer says some applicants refuse to create a business plan. "It makes us doubt whether or not they'll follow through with their

business if they flat-out refuse to make a business plan. If they don't work with us to make a satisfactory business plan, we won't fund them. That said everyone who has made a good business plan and filled out the application has received a loan."<sup>24</sup>

Excessive risk is not a prohibition from the RLF lending to small ventures. Mr. Reamer said, "We recognize that there is a large inherent risk in lending to these small businesses. We're willing to take that risk. Banks are not." The RLF wants to understand the risk, but it does not turn away qualified applicants who have completed all the requirements.

The six businesses to benefit from Buena Vista's microloan program are surprisingly diverse, so much so that it is best to review them one-by-one. When I spoke with Mr. Reamer, I asked him to specifically address the quality of the jobs created by each business. The jobs created essentially fall into two categories if the venture is successful: one higher paying job for the owner/operator, or minimum wage jobs for community members.

His position on minimum wage jobs was very pragmatic. He essentially gave two reasons why minimum wage jobs were beneficial to the community. "We live in an area where the great majority of households have two incomes. As a supplemental income, an extra \$15,000 a year isn't bad." Secondly, given the current state of the economy he commented that, "When the primary wage earner often isn't getting the

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<sup>24</sup> Ibid

same number of hours as he or she used to, any job [worked by a spouse for secondary income] is a good job.”<sup>25</sup>

- Pandit was a book seller on amazon.com that relocated to Buena Vista.

The company would buy overstock or irregular books in bulk from wholesalers and resell them individually. At one point it was the second largest individual seller on amazon and employed 38 people. Mr. Reamer estimates approximately 80% of these workers were part time and were paid minimum wage. The 20% who worked full time were probably managerial staff and making a slightly higher wage. It is doubtful that any of these workers received benefits. Unfortunately, soon after receiving the loan, the owner was forced to close because his health was failing. The business did repay the loan in full.

- The Tired Feet Café was start-up restaurant designed to appeal to hikers on the Appalachian Trail. The restaurant created 3 jobs waiting tables—essentially minimum wage jobs—and full-time jobs for the owners. TFC has since closed, but the owners continue to repay the loan.

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<sup>25</sup> Tim Reamer (personal communication (2), March 2010)

- Stone Grey Pub, a downtown Buena Vista bar and restaurant, was an existing locally owned business that used the loan as working capital. They created, or sustained, 3 jobs waiting tables. Stone Grey is still in business and is paying back their loan on schedule.
- Dean Insurance was a start-up insurance agency that used the loan to create one position for the owner/operator.
- Mariner Media, a local book publishing and marketing company is the microloan program's greatest success story. Mariner has a serious cash flow issue when they approached the program, and probably would have closed down without the \$15,000 loan. Because Mariner has been able to stay in business, 6 jobs were preserved. While these jobs probably do not have benefits, they do pay substantially above minimum wage.
- The final business to receive a loan was Ethanar Auto, a local car repair shop. Ethanar was a start-up that created 1 ½ positions; a full-time position for the owner and a half-time position for an assistant. The assistant probably makes minimum wage.

Through the two years of Buena Vista's microloan program, approximately 53 wage earners have been helped indirectly by the program. The closing of Pandit seriously hurts any cost-benefit analysis of the program, because raw statistics would make it seem that most of the jobs "created" or "sustained" by this program have

ceased. Without the exogenous shock of an owner's personal health, the program seems to have increased small business activity in the Buena Vista area. Interestingly, these businesses by and large create minimum wage jobs, potentially indicating that small businesses are a way to reach those with low skill sets or opportunities.

### **Analysis: What Should be Done for Low-Skill, Low-Wage Workers in the Rockbridge Area?**

The final analysis of microfinance's potential in the Rockbridge Area begins and ends with the needs of the low-wage, low-skill labor force. While there is certainly a commercial lending gap in this area, it does not necessarily affect the low-wage, low-skill workers. While the closing of the commercial lending gap would undoubtedly help businesses and should be pursued, my paper focuses on the needs of the low-wage, low-skill laborers, who are often different from business owners. National research on microenterprises—small, sole-proprietorship businesses that are essentially funded through microfinance—bears out the ineffectiveness of microfinance generally being a universally cost-effective poverty alleviation method in the US.

#### *Microfinance and Poverty in the US*

National research puts Buena Vista's program in pragmatic perspective that suggests microfinance might not be the most cost-efficient way of aiding low-wage workers. Microenterprise Programs (MEPs) have received some research attention as a

means of helping Americans out of poverty. The most recent study, the Self-Enterprise Learning Project (SLEP), found that MEPs have the potential to draw the very poor out of poverty. SLEP studied 405 individuals, 133 of whom were classified as very poor, meaning they had incomes of less than 150% of the poverty line in 1991, the year of the study's inception. During the five following years, 53% of these entrepreneurs moved their households out of poverty with an average change of household income from \$13,889 to \$22,374.<sup>26</sup> On the flip side, these gains were only experienced by 72% of the micro entrepreneurs, telling a clear story of success and failure. Those that succeeded in business, by and large were able to pull their household out of poverty. Those whose business ventures failed were forced to seek assistance elsewhere.

That said, the SELP program results were slightly more nuanced with respect to the role of the "micro-business success." For the households experiencing an income increase, the business accounted for 37% of the growth.<sup>27</sup> While these businesses are a wonderful success story, the reality of these entrepreneurs climbing out of poverty is a story of multiple causations. Over half of the income growth comes from other sources, whether it be other wages, inheritances or cash transfers. In fairness the average entrepreneur decreased their government assistance by 61%, indicating cash transfers play a secondary role in the rise out of poverty.<sup>28</sup> Ultimately the opportunity to be a

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<sup>26</sup> Microenterprise and the Poor: Executive Summary, vii

<sup>27</sup> Ibid, viii

<sup>28</sup> Ibid, vii

successful entrepreneur can play a key role in elevating the poor, but the mysterious missing factors cannot be ignored. SLEP does not elaborate on the other major contributors to income, leaving the question open.

Mark Schreiner, a major contributor to microfinance research, paints a picture of MEPs as a program that only helps a few of the poor. He acknowledges that MEPs do help some rise out of poverty, but he estimates that even if the program were implemented on a large scale, only 1 out of 100 of those currently in poverty would be drawn out.<sup>29</sup> Schreiner also reviews the Self-Employment Investment Demonstration (SEID) which provided a mixture of classes, funding, and business support to potential entrepreneurs initially on welfare. While many participants did start businesses, Schreiner calculates only 6 businesses started for every 1,000 welfare participants.<sup>30</sup> In other words, MEPs could help draw a few entrepreneurs out of poverty, but at the cost of potential expensive business failures.

#### *Specific Needs of the Low-wage, Low-skill Labor Force in the Rockbridge Area*

The needs of low-wage workers are straightforward, based on the analysis of the labor force and economy of the Rockbridge Area. The community needs a plan to train the workforce and attract businesses to provide more high-skill, high-wage opportunities to newly trained workers. Microfinance's place in the community must fit

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<sup>29</sup> Schreiner, *Microenterprise and the Poorest*, 501. He bases his claim off a Unemployment Insurance Self-Employment Demonstration (UISED) that increased businesses only by 1 per 100 unemployed workers in the US.

<sup>30</sup> *Ibid*, 505



into these needs. A community economic development process is the most logical way to go about creating and executing the process of meeting the needs of the low-wage, low-skill labor force and the community as a whole. The process requires three steps: research, creating a plan, and executing the agreed-upon directives. The difficulty comes not in describing the process, but in getting a critical mass of community members to actively participate.

### Research

Researching, drafting, and implementing a strategic plan for the Rockbridge Area is unquestionably a long process that will lead to a longer process of executing the directives. . My research is very anecdotal. If more community stakeholders were interviewed, we would have a better idea of the community's potential for economic development. Good plans and funding will not come without more extensive and disciplined research.

I suggest two areas of research: community focus groups and local government roundtables. Both would be designed to bring together individuals and organizations that do not communicate frequently for the purpose of sharing knowledge and visions for the community.

Community focus groups would have to be well-advertised and local to get maximum input. I would suggest continuing the City of Lexington's business focus groups that met earlier this year to discuss the needs of local businesses. Notes from

these meetings should be circulated to local officials. Once focus groups have taken place in all the communities of the Rockbridge Area, local officials will hopefully have the information necessary to move forward.

Bringing local officials together in a roundtable discussion of economic development is essential. Each local official from different communities brings a slightly different perspective and expertise. Officials could compare ideas for development and collaboratively decide if more research is needed. Some options could be a County-wide survey or more focus groups.

Any further research into the area would reveal that one of its greatest untapped potentials is the untrained workforce. If workers could acquire the skills and training necessary to jump to a higher-skill, higher-wage job, the community as whole would benefit. Not only would the number of poor wage earners decrease, the area's entire economy would benefit greatly from increased gross earnings. Even with only the benefit of my initial research, I can definitively say the Rockbridge Area needs at least the following two programs.

A job training program that provides the participants with skills to get a job paying more than \$10/hour is necessary. Careful further research would be required to pinpoint the best skills to train, whether green jobs, more manufacturing, or some kind of export business. Past job training efforts worked inefficiently due to weak connections between industry and the training programs, leading to the second need. A

program for the persistent pursuit of outside industry for the Rockbridge Area is necessary. The service economy for the area given its current state is relatively developed. Future economic development efforts will need to focus on bringing in businesses who export goods or services to other parts of the country or world. These businesses could provide jobs for local, newly trained, employees while getting revenue from outside the county, increasing the Rockbridge Area's overall wealth.

### *Creating a Plan for the Rockbridge Area*

The leaders of this project would do well to make the development efforts a community effort at all phases of the planning and implementation process. William Simon, in his book on Community Economic Development highlights four criteria necessary for a successful and beneficial implementation of CED. First, any development must provide benefits to the residents of the community, whether through jobs or other positive externalities. Second, the CED should have synergies with existing local organizations, such as businesses or non-profits. Third, negative environmental externalities, pollution and resource use especially, should be kept at a minimum. Finally, all projects must support a "stable, independent community structure," — development needs to fit into the fabric and identity of the community, not vice versa.<sup>31</sup>

These four criteria would guide development efforts in a way that respects and supports the Rockbridge Area's identity and values. There is no question the area

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<sup>31</sup> Simon, William. *The Community Economic Development Movement*. Durham NC: Duke UP, 2001. 69-73.

would benefit from development, but the new programs or businesses must respect the community as an entity. If the community is able to take an active role in the CED process, the result will be businesses more sensitive to the needs of underprivileged low-wage workers. There will always be some low-skill workers and an unassuming and flexible CED model could provide a platform for fair treatment of the entire workforce. If the community cared about the disadvantaged, the resulting CED would care as well. From a long-term perspective, a CED initiative is best for the low-wage, low-skill labor force of the Rockbridge Area.

### Executing the Plan

The leaders who conceive the plan must ensure its execution. It takes effort from a smaller group of people to lead research and a few more to create a plan with community input. Putting the plan into action takes a large community participation rate and time. Leaders will have to tirelessly encourage local officials and educators to meet the goals necessary to attract new business.

Equally important is securing new businesses to the Rockbridge Area. This process takes time and undying effort, especially considering the number of rural community seeking to attract outside business. The Rockbridge Area must first set itself apart and then advertise and incentivize to ensure new business. This is by definition a long-term project because businesses will not be interested until they see a labor force and an infrastructure that fit their needs. Community stakeholders must be fully

supportive financially and be willing to wait or risk losing the investment in the community.

### **The Role of Microfinance**

How does microfinance fit into this long term plan? In this ideal scenario, with a fully functioning CED, microfinance has only a small specific role. Any successful CED venture must have balanced economic development. Administrators of the Empowerment Zone program refer to balanced economic development as “creating jobs on many scales: local and corporate, service-oriented and export-oriented . . .

supporting new start-up businesses as well as preserving existing establishments.”<sup>32</sup>

Given the current state of the Rockbridge Area’s commercial lending market, microfinance will be necessary to take the risks with small businesses that banks are generally unwilling to take. If CED programs are able to thrive, there will be an increased interest in starting new businesses to meet the expanding market and consumer preferences.

That said, CED is years away from influencing the Rockbridge Area. CED is economic development down with the community’s impact and the process of starting the research, compiling it, and creating a plan will take a long time. The hard economic times are hitting the Rockbridge Area right now and immediate steps should be taken.

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<sup>32</sup> Ibid, 72

*Immediate Impact: The Argument for Expanding Microfinance in the Rockbridge Area*

Microfinance has a place right now in the Rockbridge Area. Buena Vista's Revolving Loan Fund is an excellent model of microfinance's potential for our community. Its model should be expanded into Glasgow and Lexington, with potential for another that serves businesses not in these three population centers.

The RLF currently serves two purposes: (1) it gives a small but accessible safety net to local businesses that (2) are able to keep local jobs in the Rockbridge Area. Given the difficult economic times, the Rockbridge Area can ill-afford to lose jobs, even if they do pay minimum wage. Microfinance is currently providing a safety net that banks cannot give to stricter lending standards.

The concern is fading that the jobs provided by microfinance are minimum-wage and do not allow workers to support a family. Most concretely, many of these low-wage, part-time jobs are used as supplemental income by a household's second wage earner. The extra income, though small in and of itself, when coupled with another worker's full-time earning can make a significant difference to a local household.

Furthermore, the new healthcare reform would appear to help minimum-wage workers substantially by giving them essentially free healthcare. Before this reform, a \$15,000 a year salary could not even hope to provide healthcare to a family. Now, the picture looks less bleak. If that \$15,000 is supplemented by another \$5,000 from a spouse's part-time work, the family has \$20,000 in income and minimal healthcare costs. They are not

wealthy, but not nearly as vulnerable to poverty as previously. It is essential to note that single parents still face poverty while working a minimum-wage job, even with free healthcare. Additional intervention is needed for them, but is beyond the scope of the economic development discussed here.

The best reason to expand microfinance into the rest of the Rockbridge Area is that the capital is essentially free. The federal government, through the USDA, wants to help rural communities like Rockbridge through the Intermediary Relending Program. The government will provide the capital to lend, provided the communities create the proper authority to administer the program. Lexington, especially, should take advantage of this opportunity and create a RLP like Buena Vista's and ensure all of its small businesses and their employees survive the slow road to economic recovery.

To implement the Intermediary Lending Program, local officials from Lexington and any other interested part of the Rockbridge Area should initiate the process of creating the proper organization to receive an IRP grant. The grant can go to a non-profit or public authority that has the capacity and staffing to make the loans. Given the lack of appropriate non-profits and the City of Buena Vista's success, local governments should take the initiative in creating the "intermediary" for the IRP grant.

Once the intermediary is in place, interested community members should be approached to serve on either the lending committee or as loan officers. Local officials do not have to do all the work, just initiate the process. Banks will probably be willing

to offer assistance, since they benefit from increased business in the community. If the IRP program expands beyond Buena Vista in the Rockbridge Area, it will be because the entire community helps promote and support the organization. More importantly, an IRP program will show concern for the low-wage, low-skill workers who can benefit from the extra liquidity in the commercial lending market. Like microfinance in developing countries, an IRP program will be a hand up, not a handout to local businesses and entrepreneurs.

# Washington and Lee University



Many stakeholders are already taking steps to combat poverty in the Rockbridge Area. Microfinance is not some magical solution. Instead, it is an actionable step that could legitimately benefit the local economy and struggling businesses in particular within a year. It can be an integral part of the fight to provide capability to the poor around us.

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