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Policy Options for Microlender Funding in Arkansas

Harvard Law School Mississippi Delta Project

POLICY OPTIONS FOR MICROLENDER FUNDING IN ARKANSAS

Harvard Law School Mississippi Delta Project
Financial Services Team*

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Law students working under faculty supervision prepared this report. The report is not intended to serve as legal advice and you should not rely on it alone to make decisions. You should consult with an attorney, certified public accountant, and/or insurance representative certified in any applicable states before taking any action in reliance on the legal analysis in this memorandum.

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EXECUTIVE SUMMARY

Very small businesses, otherwise known as "microenterprises," play vital roles in the local, state, and national economies. As engines of employment, entrepreneurship, and innovation, microenterprises can be highly successful vehicles for inclusive and robust economic growth. However, many such businesses are constrained by lack of access to credit. Microenterprise owners and entrepreneurs may lack the credit or operating history needed to obtain a traditional small business loan at a commercially viable rate of interest, or the loan amount requested may be too small for a traditional lender to consider. Undoubtedly, a great many entrepreneurial opportunities are lost for lack of viable financing.

To address this problem, many state governments have established programs to help fund microenterprise, often through private "microlending" organizations that borrow from the state at subsidized rates and then relend those funds to microenterprises. Similar to a bank that takes in deposits and subsequently uses the funds to make loans, these programs supply funding to microlenders who can then put it to great use by leveraging their expertise in working with microenterprises. Because several other states have adopted various programs along these lines, Arkansas can look beyond its borders for policy options in designing its own microlender funding program.

This brief recommends the creation of a state-supported microlending funding mechanism and the adoption of several provisions related to that mechanism:

- Eligibility criteria for microlender participation in the state program to promote efficient allocation of funding, including non-profit status, a reasonable prospect of success, and a focus on target populations
- Eligibility criteria, including size limits and evidence of credit constraints, to ensure only true microenterprises are borrowing from microlenders
- Loan principal limits and relending requirements to promote maximum impact of state funds
- A system of incentives for microlenders to promote best practices

I. INTRODUCTION

This brief recommends the creation of a state funding mechanism to support microfinance and describe some of the policy options available to the state to structure such a mechanism in a way that ensures its sustainability and integrity. The options laid out below have been taken from a survey of similar microlending programs established or proposed in several states, including Illinois, Louisiana, Montana, Nebraska, South Carolina, Virginia, and Washington. In the interest of brevity, the major design variables are discussed at a high level of generality, and some smaller issues are not discussed. Nonetheless, we hope that this brief can serve as a sound starting point for the design and drafting of legislation to expand access to microlending in Arkansas.

Before continuing, it bears mentioning that this report is a student research project that was conducted under faculty supervision. No attorneys from the states at issue were involved in the research or writing of this report. Consequently, it constitutes neither legal advice nor the opinion of legal experts.

II. THE ROLE OF MICROENTERPRISE IN THE ARKANSAS ECONOMY

Microenterprises, typically defined as businesses with 10 or fewer employees, represent a critical component of the national economy, representing nearly nine out of ten businesses in the United States.[1] The role of microenterprises in Arkansas is just as pronounced, representing approximately 88% of all businesses in the state.[2] As robust engines of economic growth and development, as well as important sources of employment for millions of workers in Arkansas, microenterprises represent an important stabilizing force in the economy. Entrepreneurs and microenterprise owners are a vital force for creativity and production in a diverse set of sectors ranging from agribusiness to retail to service providers.

Why Microfinance?

Despite their central role in economic growth, microenterprises and entrepreneurs are often faced with a number of significant barriers when seeking to access tools and resources needed to fund operations and fuel continued growth. Among these barriers, one of the most significant is a lack of access to credit and lending facilities, which puts microenterprises and entrepreneurs at a significant competitive disadvantage in the marketplace, particularly when compared with larger businesses. While businesses of all sizes require access to credit to fund ongoing operations, finance expansion, and provide a buffer against unexpected events, access to credit is of particular importance to microenterprise owners during the start-up phase of operations.

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[1] Ass'n for Enter. Opportunity, *Arkansas Microbusiness Sate Fact Sheet* (2012), *available at* http://www.aeoworks.org/pdf/states/Microbusiness_State_Factsheet-AR.pdf.
[2] *Id.*

While the formal banking sector does offer loans to small businesses, and existing government-sponsored programs such as the Small Business Administration (SBA) seek to increase the availability of credit, many microenterprises and entrepreneurs are nonetheless unable to obtain traditional bank or SBA loans. Indeed, an estimated 10 million microenterprises in the United States report insufficient access to the loans they need to start and grow.

What factors explain this disconnect? Microenterprise owners and entrepreneurs may lack the credit or operating history needed to obtain a traditional small business loan at a commercially viable rate of interest, or the loan amount requested may be too small for a traditional lender to consider.

The barriers to access to credit faced by microenterprise owners and entrepreneurs are further exacerbated during periods of low liquidity in the lending market, such as the current economic downturn. For microenterprise owners unable to tap formal lending opportunities, these periods of tight credit conditions often require making a difficult decision to tap into household savings or personal family networks for the necessary capital.

Microfinance can fill an important gap by connecting microenterprise owners and entrepreneurs with access to credit. By providing small loans, typically lower than the average size provided through traditional lending institutions, and utilizing collateral conditions customized to meet the unique cash-flow needs of microenterprise owners in the start-up phase of operations, microfinance allows microenterprise owners to develop their businesses and operations in a commercially viable manner. Along with the immediate provision of credit provided by microfinance loans, microfinance borrowers also have the opportunity to build their credit history, which is often very helpful if and when microfinance borrowers seek to tap traditional lending sources later on in the lifecycle of their enterprises.

III. THE NEED FOR A MICROLENDER FUNDING MECHANISM

Microlenders generally use funding for purposes beyond simply providing capital to businesses. Microlenders often provide a variety services to their borrowers, including business training, business education, technology consulting, and a variety of other services. These services benefit communities, microlenders, and entrepreneurs alike by reducing the risk of default on loans and increasing the likelihood that enterprises will survive.

Unfortunately, many microfinance institutions struggle to find a constant flow of funding. Loans made by microlenders are typically for small amounts and made to relatively high-risk borrowers; traditional banks generally will not offer such loans. In microfinance, margins are often relatively low and portfolio risk relatively high as compared to those of traditional financial institutions. Individual microlenders, unless they are large and well established, might find it difficult to securitize their loans, even if a secondary market for such securities existed. As a result, microfinance institutions cannot always access funding sources designed for traditional financial institutions while still charging reasonable interest rates and remaining financially viable.

A state funding mechanism would help fill a microlender's otherwise unmet need for funding and ensure access to affordable credit for viable microenterprises. We recommend, however, that any such mechanism include qualify criteria that limits funding only to microlenders that adhere to well thought out best practices and microenterprises that truly lack access to other sources of funding. In the sections to follow, we will describe initiatives put in place in other states in an effort to provide examples of potential approaches and their strengths and weaknesses.

IV. ELIGIBILITY REQUIREMENTS AND DEFINITIONS

To ensure that a microfinance funding mechanism can limit access to true microenterprises, well-crafted criteria must be utilized to determine which lenders may receive loans from the state and which small businesses may in turn borrow from those lenders. Because of its importance, this brief treats this topic in more detail than other aspects of program design.

"Microfinance Institution" and "Microenterprise" Definitions as Screening Mechanisms

There are two major concerns with intermediated, state-funded programs: First, there is the concern that that non-microfinance institutions or sham microfinance operations may attempt to access funding intended for legitimate microlenders. For example, non-microfinance institutions may attempt to supplement their profits by strategically accessing low-interest state funding and re-lending at higher rates. The second concern is that businesses that have access to traditional lending may attempt to take advantage of microloans. Under such a scenario, a business may attempt to replace the lending to which it has access via a traditional lender with more favorable loans from a microlender. As microfinance institutions typically take on loans with relatively high risk of default, they may be tempted to divert funding that would otherwise go to microenterprises to relatively low-risk traditional businesses. Clearly, there is compelling need for the state to subsidize lending to businesses that cannot easily access the mainstream financial system.

Multiple states have implemented funding programs that lend only to strictly defined microfinance institutions and, via those legitimate microlenders, only to true microenterprises. Statutory definitions with clear eligibility requirements have thus played important roles in screening applicants at both levels.

Examples of State Eligibility Criteria

(i) Montana MicroBusiness Development Act

Montana's MicroBusiness Development Act defines a Microbusiness Development Corporation ("MBDC"), a type of microfinance institution, as "a nonprofit corporation organized and existing under the laws of the state to provide training, technical assistance, and access to capital for the startup or expansion of qualified microbusinesses."[3] Under the Act, a microbusiness is defined as a business enterprise located in Montana that:[4]

(a) produces goods or provides services and has fewer than 10 full-time equivalent employees and annual gross revenue of less than $1 million; or

(b) produces energy using an alternative renewable energy source

The Montana Department of Commerce is responsible for certifying MBDCs. To become certified, a potential MBDC must present a plan including:[5]

- its ability to administer loans,
- a staffing plan,
- evidence of community support,
- evidence of sufficient operating income,
- and evidence of business clients as potential borrowers.

The Act limits microlending facilities to provide loans only to businesses that are of a certain size or involved in certain nascent industries. The Act also requires that qualifying microfinance institutions provide services beyond the mere provision of capital to their clients. Taken together, these provisions assure that microfinance institutions will take steps to lower the overall risk of default on loans backed with state funds and lend only to enterprises that are unlikely to have access to other sources. The Act does not, however, require that enterprises provide proof of a lack of access to traditional funding. A provision requiring proof of denial from a traditional bank may help further limit access to funding to those enterprises truly in need.

(ii) Nebraska Microenterprise Development Act

Nebraska's Microenterprise Development Act, enacted in 1997 and repealed in 2011,[6] defined a microfinance institution as "any community-based or nonprofit program which has developed a viable plan for providing training, access to financing, and technical assistance for microenterprises and which meets the criteria and qualifications for LB 327."[7] Factors taken into account in the determination of whether an institution qualifies for funding include:[8]

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[3] Mont. Code Ann. § 17-6-403(4) (West 2012).
[4] Mont. Code Ann. § 17-6-403(7) (West 2012).
[5] Mont. Code Ann. § 17-6-408 (West 2012).
[6] In 2011, the Microenterprise Development Act was superseded by the Business Innovation Act, which kept many of the provisions of the former program intact.
[7] Neb. Legis. Legis. Research Div., *A Review: Ninety-Fifth Legislature First Session, 1997*, at 14.
[8] *Id*.

- the institution's plan for providing business development services and microloans to microenterprises,
- the scope of services provided by the institution,
- the plan for coordinating services and loans by the institution with commercial lending institutions,
- geographic representation of all regions of Nebraska (rural, urban, and neighborhoods),
- the ability of the institution to provide for business development in areas of chronic economic distress and low-income regions of the state,
- the ability of the institution to provide business training and technical assistance to microenterprise clients,
- the ability of the institution to monitor and provide oversight of microloan recipients, and
- the sources and sufficiency of operating funds for the institution.

The Act also defined "microenterprise" and "microloan." Microenterprise was defined as "[a]ny business with five or fewer employees." Microloan was defined as "[a]ny business loan up to $35,000."[9]

The Act attempted to limit funding only to these microfinance institutions that targeted microenterprises truly in need. At the same time, however, the $35,000 maximum microloan may be somewhat limiting for certain businesses. Even small entrepreneurs often need over $35,000 and more than five employees to get a business up and running. If the concern is risk of loan loss, this could be somewhat mitigated by putting in place specific programming to be offered to microenterprises to reduce risk of default. Additionally, the amount of state funds to which a microfinance institution has access could be made to vary based on their percentage of funds repaid, number of loans current, or portfolio default rate.

<u>(iii) Virginia Enterprise Initiative</u>
The Virginia Enterprise Initiative ("VEI") uses a "hub and spokes" model for the distribution of state funds to Microenterprise Development Organizations ("MDO"). An MDO is defined as a "[l]ocal organization that delivers micro-enterprise services. Services offered may include business skills training, business plan development training, one-on-one technical assistance, micro-loans and post-loan assistance."[10] A microenterprise is defined as a business with five or fewer employees that requires $35,000 or less in capital.[11] The VEI provides funding to MDOs at both the regional and local levels. MDOs called Regional Service Providers ("RSP") are responsible for identifying Local Service Providers ("LSP"), which provide funding directly to microenterprises within their region. The amount of funding a given RSP receives is based on a

[9] Neb. Dep't. of Econ. Dev., *Report to the Legislature on the Nebraska Microenterprise Development Act* (2007), *available at* http://www.neded.org/files/businessdevelopment/microenterprise/06MicroEntAnnRep.pdf.
[10] *See* Va. Enter. Initiative, *2011 VEI Program Design* (2012), *available at* http://www.dhcd.virginia.gov/CommunityDevelopmentRevitalization/PDFs/VEI_Program_Design.pdf.
[11] *Id.*

"performance pay" model that evaluates their past performance. Performance incentives may be based on number of qualified business plans, jobs created, and loans made.[12]

The "hub and spokes" model has both advantages and disadvantages. RSPs are more likely to be familiar with the needs and opportunities within their region than a state agency would be, and the performance pay model gives them an incentive to channel funding to only the best LSP programs.[13] Likewise, LSPs have an incentive to be innovative and well managed in order to be chosen for funding by the RSP in their region. A downside, however, may be the potentially higher administrative costs of having two intermediaries between the state funding and the microenterprise that will ultimately put the funding to use.

The VEI does not include a requirement that microenterprises seeking funding be unable to secure traditional loans. Such a provision would be useful in ensuring that only businesses with no other source of funding have access to state funding. In addition, and similar to the Nebraska program described above, the requirements in the VEI that a microenterprise have five or fewer employees or require $35,000 or less in capital are very restrictive and may exclude many potential businesses.

Recommendations Regarding Eligibility Criteria

To prevent non-microfinance institutions, such as traditional banks or high-interest payday lenders, from taking advantage of lending facilities meant for microlenders, access must be strictly limited. Accordingly, we recommend limiting access to state funding to only "qualified microfinance institutions." Qualified microfinance institutions should be certified by the Arkansas Department of Commerce. Factors determining whether a microfinance institution is to receive certification should include:

- Non-profit status (i.e. funding should be limited to non-profit organizations)
- Demonstrated record of success in microlending or, alternatively, a thorough evaluation of a proposed microlender's business plan
- Focus on target populations (e.g. minority communities, rural areas, urban poor, disadvantaged populations, etc.)

In addition, we recommend that "microenterprise" be defined so as to ensure that the state's goals of financing microenterprises are advanced. Factors taken into account in defining microenterprise businesses eligible to take advantage of state-supported lending should include:

- Number of employees
- Annual revenue

[12] *Id.*
[13] *Id.*

- Inability to access traditional credit, determined by proof that they have been denied a loan by at least one traditional lending institution.

V. FURTHER POLICY PROVISIONS

In addition to eligibility criteria for microlenders and microloan recipients, a state funding program should also consider other provisions designed to promote sustainability and effective use of funds. Several such provisions are discussed below.

Limits on the Dollar Amount of Loans Provided to Microenterprises

An obvious complement to restricting the size of microenterprise customers of microlenders is a restriction on the dollar amount of loans that can be provided to any one microenterprise. This restriction has several possible benefits: serving as a second screen to limit participation by businesses that have access to traditional lending or businesses that are not true microenterprises, forcing diversification of microlender loan portfolios, and allocating benefits across a wider constituency. Most states with intermediated lending programs have opted to impose limits on the amount a microlender may lend to any one microenterprise. Those limits range from $100,000 in Montana[14] to $10,000 in the former Nebraska program.[15] Other examples include a proposed Illinois program ($35,000),[16] a Virginia program ($50,000),[17] and a Washington program ($50,000).[18] Washington's program also provides for a $500 *minimum* floor for loans to businesses,[19] perhaps in an effort to avoid financing consumption or to promote investment in business expansion.

One concern is that loan amount limits might induce microenterprises to seek loans from more than one microlender. It is not clear if any other state has addressed the possibility of such "double-dipping" or even whether such behavior is undesirable. Though double-dipping might allow businesses to circumvent the dollar amount limits, spreading the default risk among several microlenders might have benefits for the businesses while serving the same purposes as traditional loan syndication, providing other positive outcomes for the program goals.

Restrictions on the Use of Funds by Microenterprises

In addition to specifying maximum dollar amounts available, some states have opted to impose restrictions on how microenterprises may use the proceeds of loans from microlenders. Louisiana's microenterprise program is a strong example. There, the relevant state agency has determined that loan recipients may not use the proceeds of state-backed loans for any of the

[14] Mont. Code Ann. § 17-6-407(6)(b) (West 2012).
[15] *See* Neb. Legis. Legis. Research Div., *supra* note 7, at 15.
[16] H.B. 5420 25(e), 96th Gen. Assemb. (Ill. 2009).
[17] *See 2011 VEI Program Design*, *supra* note 10, at 2.
[18] *See* State of Wash. Joint Legis. Audit & Review Comm., *Microenterprise Development Program Meets Statutory Objectives but Department of Commerce Oversight is Inadequate* (2012).
[19] *Id.*

following business purposes: starting a restaurant, bar, or consumer finance business; renovation expenses; refinancing debt; or purchasing another business.[20] It is beyond the scope of this brief to examine which particular business purposes, if any, should be removed from eligibility, and, as in Louisiana, that question might best be resolved by the General Assembly or administering state agency.

Relending Requirements for Microlenders

Another common feature of state microlending programs is a requirement that each microlender relend a specified percentage of its capital. Montana, for instance, requires that its intermediaries lend at least 60% of state funds to small businesses within two years of accepting such funds.[21] As another example, Nebraska requires microlenders to disburse at least 50% of state funds as microloans.[22]

These restrictions are clearly meant to ensure that state funds reach their ultimate target, microenterprises, but there might be some risk that, if calibrated too strictly, a relending percentage requirement would push a microlender to accept higher-risk applicants than it would otherwise. This concern might be compounded by loan size limits that force lenders to spread their funds across a wider number of businesses. Thus, consideration of a relending requirement highlights the fundamental tension between maximizing access to capital and ensuring the sustainability of microlending.

A similar but distinct requirement would cap the amount of state funding that a microlender could use for administrative or overhead costs. This type of cost-based restriction could either replace a relending percentage requirement or, as in Nebraska, serve as a complement to such a restriction.[23] An administrative cost cap might be preferable to a relending requirement in that it might not force microlenders to drop credit standards to meet a percentage goal, but there may be countervailing problems with clearly defining administrative costs.

Matching Requirements for Microlenders

A matching provision would require each microlender to raise a certain amount of non-state funding for every dollar received from the state program. This type of provision has the obvious goal of increasing the ultimate impact of each state dollar. To that end, most states in our survey utilize some sort of matching requirement. The required ratio, though, varies considerably across states. At one extreme is a bill introduced but never passed in Illinois, which would have required a microlender to raise only 15% of the amount it lent from non-state

[20] La. Admin. Code tit. 1, § 7503 (2012).
[21] Mont. Admin. R. 8.99.504(6) (2012).
[22] *See* Neb. Legis. Legis. Research Div., *supra* note 7, at 15.
[23] The Nebraska legislation mandates that microlenders spend no more than 10% of their funds for administrative purposes. *Id.*

sources, that is, an 85:15 state to non-state ratio.[24] At the other extreme are programs that require 1:1 state to non-state matching.[25]

Montana provides an interesting case study on matching requirements. While the state only requires $1 of private funds for every $6 of state funds received, it seems that the more successful microlenders in the state raised far more than the required amount of private funding.[26] In Nebraska as well, successful microlenders raised far more in private funds than they received from the state program; nine microlenders were able to raise roughly $2.4 million in outside funds after receiving about one-tenth that amount from the state.[27] These experiences suggest that substantial private matching is necessary for successful microlending, though the authors of this brief expect that microlenders currently operating in Arkansas already exceed any matching requirements. Moreover, the success of private matching demonstrates that states can achieve significant "bang for their buck" by leveraging private fundraising. At the same time, matching requirements pose a barrier to entry for new microlending operations, but that barrier might serve as a desirable method for screening out unsustainable programs.

If the ideal matching requirement is unclear, Arkansas might consider incentivizing private fundraising rather than setting an obligatory ratio (*see infra*).

Performance Incentives and Reporting Requirements for Microlenders

Beyond the types of provisions discussed above, several state programs provide performance incentives for microlenders. Both the cost loans to microlenders (in terms of interest rates) of and the amount of state funding available to a lender can serve as appropriate incentives. It is useful to note an analytical distinction between the two broad frameworks for incentive schemes.

A first framework for incentives is tied to the ultimate outcomes of lending, like jobs created by microenterprise borrowers. In the eyes of the state, the economic outcomes of lending are what ultimately matter, and thus these criteria have the advantage of being more directly tied to the program's objectives. However, because the data on outcomes would generally be one step removed from the microlender, the information may be harder to verify and potentially less accurate. Causality might also present a problem; for example, a microlender with theoretically better processes might simply be operating in a tougher local economy where job creation is more difficult.

[24] H.B. 5420 25(b), 96th Gen. Assemb. (Ill. 2009).
[25] Nebraska formerly had such a requirement, *see* Neb. Legis. Legis. Research Div., *supra* note 7, at 15, but has now moved to a requirement that microlenders match only 35% of state funds, Neb. Dep't of Econ. Dev., *2011 Business and Innovation Act Application Guidelines Microenterprise Lending Program* 3 (2011).
[26] For example, the Montana Community Development Corporation, one of the state's qualified microlenders, made over $5 million in loans despite receiving only $1.6 million from the state. Mont. Cmty. Dev. Corp., *2011 Annual Report* 13 (2011), *available at* http://www.mtcdc.org/images/stories/documents/montanacdc_annualreport_web.pdf.
[27] Neb. Enter. Fund, *Annual Report January 2012*, at 8.

In the second framework, incentives are tied to particular microlender behavior or processes, like raising private funds to match state funds. Process-based criteria have the advantage of being more directly observable; the microlender should have clear data on the actions it has taken. However, process targets are useful only insofar as they are good proxies for ultimate outcomes, and it might not be clear if a certain practice (or set of practices) is truly optimal.

Possible criteria drawn from state and federal programs are listed below:

1. *Outcome-based criteria*
   - Loan repayment/delinquency rates
   - Impact of lending in terms of job creation[28] or job retention
   - Impact of lending in terms of microenterprise business plans created[29]
   - Focus on disadvantaged areas (measured perhaps by percentage of loans made in economically distressed areas)[30]
   - Extent of a microlender's geographic coverage[31]
   - Increase in microenterprise gross revenue over a period of time
   - Amount of microloan spent by microenterprise in local areas or on local goods
2. *Process-based criteria*
   - Average loan size (incentivizing smaller loans)[32]
   - Innovation in lending techniques or credit products[33]
   - Amount or percentage of non-state funds used
   - Amount or quality of technical training or management assistance provided to businesses[34]
   - Low administrative costs or reductions in administrative costs of microlenders[35]

Some of these criteria likely target the same objectives through different means and thus may be duplicative. For example, average loan size might serve as a proxy for both portfolio diversification and for lending to communities that have little access to traditional banking. However, there is not necessarily a major downside to redundancy.

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[28] *See 2011 VEI Program Design*, *supra* note 10, at 7.
[29] *Id.*
[30] Used by the proposed Illinois Microloan Program Act. H.B. 5420 30(c).), 96th Gen. Assemb. (Ill. 2009).
[31] Virginia Enterprise Initiative, *supra* note 28.
[32] Used by the proposed Illinois Microloan Program Act. H.B. 5420 10(3)(A), 96th Gen. Assemb. (Ill. 2009).
[33] Virginia Enterprise Initiative, *supra* note 28.
[34] The Illinois Microloan Program Act would have created a parallel funding mechanism for marketing, management, and technical assistance to small business. H.B. 5420 10(3)(B), 96th Gen. Assemb. (Ill. 2009).
[35] Though it does not provide direct incentives for administrative cost reductions, the Virginia Enterprise Initiative provides fixed-amount grants up to $20,000 to provide staffing capacity. *2011 VEI Program Design*, *supra* note 10, at 25. This hard limit might be viewed as an indirect incentive to keep administrative costs (or at least staffing costs) low.

Whatever criteria are used, an incentive program would entail reporting requirements to be promulgated by the Department of Commerce or other relevant state agency. While an incentive-based system might be preferable to a requirement-based system for several reasons, the former would likely create more monitoring costs for the state agency, which would need to develop and periodically update formulae for allocating the pool of state funds.

Recommendations Regarding Further Policy Provisions

It is beyond the scope of this brief to provide detailed recommendations, but we believe that a few high-level conclusions might serve an Arkansas program well. First, given the ubiquity of the practice, limits on the dollar amounts loaned to individual microenterprises are probably beneficial. That said, the ideal limit might be difficult to determine ex ante, and so we recommend delegating such a decision to the Department of Commerce or another relevant state agency. Second, a “hard” requirement to relend a certain percentage of state funds certainly has the appeal of ensuring state money finds its target, but an initial requirement would likely need to give new microlenders an extended period of time to meet that goal. Third, a matching requirement is clearly necessary for sustainability, though it should probably be set below a 1:1 ratio to avoid deterring entry. If microlenders see a need to exceed the matching ration, there is no barrier to doing so.

Finally, the General Assembly should direct the Department of Commerce or another relevant state agency to devise an incentive scheme from some or all of the criteria listed above. This scheme would help the state allocate its funds in an efficient manner and, if inclusive of enough criteria, would still allow microlenders the flexibility of experimenting with different business models. Arkansas might wish to concentrate on one or a few potential criteria, but if it adopts a significant number, the state might do best to implement something like the “point system” used by USDA’s Rural Business Enterprise Grants, in which participants are awarded a variable number of points based on each of a wide variety of factors.[36]

VI. CONCLUSION

The overriding concern of program design in this context is the extension of state aid to promote entrepreneurship and inclusive growth. At the same time, the state must ensure that its money is being used appropriately. Through adequate eligibility criteria, lending restrictions, and incentives for microlenders, we believe that the state can achieve both goals simultaneously.

[36] *See* 7 C.F.R. § 1942.305.

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APPENDIX A – CHART OF POLICY OPTIONS

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