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## Small Business 101

*Why financial literacy is critical to small business success*

### Introduction

The development of microenterprises — businesses with low capital requirements and no more than five employees — has become a widely used strategy for creating job opportunities for low-income individuals in many parts of the world. Long-term business survival and rising household income indicate encouraging levels of success among these small businesses. With this success, the question then becomes how to spread the benefits of microenterprise development to more low-income people.

To answer this question, the N.C. Rural Economic Development Center recently examined the process and outcomes of the center's Microenterprise Loan Program. This examination covered four years' worth of loan applications, decisions, and outcomes. The center's staff concluded that the lack of financial literacy by loan applicants and small business owners was the major stumbling block to securing a loan and to operating a successful business.

This conclusion is consistent with the results of surveys that have documented low financial literacy levels throughout the United States. These surveys further show that low money management skills are especially prevalent among populations targeted by microenterprise programs: low-income individuals, women and people of color.

Strategies that promote self-employment, therefore, need to incorporate financial literacy into their educational programs if they are to benefit more people and increase business success rates. A survey of North Carolina's financial literacy programs, also conducted as part of this study, suggests opportunities for financial literacy and microenterprise programs to strengthen each other's services and share resources.

### Microenterprise programs: an anti-poverty strategy

Microenterprise programs are built on the premise that business ownership and self-employment can lift people out of poverty

### Financial literacy: more complicated than it used to be

In the simplest terms, financial literacy requires the ability to read, analyze, manage and communicate concerning matters that affect one's financial well-being. Yet it is anything but simple, as Federal Reserve Board Chairman Alan Greenspan has noted:

"Today's financial world is highly complex when compared with that of a generation ago. Forty years ago, a simple understanding of how to maintain checking and savings accounts at local banks and savings institutions may have been sufficient. Now, consumers must be able to differentiate between a wide range of financial products and services, and providers of those products and services."

A person's degree of financial knowledge dramatically affects everyday activities: from balancing a checkbook to reading and understanding a contract. Individuals must judge the wisdom of incurring debt, whether for education, everyday expenses or homeownership, and then decide among competing borrowing plans. Something once straightforward — such as telephone service — now requires a multitude of decisions. More and more individuals also must make decisions that have a profound effect on their long-term well-being: about health insurance and retirement savings, for example. And all of these decisions must be made against the backdrop of a complex and rapidly changing economy.

and build assets. They generally offer business education, technical assistance and capital loans targeted to people outside the economic mainstream, including those with limited incomes, women and people of color. Training and education may cover business plan development, accounting, pricing, marketing and other topics related to running a successful business. Loan programs make business capital available to those who may not qualify for traditional bank loans because of credit problems,

a lack of collateral or lack of business experience. Some microenterprise programs also provide free or low-cost business space and equipment.

Microenterprise support programs first entered the U.S. economic development toolbox in the mid 1980s. By 1992, several major private foundations had funded microenterprise development programs, and the U.S. Small Business Administration had launched its Microloan Demonstration Program, which worked through local organizations with the capacity to identify and assist potential clients. The SBA adopted microlending as a permanent program in 1997. As a result of these developments, microenterprise programs proliferated across the nation. Between 1992 and 2002, more than 500 programs emerged around the country. The industry now supports its own trade group and has developed accreditation standards.

Several studies have tracked the long-term success of individual microenterprise programs. The largest such study, reported by the Aspen Institute in 1999, found that 57 percent of micro businesses survived after five years. This exceeds the 47 percent survival rate that the SBA estimates for small businesses overall.

Microenterprise programs also have shown that they can improve the standard of living for their clients and break the cycle of poverty. In the study "Microenterprise and the Poor," three out of four microentrepreneurs surveyed reported an increase in income. Of those, average household income rose \$8,485, from \$13,889 to \$22,374. The study also found that dependence on public assistance among these households dropped by 61 percent.

## The N.C. Microenterprise Loan Program

Since its inception in 1989, the N.C. Microenterprise Loan Program has become a leader in the field, in terms of size and national recognition. It has issued loans totaling more than \$6 million to more than 1,100 small businesses. Half of its clients are women and people of color. It operates in all 85 rural counties.

From the beginning, the program has offered two avenues for obtaining loans: group lending and individual lending.

The group program operates through local sponsors. Individuals participate by forming into groups of four to 10 people. Each group takes part in intensive training and a certification process. Once certified, the group can make credit decisions for its members. Groups may extend new loans only if all existing borrowers are current on their repayment schedule. These loans are limited to a maximum of \$8,000. Group members also work together to support the growth and development of one another's businesses.

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The individual lending program is designed for people with more business experience and offers loans up to \$25,000. Loan decisions are based in large part on the borrower's business plan, character and local economy.

N.C. Microenterprise Loan Program 1989-2004	
Number loans made	1,200
Cumulative dollars loaned	\$6,160,535
Percent female borrowers	54%
Percent minority borrowers	49%
Percent low-income borrowers	48%

Initially, the individual lending program made lending decisions in conjunction with local sponsors. In 2001, the Rural Center introduced the Micro Intake Professional Program. This allows local small business service organizations to refer clients to the Rural Center, which decides whether to issue a loan and manages the loan account. Community college small business centers and community development organizations comprise the majority of these service organizations. Individual borrowers also may contact the Rural Center directly.

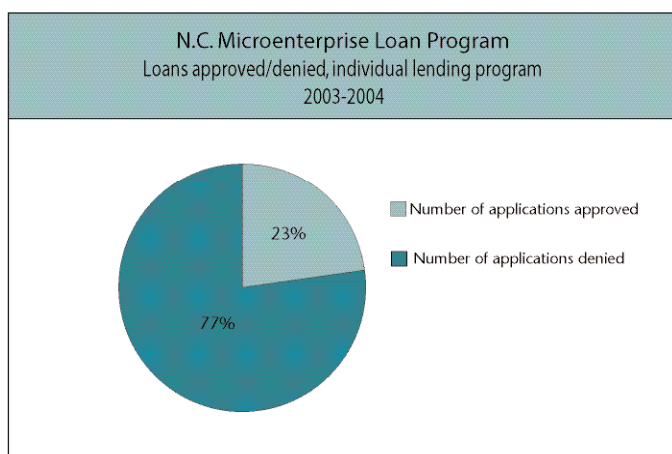
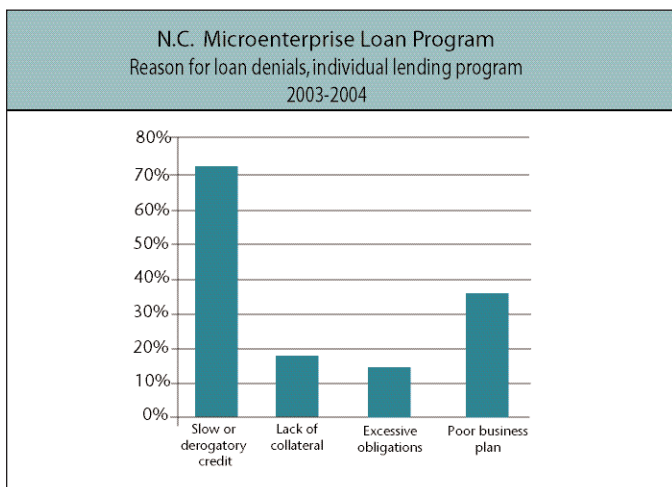
## Limitations on success

The goal of the Micro Intake Professional Program was to increase access to microenterprise loans. Success was mixed: In the first four years, the number of applications increased, but the number of closed loans did not rise proportionately. Concerned, the Rural Center undertook a thorough review of loan applications received and processed through the individual lending program over four fiscal years, studied repayment histories and interviewed local program partners.

The center found that, even though the requirements for borrowing through the Microenterprise Loan Program are more lenient than at a traditional bank, the program had turned down 75 percent of loan applications. Of those rejections, nearly three-quarters were attributed to personal financial management issues. These included poor credit histories, lack of collateral and excessive outstanding obligations. Thus, past financial difficulties — rather than a poor business plan or lack of business experience — ranked as the No. 1 reason for loan denial.

## Experience pays off

An analysis of repayment histories found the most significant predictor of successful repayment to be home



ownership. Of those who repaid their loans in full, 55 percent were homeowners. By contrast, among borrowers who defaulted on loans, only 22 percent were homeowners. The predictive value of homeownership held true, regardless of income or other outstanding debt. In fact, those who repaid the micro loan in full had a slightly higher debt-to-income ratio than did those whose loans were rejected or who defaulted on their loan.

These findings suggest that someone who has the ability to save for and purchase a home has a higher financial proficiency and so represents a better risk for a business loan. The reverse also was true: Among those who received a business loan but lacked the home-buying experience, poor financial skills continued to stymie business success.

### Value of training

A comparison of the Microenterprise Loan Program's two models indicates the value of financial literacy training. Through the individual-lending model, people may apply for a loan without meeting any training or technical assistance requirements. The group-lending model, on the other hand, requires participation in a training program that covers financial literacy, credit worthiness

and credit repair. It also provides ongoing peer support. Loan defaults were lower among participants in the group-lending model (11 percent) than among individual borrowers (14 percent).

Although the number of cases studied does not allow definite conclusions, these results suggest that the combination of training and peer support increased the likelihood an individual will repay a loan. This is consistent with conclusions drawn from other studies. The federal mortgage lender Freddie Mac found lower delinquency rates among borrowers who participated in financial education programs. Similarly, the American Dream Demonstration of the Individual Development Account program correlated higher rates of savings with financial literacy training.

### A nationwide issue

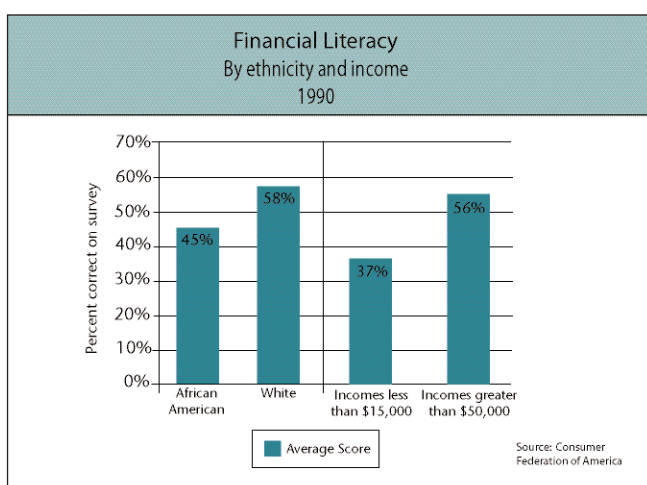
In short, the Rural Center concluded the primary cause of unsuccessful applications and business failures to be a lack of financial literacy among aspiring business owners in this low-income market. Financial difficulties, however, are limited neither to this state nor to low-income individuals. A series of surveys show that many Americans lack the skills necessary to spend money wisely, save for the future and cope with the unexpected. For example:

- In a survey conducted for Bankrate.com, more than half of the 1,000 survey participants scored the equivalent of a D or F in financial literacy.
- A survey of students by the Jump\$Start Coalition for Personal Financial Literacy found modest knowledge about income and spending (62.9 percent and 55.4 percent of questions answered accurately in the respective categories) and even less understanding of money management (45.4 percent) and saving (41.0 percent).
- Older adults also lack knowledge of basic financial and investment terms and practices, according to surveys conducted by AARP and the Federal Reserve Board.
- A survey by the Consumer Foundation of America and VISA, conducted in April 2005, found significant numbers of women worried about lack of savings to cover emergencies. Forty-two percent of women surveyed had less than \$500 in savings for emergencies. Among women 25 to 34 year olds, 55 percent lacked even \$500 in savings.

### Compounding poverty

While not limited to one demographic group, poor money management skills are especially prevalent among minority ethnic groups and lower income

groups. In a 1990 study of financial literacy by the Consumer Federation of America, the average score among African Americans was 45 percent. Among whites, it was 58 percent. Income made an even bigger difference. Those who earned more than \$50,000 a year had an average score of 56 percent, compared with 37 percent for people making less than \$15,000 a year. The problems of inadequate financial knowledge and poverty often compound one another. For example, the poor are disproportionately represented among Americans who lack basic checking or savings accounts. This is harmful because banks charge less for services than do non-traditional financial organizations, such as check-cashing services and pay-day lenders. Furthermore, households with established banking accounts have been found to save more than do households at the same income level that lack bank accounts.



Credit provides another example. Individuals first must understand the importance of shopping for lower rates and better loan terms. Even with this knowledge, options for the poor may be limited by a low net worth and perhaps unfavorable credit histories. As a result, they can rarely take advantage of declines in the level of short-term interest rates.

## Approaches to increasing financial literacy

Nationwide, the issue of financial literacy is being approached from a variety of angles. This includes action by the federal government. The Financial Literacy and Education Commission was established in 2003 to improve financial literacy and education throughout the United States. Its responsibilities include encouraging government and private sector efforts to promote financial literacy and coordinating related federal efforts.

States, banks and employers offer a variety of financial literacy programs to reach specific audiences. Notably, the Federal Reserve Board — the nation's central bank — has developed a financial literacy initiative for its own employees.

Schools are incorporating financial literacy into the K-12 curricula. At least 48 states and the District of Columbia include economics in their education standards, and at least 17 states require students to take an economics course. (Currently in North Carolina, only students in the "career and technical education track" are required to take a business course covering basic finance. The state Senate in 2005 passed legislation [S.B. 912] that would require all students to take financial management training. The House did not act on the proposal.)

New poverty alleviation programs also recognize the link between mitigating poverty and the provision of financial literacy education and training. Individual Development Accounts and similar programs combine financial education with a savings program. Participants create a nest egg for education, homeownership or small business ownership while learning how to manage their money more effectively.

## Coupling financial literacy and preparation for business ownership

At first glance, it seems logical that financial literacy should precede attempts at business ownership. For people of limited means, however, microenterprise can offer the best, perhaps only, available route to self-sufficiency. This adds an urgency that can help rather than hinder the financial management learning curve.

*Grasping the moment.* A key characteristic of an effective adult educational program is taking advantage of a "teachable moment." This is when the individual is both receptive to the lesson because of a current need and able to apply the lesson right away — reinforcing the concept. The most common example is the homeownership class. Workplace sessions on retirement planning also have been shown to increase employee participation in retirement savings programs.

*Keeping it relevant.* Professionals in the financial literacy field stress the importance of clear, achievable goals in keeping the participant engaged. Home ownership programs again provide the best example. Individual Development Account programs also have found that it is important that participants be able to reach their financial goal on a short time-frame, such as six to 18 months. In fact, they saw that participants within two or three months of a goal increased their savings rate to reach the goal sooner. When the overall goal is long term, such as retirement savings, interim goals can be important.

By both of these measures, aspiring microentrepreneurs are prime targets for financial literacy education. Many people interested in starting a business already seek out

training in business management. Others, who may have been turned down for a business loan, want to improve their chances for obtaining credit. Thus, they are receptive to help in general and are in a position to put concepts they learn to immediate use.

Furthermore, aspiring small business owners have readily identifiable goals. If needed, these goals can be divided for short-term achievement, such as saving for a piece of equipment or improving loan readiness. By marrying financial literacy with small business education, financial educators can help prospective business owners use their impatience for short-term results to inculcate lessons that will serve long-term success.

## Designing an effective program

The principles cited above, combined with the experience of the Microenterprise Loan Program and other small business service providers, suggest some basic elements for an effective microenterprise/financial literacy program.

First, financial education needs to be closely tied to small business management. One program, for example, draws connections between the personal budget and the business budget. This not only reinforces concepts, but makes the information more relevant to students.

Second, financial education needs to cover loan readiness. This includes the importance of collateral, debt-to-income ratio and credit repair. Loans are often a critical step for small businesses.

Third, the financial lessons must be immediately applicable. Entrepreneurs will be less likely to feel their time is being wasted, and the lessons will be retained better if used in real world applications.

Fourth, classes need to be offered frequently and on a convenient schedule. Currently, small business owners may have to wait for months to begin a training session, and it may be impossible for them to attend classes that conflict with their normal business hours.

Finally, it's important to note the importance of *structured* training.

In this regard, students do not always know best. When asked how they would like to receive financial information, participants in one survey cited preferences for mass media, brochures and home-videos, all of which they could access on their own time. A Freddie Mac study, however, found lower loan delinquency rates among borrowers who attended classroom financial instruction than among those who engaged in self-study or who received telephone counseling.

The amount of time spent in training also affects its

effectiveness. The Individual Development Account/American Dream Demonstration judged effectiveness by the average monthly net deposits of their participants. An evaluation found that deposits increased with each additional hour of training, up to twelve hours. Both of these studies point to the importance of intensive financial education training over convenience.

A small business owner is eligible for one-on-one assistance throughout the life of his or her businesses. If financial literacy becomes part of this on-going support, it will reinforce the financial lessons and likely increase the business owner's chance for success, including successful loan repayment.

## Available programs in North Carolina

In North Carolina, most small business service providers look for business training needs, not at financial literacy. They may discover through the course of assisting a client with a loan application that the client has poor credit. The typical response, including that of the Microenterprise Loan Program, is to refer the client to a credit counseling agency. This approach treats poor credit as a short-term problem, a barrier to accessing capital, rather than as an indicator of the larger problem, a lack of financial literacy. A few programs are beginning to make the link between technical business assistance and training to increase financial literacy and business success. Several other organizations provide financial literacy training that is not small-business specific, but a valuable resource nonetheless.

The state's leading options for business and financial education include:

### *N.C. REAL*

N.C. REAL, or North Carolina Rural Entrepreneurship through Action Learning, provides educational programs and support for adults and youth interested in entrepreneurship, often in conjunction with small business centers and community groups. The organization develops its own entrepreneurship curricula and trains facilitators to teach the curricula. The curricula cover financial literacy and a variety of other life skills needed to increase the chance of business success. The youth curriculum, in particular, has a strong emphasis on financial education.

### *Small Business Centers of North Carolina Community Colleges*

Small business centers are the primary stop for aspiring entrepreneurs because of their statewide presence. There, entrepreneurs are offered a wide variety of classes and one-on-one assistance. While this is an excellent and often free resource, the offerings are narrowly focused on business development. In general, they do not adequately cover financial literacy.

When several small business centers were surveyed on the training and technical assistance to which they most often referred clients, they listed marketing, business plan development and strategic planning. Financial education was not mentioned. When small business owners do need financial assistance, they usually are referred to consumer credit counseling, which focuses on credit repair.

### *The Cooperative Extension Service*

A pioneer in the field of financial literacy, the Cooperative Extension Service has a long history of promoting financial literacy and a well-developed educational program. It is a statewide resource with an office in every county. Most Cooperative Extension offices offer financial literacy training regularly, and the training is available to anyone who signs up for the classes. Financial literacy classes also are provided on demand for organizations such as IDA groups or Habitat for Humanity.

### *N.C. Microenterprise Loan Program*

"Getting to Yes" is a financial literacy workshop developed and presented by the staff of the Microenterprise Loan Program. The program conducts approximately 20 workshops each year in partnership with the North Carolina Community College System, faith-based institutions and other economic development nonprofits. Like the rest of the Microenterprise Program, the workshop is targeted to low-income individuals, people of color and women.

Among its topics, the workshop covers ways that individuals can increase their chances for business loan approval. Workshop sessions talk in depth about credit, collateral, capacity, cash flow and character, and the how and why these factors influence loan decisions. The discussion is interactive, with an assessment of the credit history and the roadblocks to obtaining credit.

### *N.C. IDA Program of the IDA Collaborative*

Individual Development Account (IDA) programs also are available statewide through a variety of agencies, such as departments of social services, community colleges, community development corporations and other non-profits. The North Carolina IDA and Asset-Building Collaborative provides coordination, technical assistance and advocacy for many of the state's IDA programs.

IDA programs teach financial literacy and encourage low-income participants to save by matching their savings at rates ranging from 1:1 up to 5:1. Participants follow one of three savings tracks: homeownership, higher education and small business. The large majority of participants choose the homeownership track. Homeownership's popularity can be attributed to several factors, beginning with the obvious priority that families

place on homeownership. In addition, the most common sponsors of the program are community development corporations and housing organizations, both of which focus on homeownership. Furthermore, much of the state and federal money used to matching individual savings is expressly for housing.

### *GoodWork*

GoodWork is a Durham-based organization that trains low-income entrepreneurs. The 18-hour program covers household budgeting and the credit report as the first topics in training. Those lessons then expand into business budgeting. Training sessions are available in English and Spanish. After the structured program concludes, GoodWork provides ongoing personal coaching and technical assistance.

### *North Carolina Saves*

North Carolina has joined the America Saves Campaign, an initiative of the Consumer Federation of America to encourage individuals to save and take control of their finances. The program provides no-fee savings accounts through various local financial institutions and matches individuals with either a financial literacy class or a wealth coach.

Service provider	Financial literacy curriculum	Business planning	Statewide	Fee for program	Targets low income
Good Works, Inc.	●	●		●	●
Small Business Centers		●	●		
N.C. Cooperative Extension	●		●	●	
N.C. Rural Center Microenterprise Loan Program		●	●		●
N.C. Saves			●		●
N.C. Public Schools			●		
IDA Collaborative	●				●

North Carolina Saves is a statewide coalition of nonprofit, corporate and government groups, including the IDA and Asset Building Collaborative of North Carolina, N.C. Cooperative Extension and RBC Centura. The North Carolina State Treasurer's Office coordinates the program.

## **Recommendations**

Many financial literacy and microenterprise programs have similar goals: help alleviate poverty by improving financial security and create financial independence. The two strategies also serve similar clients. Despite these commonalities, they have not explored ways to work together. There are several opportunities to strengthen each other's services through partnering and

sharing resources.

Specific recommendations to improve financial literacy training for microentrepreneurs are:

**1. Incorporate financial literacy as part of small business development education and technical assistance.**

Financial education is as important as a business plan or marketing strategy for business success. A client's level of financial understanding needs to be ascertained, and, if needed, the client should be referred to the appropriate financial training.

**2. Increase awareness among small business service providers of the integral role of financial literacy to small business success, especially among low-income owners.** Strategies include:

- Provide training to small business center directors and other small business service providers on the importance of financial literacy to business management. This could be carried out through professional development meetings of the N.C. Microenterprise Loan Program, meetings of the Small Business Center Network and meetings of community development corporations.
- Encourage small business service providers to become involved in statewide financial literacy programs, including the IDA Collaborative and Asset Building and North Carolina Saves.

**3. Develop partnerships and connections among small business service providers and financial literacy educators at the local level.** Small business service providers who are knowledgeable about the financial literacy programs in their community can make better referrals to clients or request financial classes specifically for their small business clients.

**4. Create a financial literacy curriculum that focuses on small business applications.** This would allow small business owners to attend one program instead of shuttling among different classes.

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