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# **No Magic Bullet: Microenterprise Credit and Income Poverty in Sri Lanka**

**PhD thesis**

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This thesis contains no material which has been accepted for the award of any other degree or diploma in any university or other institution. To the best of my knowledge it contains no material previously written or published by another person except where due reference is made in the text.



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## Glossary of acronyms and Sinhala terms

BDS	Business Development Services
BOI	Board of Investment
CCPI	Colombo Consumer Price Index
<i>chena</i>	A traditional form of slash-and-burn cereal and vegetable cultivation
DCS	Department of Census and Statistics
EPZ	Export Processing Zone
HVE	High-value enterprise
IPM	Integrated Pest Management
<i>kade</i>	A petty retail outlet selling food and essential non-food items
LIC	Low-income country
LVE	Low-value enterprise
<i>maha</i>	The November-April cropping season
NDTF	National Development Trust Fund
OFC	Other field crop
<i>pola</i>	Weekly market day
REDS	Rural Enterprise Development Services
SEEDS	Sarvodaya Economic Enterprise Development Services
SME	Small or medium enterprise
THGFP	Two Hundred Garment Factory Program
VHVE	Very high-value enterprise
WDF	Women's Development Federation
<i>yala</i>	The May-September cropping season



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## Abstract

This study seeks to add to what is known about the capabilities and limitations of microenterprise credit as a poverty reduction strategy. It investigates the microenterprise performance and household economic status of a sample of 253 participants in two Sri Lankan NGO-led microfinance programs, the Women's Development Federation (WDF) and Sarvodaya Economic Enterprise Development Services (SEEDS), located in Hambantota district in the country's south-east. It finds that although microenterprise credit has contributed to an overall increase in average income levels its performance in reducing poverty is less impressive, as benefits are skewed towards the upper end of the borrower income spectrum. The largest income increases have accrued to borrowers who were above the poverty line to start with: both microenterprise incomes, and credit-generated improvements in microenterprise incomes, are consistently positively associated with initial household economic status. Initially below-poverty-line borrowers earn less from their microenterprises, their incomes are less likely to increase after taking loans, and when improvements do occur they are usually minor. As three-quarters of initially-poor borrowers remain in poverty after taking loans, including one half who have derived little or no income benefit from their participation, the findings do not support claims that microenterprise credit is an effective solution to poverty.

The central argument is that an income-related impact gap exists, and most poor borrowers do not exit poverty, because the programs do not address non-credit constraints to microenterprise development which impact most severely on poor borrowers. Poor households are less able to use microenterprise loans productively because they are more likely to live in neighbourhoods where profitable investment opportunities are scarce due to deficiencies in local markets and infrastructure; and because even where local environmental conditions support higher-value microenterprises, financial, human capital and sociocultural factors impose prohibitive barriers to entry to higher-value microenterprises.

## Chapter 1

### Introduction

#### 1.1 Microfinance: a cost-effective solution to poverty?

In the 1990s microfinance - the provision of small-scale financial services to households which have difficulty accessing the formal banking sector - has emerged as a major development strategy. Its great advantage is that it offers the possibility of a financially sustainable means of reaching the estimated 80 per cent of developing country households which lack access to institutional loans and savings facilities. Commercial formal financial markets have traditionally failed lower-income groups in developing countries because of the deterrents imposed by lack of information on borrowers' creditworthiness, the high transaction costs associated with small loans to geographically dispersed clients, and the inability of poor borrowers to provide physical collateral. On the other hand attempts to subsidise rural credit, a key poverty reduction strategy in many developing countries in the 1960s and 1970s, have fallen into disrepute, having proved costly, prone to politicisation and relatively ineffective in reaching their intended target groups. Microfinance appears to offer a way out of the dilemma, with its pioneering of new techniques which dramatically reduce the costs and risks of lending to poor clients. Foremost among the new lending strategies is group-based lending, which replaces collateral requirements and the need for lenders to appraise prospective borrowers with joint liability arrangements in which borrowers' peer groups approve and guarantee loans and take on much of the administrative responsibility for monitoring and collection.

The impressive loan recovery rates of microfinance institutions, in most cases well over 85 per cent (Morduch 1999), indicate that many clients can afford to borrow at rates which, while generally higher than standard bank rates, are well below those of the moneylenders, traders and other informal agencies which are the only alternative sources of finance available to most borrowers. In a global development environment which is generally hostile to ongoing subsidisation, microfinance offers donors the enticing prospect of an effective poverty reduction strategy in which program costs are shifted away from donors towards the users themselves, as financially independent microfinance institutions generate sufficient profits from interest on loans to cover their operating expenses and the costs of raising funds in commercial capital markets.

The prospect of commercially viable poverty reduction has generated considerable excitement in development circles, and in the last decade there has been a proliferation of microfinance services, fuelled by funds from OECD and multilateral donors. Many microfinance institutions receive donor funds on the optimistic premise that external assistance is a temporary measure and that they will eventually become entirely self-funding<sup>1</sup>. The World Bank and USAID are supporting major research and development programs with a heavy emphasis on identifying and promoting "best practices" which foster institutional financial self-sufficiency<sup>2</sup>. The World Bank's Consultative Group to Assist the Poorest, with a budget of \$200 million, is dedicated entirely to microfinance and in 1997 the Microcredit Summit, a high-profile consortium of donors and implementing agencies, resolved on the ambitious target of reaching 100 million of the world's poorest people with \$22 billion for microfinance by 2005. By the end of 1999 the 1600 microfinance institutions registered with the Microcredit Summit were serving 24 million clients in Asia, Latin America, Africa and Eastern Europe (Microcredit Summit 2000).

Outside the industry microfinance has attracted something of a reputation as a magic bullet against poverty, supported by vigorous public relations campaigns on the part of its proponents, which rely heavily on "case studies" of desperately poor clients whose lives have been transformed by credit (see for example the Microcredit Summit's website at

www.microcreditsummit.org), and endorsements from such high-profile figures as the president of the World Bank, who has said that

Microcredit programs have brought the vibrancy of the market economy to the poorest villages and people of the world. This business approach to the alleviation of poverty has allowed millions of individuals to work their way out of poverty with dignity (James Wolfensohn, cited in Microcredit Summit 1997:9).

Microfinance remains controversial within the development industry, however. In an environment of shrinking OECD development budgets new microfinance initiatives are supported by reallocating resources from other poverty reduction strategies; a phenomenon reflected in the growing numbers of NGOs which have abandoned their non-financial assistance programs in favour of an exclusive or near-exclusive focus on microcredit (Dichter 1996). The new emphasis on financial services at the expense of more traditional programs is viewed with concern by many observers. Some warn that microfinance may divert funds from other necessary interventions which may be more appropriate for the very poor (Rogaly 1996); others that concentration on a single mechanism such as credit is less effective in reducing poverty than a holistic approach in which economic initiatives are combined with social services such as education and primary health care (Lipton 1996). Still others argue that support for microenterprises - the principal function of microcredit - perpetuates an insecure and poorly-paid form of employment and detracts from interventions aimed at addressing fundamental inequalities in the distribution of resources and labour market opportunities (Buckley 1997).

In what some have described as a climate of enthusiasm bordering on hysteria (Rogaly 1996), claims for the effectiveness of microfinance as a poverty reduction agent have run well ahead of the evidence. There is general agreement that in the right circumstances microfinance can generate substantial improvements in household incomes, but the jury is out on the extent to which it does so among poorer clients. An authoritative cross-country study has produced convincing evidence that microfinance is not the universal panacea for poverty that many hoped for, as its income impact is positively associated with initial client economic status, with differential outcomes at different poverty levels. Consistent findings across a wide range of countries and settings indicate that microfinance produces the greatest percentage increases in household incomes among "upper-poor" and non-poor borrowers who are close to or above national poverty lines. Those who are well below the poverty line - the "extreme-poor" - are not only less likely to participate in microfinance programs; when they do participate they are less likely to experience improvements in their incomes, any improvements which occur are usually too small to enable poverty exit, and they run a higher risk of deepening their poverty by incurring excessive debt (Hulme and Mosley 1996).

Although the impact of microfinance on household incomes declines in line with borrower economic status, and is lowest in the poorest households, there is evidence that it may generate significant non-income benefits for the very poor. Microfinance serves two sets of objectives which are associated with distinct strategic emphases. Promotional approaches, which remain the primary goal of most microfinance programs, aim to move borrowers "from a stable 'below-poverty-line' situation to a stable 'above-poverty-line' situation" (Hulme and Mosley 1996:106). They focus on producing sustained improvements in household incomes through microenterprise development, which they support with business lending, sometimes accompanied by non-financial services such as training and technical assistance. Protectional approaches on the other hand do not aim to increase incomes over time, but to reduce economic vulnerability by smoothing consumption through seasonal income fluctuations and unexpected shocks, ensuring

continuity of access to basic survival needs. Protectional strategies include savings facilities and small, short-term loans which finance consumption, retirement of more costly debts, non-productive asset purchases and subsistence production. As women and members of female-headed households are among the most vulnerable poor, and because of the importance of income controlled by women in reducing intra-household inequalities in consumption, the social and economic empowerment of women is a key protectional strategy.

In recognition of the weakness of promotional microfinance at the low end of the income spectrum donors are becoming increasingly interested in protectional measures (Sebstad and Cohen 2000). There is evidence that the very poor benefit from microfinance services which support basic living standards and empower disadvantaged individuals, and may provide a first step towards sustained poverty reduction, assisting them to reach a minimum threshold of income security from which they can launch higher-risk, higher-return income-generating activities (Hulme and Mosley 1996, Sebstad and Cohen 2000, Zaman 1999). The limitations of protectional strategies in reducing income poverty, however, need to be clearly recognised. They aim to alleviate rather than eliminate poverty. Although they provide a valuable service for households at the margins of survival, mitigating some ill effects of poverty, and may help to establish conditions which allow for eventual poverty exit, they have little impact on average incomes over time. They do not by themselves reduce poverty incidence, and certainly do not provide a means for "millions" to "work their way out of poverty".

Reliable information on who is reached by microfinance, and its client impact, is important for two reasons: to prove impact and improve interventions (Hulme 1997). As most microfinance programs rely on subsidies they need to demonstrate that they produce humanitarian or developmental benefits which justify ongoing donor support. Ideally, they need to meet not only the minimum criterion of proving a generally beneficial impact, but also more rigorous proofs that they reduce or at least alleviate poverty, that they do so more cost-effectively than other interventions and that such impacts could not be achieved without subsidy. Where donors make a poverty focus a condition of their support, as is commonly the case, programs should be able to show not only that they benefit their clients, but also that they generate poverty impacts by including and benefiting *poor* clients, a point reinforced by emerging evidence that impact declines with client income. Reliable impact data provides donors with the information they need to meet the accountability demands of their own stakeholders, and also provides a basis for comparing microfinance with alternative social investments (Woller et al 1999). While little is known about the relative efficiency of microfinance in comparison with investment in health and education services, agricultural extension and other anti-poverty strategies (Mosley 1999), it is arguable that where the poorest groups receive only marginal benefits from microfinance, there may be a high social opportunity cost - i.e., the social costs of foregone social investments - associated with the use of donor funds to support a relatively ineffective poverty reduction activity.

Furthermore, as microfinance subsidies come under increasing pressure from the commercialisation lobby (see footnote 2), arguments for donor-funding would be significantly strengthened by strong evidence that the replacement of subsidies with alternative forms of funding would compromise their poverty impacts. Somewhat surprisingly, given its centrality in the debate, there has been little empirical investigation of the sensitivity of microcredit demand to interest rates, and the data is insufficient to confirm either the welfarists' claim that poor borrowers cannot afford commercial interest rates, or the institutionists' claim that they can (Morduch 1999).

In order to ensure optimal targeting and program design, programs need to understand who they are reaching, how their interventions are affecting their clients, and how non-program variables may constrain impact. Growing evidence that participation rates and income impacts are lowest among the poorest households make impact monitoring and evaluation particularly important for poverty-focused programs. If their interventions are not effective, or are producing differential outcomes in different client groups, they need to know why. It may be feasible for programs to improve impacts by redesigning their services to make loan sizes, repayment schedules, meeting attendance requirements and training programs more responsive to client needs. On the other hand exogenous factors such as unfavourable market environments or inadequate physical infrastructure, over which programs have little influence, may reduce the impact of microfinance on particular target groups. Where exogenous constraints are particularly severe promotional microfinance may be worse than ineffective, encouraging an over-supply of low-value microenterprises which not only provide little benefit to their owners but also generate negative externalities through environmental degradation and the saturation of limited markets, leading to aggregate declines in local incomes. In such circumstances program managers seeking to maximise the socially-beneficial allocation of their resources may decide to target less-poor borrowers who derive greater benefits from their services. If they choose to maintain a focus on the very poor, they may reorient their activities away from income promotion in favour of protectional or non-financial interventions.

## **1.2 Research methodology**

This study seeks to add to what is known about the capabilities and limitations of microenterprise credit as a poverty reduction strategy by examining why some microenterprises earn more than others, and why those of less poor borrowers tend to do better than those of the poor. It investigates the microenterprise performance and household economic status of participants in two Sri Lankan NGO-led microfinance programs, the Women's Development Federation (WDF) and Sarvodaya Economic Enterprise Development Services (SEEDS), located in Hambantota district in the country's south-east. As the primary concern of this study is the impact of microfinance on incomes and income poverty, it confines its investigations to microenterprise development services. As noted above, protectional services do not aim for sustained increases in household income and are therefore outside the scope of this study<sup>3</sup>.

The primary research instrument was a structured questionnaire (reproduced at Appendix 1) administered to 253 respondents, followed by focus group discussions in which about 120 respondents participated, and in-depth interviews conducted by the author and an interpreter with 87 respondents. In addition unstructured interviews were conducted with agency staff, international donor representatives, government officials and expert observers. An abbreviated pilot version of the questionnaire was field-tested in March 1999 when the author conducted a socioeconomic survey of 80 rural households in Kurunegala district. The questionnaire was administered in Hambantota over June and July 1999, and the focus groups and in-depth interviews were conducted during August-September 1999.

Four of the WDF's 64 Janashakthi Bank societies and seven of SEEDS' 125 village societies were selected for the survey. The village branches from which the respondents were drawn were selected, in consultation with NGO staff, with the aim of ensuring coverage of a cross-section of enterprise types and geographic and socioeconomic characteristics which reflected the composition of the NGOs' memberships (see Table 1.1). Respondents were selected randomly from the membership lists of the selected village branches, the only criterion for selection being a current outstanding balance on a microenterprise loan.

Table 1.1: Key characteristics of sample societies

Village society	Sample size	Location type	Socioeconomic mix	Microenterprise mix
<b>WDF</b>	<b>117</b>			
Pallemalala	29	Arid rural, some very remote areas, some lagoon salt flats unsuitable for agriculture.	Mostly poor	Paddy and chena farming, fishing, small-scale livestock, low-value production
Bandagiriya	34	Arid rural, some remote areas.	Mostly poor	Paddy and chena farming
Siribopura	30	Mixed: ranges from centre of Hambantota town, through densely populated but poorly serviced suburbs, to remote areas unsuitable for agriculture	Non-poor in Hambantota town centre, near-poor to non-poor in suburbs, very poor landless in rural areas	Well-established trade enterprises in town centre; petty trade, brick-making, unskilled production and livestock and petty trade in suburbs; fishing and unskilled production in rural areas
Mirijjawila	24	Urban and semi-urban. Densely populated residential areas and commercial and small workshops along Galle Road	Mostly non-poor	Trade, skilled production on Galle Road; skilled production and lower-value petty trade and unskilled production off Galle Road
<b>SEEDS</b>	<b>136</b>			
Pallemalala	27	Mostly arid rural, some very remote areas, some irrigated holdings	Mostly poor, some better-off farmers	Paddy cultivation, fishing, low-value non-farm production
Weniwelara	15	Rural, partly situated in Uda Walawe scheme, mix of irrigated and rainfed holdings	Non-poor on irrigated holdings, very poor in rainfed areas	OFC and chena cultivation, wholesale fruit and vegetable trade
Ethbatuwa	12	Rural irrigated, part of Uda Walawe scheme	Mostly non-poor	Two-season paddy-farming, commercial OFCs
Modaragama	22	Semi-urban: Coastal suburbs of Ambalantota town, varying from relatively prosperous well-serviced suburbs near town centre to very poorly serviced fishing community settlements	Mostly non-poor near Ambalantota town, mostly poor in fishing settlements further from town	Trade, non-farm production, fishing
Palugasgodella	15	Semi-urban village 3 km from Ambalantota	Landless poor and near-poor	Brick-making
Ambalantota	24	Urban: Ambalantota town centre, densely populated suburbs and built-up area along Galle Road	Mostly non-poor	Trade, skilled and unskilled production
Suriyawewa	21	Urban: Densely populated well-serviced town centre	Mostly non-poor	Trade, skilled production

The survey was conducted by the author and a research staff consisting of two interpreters and eight field assistants. Both interpreters were university graduates, one with extensive experience

in Sri Lankan development NGOs. The field assistants were secondary school graduates from local SEEDS member families, who were recommended by staff at the SEEDS Hambantota office. All but one of the field assistants were female. The author's experience with other rural household surveys in Sri Lanka indicates that young local secondary school graduates make ideal interviewers because they are relatively well educated and require a minimum of instruction and supervision, they are unlikely to hold strong biases or conflicts of interest which may interfere with their recording of responses, they are not threatening to respondents and tend to get more accurate answers, and as "locals" they are able to travel freely between villages and conduct their work without attracting undue attention.

Prior to beginning their fieldwork the field assistants attended a one-day briefing session conducted by the author and interpreters. The questionnaires were administered in Sinhala by the field assistants, and later translated into English by the interpreters. Interviews, which took about 60 minutes, were conducted at the respondents' residences. Most of the questions required a quantitative or simple "tick-the-box" type of response which reduces the margin for error and interviewer bias. Interviewers were however asked to record their impressions of respondents' living standards and any other general observations. In particular they were asked to note apparent discrepancies between respondents' reported incomes and observed living standards. In the few cases where significant discrepancies were reported they were followed up by an interpreter or selected for in-depth interviews with the author and an interpreter. Each field assistant was allocated a survey area outside her village to ensure as far as possible that respondents were unknown to interviewers. Each field assistant was given a list of 35 respondents - a total of 280 - to be interviewed, with instructions to return to the houses of those who were not at home or unavailable at first contact. With 253 completed interviews, the response rate was 90 per cent.

As a poverty yardstick the study uses an inflation-adjusted and slightly modified version of the consumption poverty line developed by the World Bank in its 1995 *Sri Lanka Poverty Assessment*, denoting the monthly per capita expenditure required for the preservation of a basic standard of health (World Bank 1995:86-94). The poverty line is composed principally of survival-level food purchases, corresponding to a daily nutritional threshold of 2,500 calories and 53 grams of protein per adult male equivalent, which account for 82 per cent of its value. The remaining 18 per cent is made up of essential non-food purchases which exclude consumer durables but include expenditure on housing, clothing, fuel for lighting, health, education and transport. The Bank set the per capita poverty line at Rs.471 per month for 1990-91. Its value was adjusted for inflation by Aturupane (1999) to Rs.717 for 1995-86, and by the author to Rs.997 for 1999, in line with movements in the Colombo Consumer Price Index<sup>4</sup>.

The median family size of the Hambantota sample was 5 and the mean 4.94. In order to derive a household poverty line the per capita poverty line of Rs.997 was multiplied by a factor of 5 to Rs.4,985 and rounded to Rs.5,000 (about \$US70)<sup>5</sup>. Although the World Bank's poverty line does not include non-cash income sources, subsistence food production is included as a component of income in this study because of its considerable importance in the economies of the sample borrowers, where it accounts for up to a third of the total income in the poorer paddy-farming households, and makes farmers considerably better-off than the landless rural poor. As household income is taken to include the imputed cash values of vouchers from government welfare programs and subsistence production as well as cash income, the poverty line used here is lower than that used by the World Bank.

The research design uses two sets of poverty-status data. One measures household income as at June 1999; the other measures income prior to the first NGO loan (for those who took their first



loan in 1994 or later), or in June 1994 (for those who took their first loan prior to 1994). Current economic status was derived by obtaining detailed data on all current and recent household income sources, averaged over a twelve-month period to take account of seasonal fluctuations. Data on pre-loan economic status was obtained by asking respondents to recollect their household income sources as at June 1994 or immediately before the first loan. Respondents were also asked to describe significant changes in household income or asset ownership since taking their first loan, and changes in their general living standards during the period of program participation. Information on the cash values of pre-loan income was sought, but as the reliability of such data is limited by memory lapses, corroborative data in the form of detailed descriptions of income sources was also sought. As historical data on wage rates, the values of welfare transfers and other common income sources is readily available, a more reliable estimate of household income is derived from knowledge of the nature of household income sources, rather than relying on respondents' recollected estimates of their value.

Borrowers were assigned a pre-loan or initial income category according to their economic status in June 1994 or, for borrowers joining the programs after that date, immediately before their first microenterprise loan, and a current income category according to their economic status in June 1999. For the purposes of the study five household income categories were constructed: two below the poverty line and three above it, as described in Table 1.2. The incomes of extreme-poor and poor households are insufficient to meet essential basic needs. The incomes of near-poor households are sufficient, averaged over a twelve month period, to finance basic survival requirements with small margins left over for modest discretionary expenditure. Because of the importance of seasonal activities such as paddy-farming and fishing in the local economy most households experience seasonal income fluctuations, which are most pronounced among farmers but also affect the non-farm sector via the impact of seasonality on demand. In near-poor households consumption levels often fall below the poverty line during lean seasons, particularly among paddy-farmers, who are over-represented among the near-poor. The remaining non-poor households are classified into two groups: the non-poor 1 group whose per capita incomes are between 133 and 200 per cent of the poverty line, and the comfortable non-poor 2 whose incomes, at more than 200 per cent of the poverty line, are well within the top half of the national income distribution.

**Table 1.2: Household income distribution before and after program participation (per cent)**

Income group	Monthly household income*	Pre-loan income status	June 1999 income status
Extreme poor	Up to 67% of poverty line: incomes Rs.3,350 or less	11.1	7.9
Poor	67-100% of poverty line: incomes Rs.3,351 - 5,000	32.8	28.5
Near-poor	100-133% of poverty line: incomes Rs.5,001 - 6,650	28.1	25.7
Non-poor 1	133-200% of poverty line: incomes Rs.6,650 - 10,000	16.2	17.4
Non-poor 2	More than 200% of poverty line: incomes above Rs.10,000	11.8	20.5
<b>Total</b>		<b>100.0</b>	<b>100.0</b>

\* 1999 currency values

### 1.3 Summary of findings

As Table 1.2 indicates, program participation has coincided with a considerable improvement in the sample's poverty profile: the percentage of households in poverty fell from 44 to 36 per cent, and the percentage in the high-income non-poor 2 category almost doubled. There is no doubt that microenterprise credit has contributed to an overall increase in average income levels. Its performance in reducing poverty however is less impressive, as the research findings strongly

support Hulme and Mosley's hypothesis of an income-related impact gap, with a skewing of benefits towards the upper end of the borrower income spectrum. The largest income increases have accrued to borrowers who were above the poverty line to start with: both microenterprise incomes, and credit-generated improvements in microenterprise incomes, are consistently positively associated with initial household economic status. Initially below-poverty-line borrowers earn less from their microenterprises, their incomes are less likely to increase after taking loans, and when improvements do occur they are usually minor and in most cases do not enable poverty exit.

To guarantee a microenterprise-led exit from poverty, microenterprises in most poor households need to earn at least Rs.4,000, or 80 per cent of the household poverty line. About one third of the sample microenterprises yield monthly net returns of more than Rs.4,000, averaged over a twelve-month period, but few are owned by poor households. Of the 87 Rs.4,000-plus enterprises in the sample, 72 are owned by initially above-poverty-line borrowers. Rates of ownership of high-earning enterprises decline consistently across pre-loan income categories, from about 50 per cent among initially above-poverty line borrowers (and more than 75 per cent in the high-income non-poor 2 category), to just 18 per cent among initially-poor borrowers and to zero among the initially extreme-poor. Conversely, 90 per cent of initially extreme-poor borrowers, and 50 per cent of the initially-poor, own marginal enterprises which earn less than Rs.2,000, in comparison with fewer than a quarter of initially above-poverty-line borrowers.

Not only do initially less-poor borrowers own higher-earning microenterprises, they also experience greater increases in their microenterprise profits after taking loans. Overall, about two thirds of borrowers experienced some improvement in the earnings of their loan-assisted microenterprises during the period of program participation. As with absolute microenterprise earnings, credit-generated improvements in earnings are unevenly distributed across initial income categories, with the largest increases and highest frequency of increases occurring at the upper end of the income spectrum. More than 80 per cent of initially above-poverty-line borrowers experienced some improvement in their microenterprise earnings, in comparison with 53 per cent of initially-poor and just 43 per cent of initially extreme-poor borrowers. Among those whose microenterprise incomes improved, initially above-poverty line borrowers were more than twice as likely than their poorer counterparts to experience large increases of Rs.1,000 or more.

The findings indicate that microenterprise credit is of limited effectiveness in reducing income poverty. About half the initially below-poverty-line borrowers experienced some improvement in their household incomes - as distinct from their microenterprise incomes - during the period of program participation. Only 25 per cent crossed the poverty line, however, as the improvements in their incomes were in many cases too small to enable poverty exit. Not surprisingly, proximity to the poverty line is an important factor in poverty exit, as those who are just below the poverty line require smaller income increments than poorer households in order to cross the threshold, and are likely to own better-performing microenterprises. One third of initially-poor households crossed the poverty line, but only one of the 28 initially extreme-poor borrowers did so. Moreover the contribution of microenterprise credit, as distinct from non-program factors, is in doubt, as a substantial proportion of those who exited poverty did so as a result of increases in remittances from migrant workers and other non-microenterprise income sources. Although increases in the earnings of loan-assisted microenterprises were usually a contributory factor in poverty exit, they were not necessarily the principal contributor. Up to a third of the 25 per cent who exited poverty could probably have done so without microfinance. If poverty exit is a program performance criterion, a success rate of only 25 per cent, or perhaps even less, should be a cause for concern for program managers and donors. Even the less rigorous criterion of a

measurable improvement, no matter how small, in the household incomes of poor borrowers, yields a modest success rate of about 50 per cent.

The central argument of this study is that an income-related impact gap exists, and most poor borrowers do not exit poverty, because the programs do not address non-credit constraints to successful microenterprise development which impact most severely on poor borrowers. Microenterprise credit can work very well under certain conditions which are relatively uncommon among poor populations. It works best for microenterprises which have access to vigorous markets and sound infrastructure, and whose owners possess technical and management skills, but need relatively small inputs of investment capital. With microfinance, microenterprises which possess these attributes can generate incomes which support their owners well above the poverty line. Because these characteristics are positively associated with initial household income, microfinance produces stronger impacts among less-poor borrowers. Poor households are less able to use microenterprise loans productively because they are more likely to live in neighbourhoods where profitable investment opportunities are scarce; and because even where local environmental conditions support higher-value microenterprises, the high financial and human capital requirements associated with high-return activities impose prohibitive barriers to entry for the resource-poor.

The local physical and economic environment is a key determinant of microenterprise performance. The geographic settings from which the sample borrowers were drawn vary widely in terms of population density, average household incomes, infrastructure development and the level and composition of economic activity, ranging from relatively densely populated, well-serviced and economically vigorous regional towns and settlements along the district's main coastal road, and prosperous irrigated farming regions, to peripheral semi-urban shanty settlements located some distance from centres of commercial activity, and the remote and underdeveloped arid rural hinterland. In towns, along main transport routes and in irrigated farming regions, favourable infrastructure and market conditions support the development of high-value microenterprises in a diverse range of occupations. In remote rural areas and - to a lesser extent - in the poorer semi-urban settlements, however, unfavourable local demand and production conditions restrict both the range of possible microenterprise occupations, and their profitability. Productivity and technological innovation are impeded by inadequate irrigation and power infrastructure. Local demand is limited by low local population densities and low incomes. Poor transport services impose severe constraints on both production and demand, reducing access to raw materials and other inputs, and to non-local customers. Intense competition imposes additional limitations on profitability and growth potential: with limited scope for diversification, microenterprises cluster in a narrow range of occupations, which combined with low barriers to entry contributes to chronic market saturation.

Poverty in Sri Lanka is largely - although not exclusively - a rural phenomenon: in rural areas, where most Sri Lankans live, rates of poverty are well above the national average, and the rural poor are poorer than the urban poor. Similarly, among the sample borrowers the incidence and depth of poverty was significantly higher in remote rural regions, where 58 per cent of borrowers were below the poverty line and 13 per cent were in extreme poverty at the time of the survey, in comparison with corresponding figures of 36 per cent and 8 per cent respectively for the sample as a whole. At the same time the loan-assisted microenterprises in remote rural areas earn far less on average than their counterparts in the irrigated settlements and in urban and semi-urban locations. As noted above, about a third of the sample microenterprises generate poverty-clearing incomes of Rs.4,000 or more; in remote rural locations however this proportion falls to just 13 per cent. At the other end of the performance continuum about 37 per cent of the sample enterprises -

but more than 50 per cent of those in remote areas - are marginal activities earning less than Rs.2,000.

Even in the better-off irrigated settlements and semi-urban and urban regions, where more favourable demand and production conditions support a more diverse range of occupations, some of which are capable of generating high returns, only half of the sample enterprises earned more than Rs.4,000. In these better-off locations borrower-related factors rather than conditions in the external environment are the key determinants of microenterprise incomes. Unlike remote rural areas, where unfavourable physical and economic conditions impose binding constraints on profitability, higher-value opportunities exist in the better-off regions, but their financial and human capital requirements present barriers to entry which deter poorer borrowers from selecting them.

The highest-earning microenterprise occupations require large capital investments which exceed the programs' lending limits, and are therefore available only to relatively well-off borrowers who can supplement their microcredit loans with savings, transfers from regular income streams or additional borrowings. Even where microcredit can cover enterprise capital requirements, poorer borrowers are reluctant to take large loans because the consequences of a loss are more severe, given their proximity to the margins of survival. In addition, as they are less able to finance loan repayments and consumption from non-enterprise income sources they tend to avoid the fixed capital investments and longer gestation periods associated with higher-value microenterprises, in favour of lower-risk, lower-return working capital investments which provide immediate cash flows.

Poorer borrowers also have lower endowments of the human capital resources required for higher-earning microenterprises. They are less educated, possess fewer technical and management skills, are in poorer health and are more likely to experience household-level labour shortages. In addition they are more likely to possess low self-confidence, poor communication skills, reluctance to innovate and other anti-entrepreneurial personal traits characteristic of social disempowerment. They are more likely to live in sociocultural environments which discourage entrepreneurship, and to be subject to gender and caste-based discrimination which restricts the range of culturally acceptable activities open to them and closes their access to some higher-value occupations.

#### **1.4 Structure of the study**

Part 1 of the study, which includes chapters 2 and 3, sets the research in context, reviewing what is currently known about microenterprise finance and poverty and describing the poverty and labour market environment in which Sri Lankan microenterprises operate. Chapter 2 reviews recent research on microfinance and poverty. Chapter 3 describes recent trends in poverty in Sri Lanka and the regional distribution of incomes and economic opportunities. Part 2 of the study, which includes chapters 4-7, presents the research findings and includes an addendum containing thirteen borrower case studies drawn from the sample which illustrate key issues identified in the preceding chapters. Chapter 4 examines the outreach of the case study programs, describing the socioeconomic composition of participants, comparing them with the wider community from which they are drawn and examining recent developments which have contributed to shifts in the NGOs' targeting focus. Chapter 5 describes the economic status and various income sources of the sample borrowers, and examines the underlying causes of differences in the size and composition of household economic portfolios, and in the role of the microenterprise in the household economy.

Chapter 6 examines the fundamental determinants of microenterprise performance, and the impact of loans on enterprise incomes. Among the sample enterprises the major determinants of performance, which vary considerably between occupations and locations, include the quality of infrastructure, input costs and access to inputs, and the market and competitive environment. It argues that as the upper limits to microenterprise incomes are set by these external demand and production conditions, which are not amenable to inputs of credit, microfinance has little success in raising the incomes of low-earning enterprises to poverty-clearing levels. Loans promote growth within the limits imposed by external constraints but they cannot usually shift growth ceilings upwards. As chapter 6 shows, there are considerable disparities between the sample microenterprises in earnings and growth potential, and the lowest-earning enterprises experience the smallest credit-led improvements in income. By itself such a finding is not sufficient to establish that an income-related impact gap exists; it needs to be shown that microenterprise performance is linked to borrowers' pre-loan economic status. Chapter 7 develops the second step in the central argument of this study, showing how the distribution of microenterprise incomes is heavily skewed towards the non-poor, and why poorer borrowers tend to select enterprises in lower-value occupations. It considers the impact of household economic status and access to finance, human capital development, gender and other sociocultural factors on microenterprise selection and performance. It concludes with an analysis of the impact of microcredit on household incomes and poverty exit.

Given the importance of non-credit factors in determining microenterprise performance, strategic non-financial interventions may offer scope for the improvement of microenterprise incomes to levels which offer poor borrowers more realistic prospects of microenterprise-led poverty exit. The concluding chapter discusses recent developments in national infrastructure policy and the role of non-financial enterprise assistance services in promoting microenterprise development.

## Chapter 2

### Microenterprise finance and poverty: a survey of the literature

#### 2.1 Introduction

This chapter reviews the current state of knowledge regarding the impact of microenterprise credit on the outreach and impact of microfinance programs, with particular attention to their effects at the lower end of the income spectrum.

Section 2.2 examines the relationship between income status and participation in microcredit programs. While the composition of client bases varies according to the settings in which programs operate, their mandates and targeting practices, cross-country evidence indicates that most microfinance clients are in the income band which ranges from just below the poverty line to some distance above it, while the wealthy and very poor tend to be excluded. Not surprisingly, rates of participation by poor borrowers are significantly higher in programs which explicitly target the poor, but even poverty-focused programs have difficulty including the poorest households. Studies have identified a number of factors which contribute to the exclusion of very poor clients: as they are relatively difficult and costly to reach, programs concerned with their financial bottom lines have an incentive to avoid them in favour of larger, more profitable loans to less-poor clients; the extreme-poor are rejected by existing members and program staff who doubt their creditworthiness; they are deterred by program requirements such as regular meeting attendance and compulsory savings contributions; they self-exclude out of a reluctance to incur debt. A number of observers have associated these exclusionary factors with the well-observed tendency of programs - even those with an explicit poverty focus - to shift over time towards a less-poor client base.

Section 2.3 examines what is known about client impact. It briefly reviews findings relating to protectional impacts on consumption-smoothing, asset accumulation and women's empowerment before going on to examine its promotional impact on microenterprise performance and household income, the main focus of this study. The evidence indicates the microfinance has a generally beneficial effect. Studies comparing microfinance participants with control groups find that the participants do better on a range of promotional indicators including microenterprise profits, household incomes and poverty exit rates. On the whole borrowers are better off with microfinance than without it, but program benefits are not uniformly distributed, flowing predominantly to less-poor participants.

Although a number of studies have investigated the determinants of microenterprise performance, relatively few directly address the question of why the enterprises of poor borrowers earn lower incomes. Section 2.4 reviews what is known about the variables affecting microenterprise performance, and the extent to which the findings illuminate the dynamics of the microfinance impact gap. Among the many factors which have been found to influence microenterprise performance are local physical and economic conditions, macroeconomic conditions, the political and regulatory environment, borrowers' human capital endowments, sociocultural factors including locally prevailing attitudes towards entrepreneurship and class and gender issues, and borrowers' attitudes to risk and debt. There is evidence that these factors are linked to borrower socioeconomic status: poorer borrowers are more likely to live in underdeveloped regions, are more vulnerable to inflation and other macroeconomic events, their enterprises receive less protection from legal and regulatory authorities (although on the other hand the larger businesses of less-poor borrowers are more likely to be subject to taxation and other adverse regulatory

impacts), their human capital bases are lower, they are more likely to be disadvantaged by sociocultural factors, and are more risk-averse.

Microenterprises need to be understood in their broader context as contributors to local labour markets and household economies. Many households in developing countries make use of a range of income sources which may include, in addition to microenterprises, regular or casual wage employment, remittances from migrant workers and government transfers, and few depend solely on microenterprises. The utility of microenterprise development as a poverty reduction strategy depends not only on the capacity of microenterprises to generate poverty-clearing incomes, but also on the accessibility and relative attractiveness of alternative income-generating activities. Section 2.5 reviews recent findings on the role of microenterprises in the national economy and in household economic portfolios. The contribution of the microenterprise sector to GDP is generally small, but it plays a major role in the labour market, through its provision of self-employment and unpaid work for household members rather than wage employment, to which it contributes little. While a minority of microenterprises are high-earning activities into which operators are drawn by considerations of profitability, the evidence indicates that growth in the microenterprise sector tends to be countercyclical, with the most rapid expansion occurring during periods of macroeconomic stress, and that most microenterprises are low-value occupations into which their owners are pushed by the failure of the economy to provide more productive forms of employment. In the context of their contribution to the household economy, absolute microenterprise incomes are, not surprisingly, positively associated with household income. The relative importance of the microenterprise in the household economy is also related in a less straightforward fashion to household income: the households which are most dependent on their microenterprises tend to be at the bottom and top of the income spectrum, while those in the middle are more inclined to diversify their income sources.

## 2.2 Who participates?

The extent to which microfinance programs reach the poor has been the subject of considerable recent research interest and has been addressed in a number of individual studies and cross-country comparisons (Sebstad and Cohen 2000, Hulme and Mosley 1996, MicroBanking Bulletin 1998). The comparability of their findings is limited by an absence of standardised poverty definitions and measurement tools; moreover information on participant income status is often of limited reliability as few microfinance agencies maintain records of their clients' baseline poverty status or have a clear idea of their poverty levels (Sebstad and Cohen 2000, Rhyne 1998). While there is a lack of uniformity among researchers on how to measure poverty and where to draw the poverty line, most evaluations use similar typologies which distinguish between various gradations of poverty: at the bottom of the pyramid are the "extreme-" or "core-poor" who comprise the bottom 50 per cent or thereabouts of those in poverty, followed by the "moderate-" or "upper-poor" whose incomes are closer to but still below the poverty line, the "near-poor" or "vulnerable non-poor" whose incomes are just above it, and above them, the relatively comfortable "non-poor".

As most microfinance agencies are NGOs which include a concern with poverty reduction among their principal objectives, and rely on donor funds which usually carry some form of poverty-focused conditionality, "reaching the poor" remains a major objective of most microfinance programs. Few microfinance programs target below-poverty-line clients exclusively, however. Within the limitations imposed by definitional and data inadequacies, the evidence indicates that most microfinance clients come from a band ranging between the upper ranks of the poor and the lower ranks of the non-poor (Koopman 1996, Copestake et al 1998, Chen and Snodgrass 1999, Barnes et al 1998), and often fall within the upper half of the local income distribution in their relatively poor communities (Snodgrass 1996, Hulme and Mosley 1996, Wright et al 1999), a



pattern which remains remarkably consistent across a wide range of national and program settings despite considerable heterogeneity between microfinance agencies in their mandates, targeting mechanisms and local geographic and economic environments (Hulme and Mosley 1996, Matin et al 2000, Sebstad and Cohen 2000).

A comparative study of East African microfinance institutions found that while all programs included borrowers who were just above the poverty line and nearly all included the upper-poor immediately below it, only 40 per cent included wealthy or extreme-poor members (Matin et al 2000). A cross-country study of twelve microfinance programs found that in four the majority of clients were below the poverty line, while in the remaining programs the proportion of poor clients varied between zero and 52 per cent (Hulme and Mosley 1996). Another cross-country survey of 20 microfinance programs found that in 11 the majority of clients were above the poverty line, while extreme-poor clients in the bottom half of those below the poverty line comprised more than a quarter of members in only four programs and were a majority in none (Sebstad and Cohen 2000).

A series of studies in Africa, Asia and Latin America commissioned for the World Bank's 2000 World Development Report found that in all countries and institutions surveyed the majority of microfinance clients were "moderate-poor" borrowers who shared a range of socioeconomic characteristics including home ownership, ability to eat regularly and send children to high school, ownership of some consumer durables, established relationships of trust in their communities and at least one regular source of income. Non-poor households, characterised by their ownership of solidly-built houses, land and high-value consumer goods, leadership positions in their communities and their ability to provide private school and university education for their children, also had high rates of participation which were slightly lower than those of the moderate-poor. Extreme-poor households, with shared characteristics which included limited ability to send children to school, low rates of home ownership and limited social connections, were considerably less likely to participate than either the non-poor or moderate-poor (Sebstad and Cohen 2000).

Participation falls close to zero at each extreme of the income spectrum. The standard features of microcredit programs, which typically include small loan sizes, regular compulsory meeting attendance, joint liability for the loans of other borrowers, interest rates which exceed standard bank lending rates, and in some cases contributions of physical labour, usually deter very well-off borrowers who have access to cheaper, higher-status and more convenient alternative sources of capital (Asian Development Bank 1997, Johnson and Rogaly 1997, Hulme and Mosley 1996:8, Matin 1998). At the other end of the income spectrum most studies find that participation is very low among the economically inactive destitute households which typically comprise the bottom 5-10 per cent of the poor (Hulme and Mosley 1996, Asian Development Bank 1997, Evans et al 1999, Sebstad and Cohen 2000). Microcredit clients who are below the poverty line tend to be from the class of "working poor" rather than from the destitute. As borrowers must generate a surplus in order to repay loans at interest, microcredit programs avoid those whose productive capacity is severely limited by age, ill-health or other severe social or physical disabilities, and are unable to use credit to generate incomes (Hashemi 1997), or where social problems such as homelessness, substance abuse, family instability or involvement in petty crime compromise creditworthiness (Rahman 1997). Many observers argue that microfinance is not an appropriate intervention for the destitute poor, who have prior needs which are best met through income transfers and essential social services rather than financial services (Robinson 1996, Asian Development Bank 1997, Chowdhury and Alam 1997).



Traditionally microfinance agencies have employed a variety of selection processes in order to ensure the participation of poor clients, including the use of wealth-ranking exercises and other poverty assessment mechanisms and the imposition of income or asset-ownership eligibility ceilings and the deliberate adoption of design features which are unattractive to better-off borrowers. Some programs target geographically, offering their services to all households within given locations where poverty incidence is high; some target specific population segments who are very poor or are particularly disadvantaged by gender or caste; others target their clients on the basis of their entrepreneurial ability rather than their poverty. Increasingly programs employ no specific targeting criteria (Johnson and Rogaly 1997). The socioeconomic composition of participants is strongly influenced by programs' targeting strategies. Rates of participation by the poor are highest in programs which employ poverty-focused targeting criteria, lower in programs which do not employ specific targeting criteria and negligible in programs which explicitly target the non-poor (Todd 2000, Hulme and Mosley 1996, Sebstad and Cohen 2000, Navajas et al 1998). Non-targeted programs operating in rural areas, which tend to be poorer, have higher rates of participation by the poor than programs with a largely urban client base (Navajas et al 1998). Targeting criteria based on perceived entrepreneurial ability rather than poverty may result in a drift away from the poorest (Johnson and Rogaly 1997).

Even poverty focused programs with most of their memberships below the poverty line have trouble including the "core-poor" (Rahman 1997, Hashemi 1997), and some show signs of movement away from their original core-poor constituencies. Microfinance programs tend to target less-poor clients as they expand over time, indicated by the widespread tendency for newer clients to be better-off than the original members when they first joined (Montgomery et al 1996, Zaman 1999). Several studies indicate that in the large-scale Bangladesh programs the proportion of nominally ineligible clients has increased from about 5 per cent in the late 1980s to 25-30 per cent in the 1990s (Matin 1998). Evidence from the Bangladesh Rural Advancement Committee (BRAC) suggests that while non-target-group members are generally better off than the target population, they are not part of the village elite, being poorer than non-target-group households which do not join (Zaman 1997).

Institutional expansion and the drive for financial self-sufficiency has been linked to shifts towards organisational cultures which emphasise credit discipline over protection and mutual support and towards a less-poor clientele (Hulme and Mosley 1996). BRAC's rapid expansion in the early 1990s was accompanied by an increasing emphasis on credit-only services at the expense of mutual group support, creating exclusionary pressures on the poorest (Montgomery 1996). An examination of a rapid increase in mis-targeting by the Grameen Bank indicates a link between pressures to improve institutional financial self-sufficiency and a drift towards a less-poor clientele. Very little of the observed 'mission-drift' could be explained by the program-related graduation of some members to higher levels of land-ownership and income; the main cause was found to be the introduction in 1992 of a new seasonal lending scheme which offered significantly larger loans than its existing loan programs, and was linked to pressures on branch managers to increase their total disbursements. The new borrowers who joined to take advantage of the larger seasonal loans owned on average more than twice as much land as the pre-1992 members (Matin 1998).

There is considerable evidence linking the commercialisation of microfinance with a dilution of poverty focus. Commercially-oriented programs which prioritise financial and institutional objectives over social objectives tend to target middle-income borrowers and serve the poor only incidentally (Navajas et al 1998). The clients of financially self-sufficient microfinance institutions are on average significantly better-off than those of subsidised programs, as indicated by both direct survey data (Hulme and Mosley 1996) and the use of loan balances as a proxy for

income levels. Cross-country evidence indicates that the average client loan balance in self-sufficient institutions is \$430 - a level which in poor countries suggests an income at least as high as the poverty line, and often well above it - but in subsidised programs is just \$100 (Morduch 1999).

In the interests of maximising institutional financial stability there are sound reasons for targeting the less-poor. Larger individual loans expand total portfolio volume, earning more interest revenue without increasing transaction costs (Mosley 1996a, McNelly and Stack 1998). As the poorest are unable to take on the risk or meet the repayment schedules of larger loans, the effort to reduce costs requires a less-poor clientele who demand larger loans. Less-poor memberships are in the interests of agencies in pursuit of commercial funds, as they reduce the portfolio share of the very poor and the perceived risks associated with high exposure to them; and the less-poor are more likely to save, thereby improving institutional deposit bases and self-financing ratios (Zaman 1998). As many studies have pointed out, the pursuit of institutional financial stability may be directly opposed to pro-poor strategies which are labour intensive and involve higher unit transaction costs (Rahman 1997, Mosley and Hulme 1998). There is concern that 'minimalist' microfinance programs which attempt to reduce their costs by eliminating 'non-core' social mobilisation and other capacity-building initiatives may exacerbate exclusionary tendencies (Evans et al 1999).

Incentive systems based on financial performance may encourage staff to give preference to larger loans to successful repeat clients rather than pursuing new, poorer, unknown clients with smaller borrowing requirements (Benjamin and Ledgerwood 1999), or to select the more "creditworthy" better-off members of the target group (Montgomery et al 1996). Koopman (1996) argues that divorced and abandoned women, who are over-represented among the very poor, are discouraged from seeking WEDP loans by administrative insistence on evidence of land ownership and a male relative's approval of the loan application. Female-headed households are reported to be under-represented in BRAC in proportion to their representation in the general population, at 10 and 23 per cent respectively (Montgomery et al 1996) but another study indicates that although female-headed households are among the poorest, female-headedness *per se* is not associated with non-membership in BRAC (Evans et al 1999).

There is a widespread evidence of a tendency among the gate-keepers of access to microfinance programs - field staff, peer group leaders and existing members - to view the poorest as "bad risks", and exclude them accordingly (Hulme et al 1996, Hashemi 1997, Evans et al 1999, Koopman 1996, Montgomery 1996, Matin et al 2000). Some groups actively seek to recruit new members who are better-off than existing members, in order to improve the group's financial stability and increase the pool of funds available for intra-group loans, and possibly to avoid alienating powerful village figures who seek access to credit (Zaman 1997). At least one study reports an instance where less-poor members dominated group leadership positions and acted systematically to exclude poorer members from accessing loans (Montgomery et al 1996). The marginalisation of the very poor by fellow group members has led some to argue that the very poor cannot be reached by programs targeting a mix of poor and less-poor clients (Simanowitz and Nkuma 1999).

Not only are the very poor excluded by other members and program staff; they also exclude themselves. They are more likely to view regular repayments as an insupportable burden, especially when they experience irregular cash flows (Montgomery 1996), and reluctance to incur unserviceable debt is a commonly-reported reason for self-exclusion (Hashemi 1997, McNelly and Dunford 1998, Matin et al 2000). The opportunity costs of microenterprises are higher for poor borrowers whose microenterprise options, for reasons discussed below, are usually limited

to low-earning activities which may generate lower returns than casual wage employment (Rahman 1997). Many studies have found the social isolation of the poor to be a significant barrier to participation. Poor non-participants in Ghana often did not hear about a new program or were not invited to join peer groups (MkNelly and Dunford 1998). The poorest are intimidated by program "rituals" such as strictly enforced attendance at weekly meetings, requirements to memorise and recite program rules, and public discussion of loan applications and repayments (Chowdhury and Alam 1997, Hashemi 1997, Montgomery et al 1996). The strong observed correlation between non-participation in BRAC and lack of education may be attributable to uneducated women's lack of the minimal skill requirements necessary for participation in meetings (Evans et al 1999). Other program-related requirements, such as the requirements to purchase "shares" or contribute to savings funds deter the poorest households. As poverty is often associated with a household-level labour shortage, the high opportunity cost of time and limited capacity for labour substitution may make it difficult for poor clients to comply with meeting attendance requirements (Evans et al 1999).

Client income status impacts on program retention as well as participation. A recent East African study found that while program dropout rates were constant across client income groups, the reasons for dropping out varied with income status: poor clients were more likely to leave programs when wealthier members joined their joint liability groups, leading to an increase in average loan sizes and placing pressure on poor members to guarantee much larger loans than they themselves are willing to take; while less-poor members were more likely to drop out through frustration with meeting attendance requirements and the small size of group-based loans (Matin et al 2000). Members of the Grameen Bank are pressured by staff to cover their arrears by taking new loans, a process which improves short-term performance on repayment and disbursement indicators, but contributes to "a spiralling debt cycle in which many members in the study area feel they have become entrapped" and the poorest households, which are least able to cope with rising debt burdens, are most likely to drop out of the program (Rahman 1999). There is anecdotal evidence that most clients who drop out of BRAC are poorer members who are unable to meet strict repayment requirements (Montgomery 1996).

## 2.3 Impact

As discussed in chapter 1, microfinance may serve the promotional objective of household income enhancement through microenterprise development, and the protectional objective of reducing vulnerability through consumption smoothing and the empowerment of women and other particularly disadvantaged groups.

### 2.3.1 Protectional impacts

This section reviews findings relating to protectional impacts on vulnerability to shocks, asset-building, food security and women's empowerment, and promotional impacts on income levels. Asset-building reduces vulnerability by enabling diversification and the accumulation of stocks which can be sold to meet consumption needs, and by improving creditworthiness and hence ability to borrow during a crisis (Zaman 1999). Several studies have noted the importance of credit in enabling poor households to build up and diversify their asset bases (Montgomery et al 1996, Hulme and Mosley 1996, Sebstad and Chen 1996, Chowdhury and Alam 1997, MkNelly and Dunford 1999). Access to loans may enhance income security during a crisis by forestalling the sale of assets (Montgomery et al 1996), and assist consumption-smoothing during lean periods by enabling households to make bulk food purchases, diversify into non-farm activities and to save part of their loans for the lean season (Zaman 1999, Rutherford 1999, MkNelly and Dunford 1999). Microfinance improves households' ability to cope with temporary food stress without longer-term trade-offs: as a result of access to consumption loans Bolivian microfinance participants were significantly less likely than non-participants to sell off animals as a coping

strategy (McNelly and Dunford 1999), and in the Philippines participants were more likely to take interest-free loans from relatives, being in a position to return the favour at a future date, and to have some working capital which they used for temporary business ventures, while non-participants were far more likely to take high-interest loans from moneylenders (Todd 2000). BRAC members experience smaller fluctuations in consumption between peak and lean seasons than non-members (Chowdhury and Alam 1997). Although microfinance has not eliminated the use of costly informal sector loans, it provides access to an extra credit source which increases borrowers' ability to consistently smooth consumption (Sinha and Matin 1998). Very poor microfinance participants are better able than non-borrowers of similar socioeconomic status to weather the effects of a general economic downturn without experiencing a decline in income (Todd 2000). While some studies have found that microfinance encourages the building of human capital assets through investments in education and health (Cohen and Sebstad 1999), there is also evidence that microenterprise credit may discourage investment in children's education as households prefer to use children's labour rather than hired labour (Wydick 1999).

Considerable recent attention has been given to microfinance as a means of reducing women's vulnerability<sup>1</sup>. Unequal gender relations reduce women's access to economic opportunity and decision-making power and render them particularly vulnerable to undernutrition and other forms of deprivation, and as women are brokers of household health, nutritional and educational status, the ill-effects of their powerlessness are passed on to other dependent family members. There is evidence that microfinance directed at women enhances their intra-household status and bargaining power by increasing their contributions to the household pool (Hashemi et al 1996, Koopman 1996), increases their participation in major household expenditure decisions and their autonomy by enabling them to make independent purchases without applying to male relatives for cash (McNelly and Dunford 1999), strengthens their control over assets (Zaman 1999, Mosley 1999) reduces their vulnerability in the event of a husband's death or abandonment (Osmani 1998), and increases their participation in public affairs (McNelly and Dunford 1996, 1998, 1999, Dunn 1999, Chen and Snodgrass 1999, Barnes et al 1998). Microfinance has been associated with women's improved awareness of their legal entitlements (Zaman 1999), and with improvements in health, literacy, reduced fertility and lower incidence of physical abuse (Hedrick-Wong et al 1997).

As men are likely to reserve part of their income for personal use, even during periods of household economic stress, while women allocate a higher proportion of their incomes to household needs, increases in household income produce the most beneficial effects on children's nutrition and household welfare when they are controlled by women (McNelly and Dunford 1996). Although the relative size of women's contributions is usually small, they have a disproportionately beneficial effect on household consumption because women's income is more likely to be spent on basic needs, and women's contributions increase their bargaining power and control over the intra-household distribution of food and other resources (McNelly and Dunford 1996). As the financial returns from women's enterprises are often very low, however, investments in women's enterprises may produce a minimal increase in welfare to the household (Goetz and Sen Gupta 1996).

In South Asia women commonly transfer their loans directly to male relatives or invest them in microenterprises controlled by men (Montgomery et al 1996, Hashemi et al 1996, Goetz and Sen Gupta 1996, Rahman 1999), while elsewhere in Asia, Latin America and Africa women appear more likely to spend their loans on their own enterprises (Barnes et al 1998, Jellinek 2000, McNelly and Dunford 1998, 1999, Dunn 1999), although a study in Malawi found a high incidence of female-to-male loan transfer (Buckley 1996a). Given the generally higher earning potential of men's microenterprises, the transfer of loans to men is often a rational economic

decision for women and households. Even when part of the loan or enterprise income is diverted for men's personal use, the returns to the household from investment in a male-controlled microenterprise may still be higher than those which a woman could hope to gain from an enterprise of her own (Rahman 1999). In Grameen Bank households women's nutritional status and consumption was highest when women controlled their own loans, lower when male relatives controlled women's loans, and lowest of all in households where the borrower was male (Goetz and Sen Gupta 1996). Even when loans are transferred to male relatives, however, women's role as the conduit for loan funds may increase their status and bargaining power within the household (Hashemi et al 1996). Loan transfers are used by some BRAC women to preserve their marriages, a rational decision given limitations on women's ability to provide for their families as single household heads (Goetz and Sen Gupta 1996). Sometimes the contract is explicit; with women exchanging control over a loan for the right to have more resources spent on food and clothing for themselves and their children, permission to participate in group meetings and training (Goetz and Sen Gupta 1996) or a share of the enterprise profits (Rahman 1999).

Research findings relating to the impact of microfinance on women's empowerment are not unequivocally positive. Gains may not be sustainable, with evidence that improvements in women's status associated with loan-related increases in household income disappear if the household falls on hard times (Rahman 1999). The transfer of women's loans to men may put women in the onerous position of being liable for repayments but lacking the means to make them (Goetz and Sen Gupta 1996, Rahman 1999). Participation in credit programs may actually increase women's exposure to violence in situations where their husbands' expectations of a new loan are unfulfilled, or if group participation obligations take them away from their domestic duties (Rahman 1999). Grameen Bank membership was found to have no impact on women's control over major household decisions other than family-planning decisions (Osmani 1998). In Ghana women's participation in credit programs significantly increased their contributions to decisions on children's education but had little influence on their role in other household decisions (McNelly and Dunford 1998). Internal studies by BRAC indicate that program participation has had little impact on the prevalence of dowries, child marriage and domestic violence, or on intra-household inequalities in food distribution or domestic divisions of labour (Montgomery et al 1996). The emergence of large-scale microfinance in rural Bangladesh has done little to alter societal rules governing the type of work women can do (Zaman 1997, Montgomery et al 1996), and has had little effect on their mobility outside the home (Zaman 1999).

### 2.3.2 Promotional impacts

There is convincing evidence that credit has a generally positive effect on microenterprise incomes. Most studies which compare microfinance participants with control groups of non-borrowers find that the average microenterprise incomes of participants improve by greater margins than those of the controls. In general microcredit clients score higher than non-clients on indicators of enterprise profits, fixed asset accumulation, ownership of household assets, food expenditures, household incomes and poverty exit rates (Hashemi et al 1997; Dunn 1999, Chen and Snodgrass 1999, Todd 2000, Mosley 1999, Copestake et al 1998).

Despite positive overall impacts microcredit is not uniformly effective in raising incomes, with many studies reporting considerable impact variations between participants. A cross-country summary of 32 impact studies indicates that credit improves the microenterprise incomes of around half of program participants, sometimes by considerable margins of 25 to 40 per cent, but that incomes remained the same or declined for the other half (Sebstad and Chen 1996). A Philippines study found that a third of clients had experienced no change in their household incomes and 28 per cent had experienced a decline in the past year (Todd 2000). A study from

Ghana found that while 90 per cent of respondents experienced post-credit increases in their non-farm incomes, there was a wide diversity in income impacts, with increases ranging from over \$200 to less than \$10 per month (McNelly and Dunford 1998). In a Bolivian study 67 per cent of participants reported increases in their microenterprise income, 23 per cent reported no change and 7 per cent reported a decline (McNelly and Dunford 1999). One study found that participation has a polarising effect on incomes: borrowers were more likely than new participants to have experienced either increasing or declining incomes in the previous year (Copestake et al 1998).

Until the mid-1990s the assumption that microfinance effectively reduced poverty was rarely tested. Most large-scale studies used participation and repayment rates as proxies for poverty impact: the fact that clients were taking and repaying loans was considered sufficient evidence that the programs were reducing poverty (see for example Christen et al 1995, Otero and Rhyne 1994). Other researchers point out that such studies provide little information on who is taking the loans, the nature of credit impacts or variations in impact between participants (Johnson and Rogaly 1997, Mosley and Hulme 1998). While relatively few impact evaluations have examined the relationship between initial borrower economic status and loan impact, those which have done so provide convincing evidence that the impact of lending on borrowers' income increases in line with their pre-loan economic status, and there is an emerging consensus that credit has differential impacts at different income levels, an effect which has been termed the 'impact gap' (Dunn et al 1996). In 1996 a ground-breaking survey of twelve microfinance programs in seven countries found a consistent relationship between initial income and the impact of loans on income both between and within programs, leading the authors to conclude that promotional credit schemes are most likely to benefit the incomes of the middle and upper-poor, while the extreme-poor receive few if any direct benefits, and moreover are far more likely than the less-poor to become worse-off as a direct result of taking loans (Hulme and Mosley 1996). As most participants are poor or near-poor microfinance programs may have a significant impact on poverty; but the benefits go mainly to borrowers with incomes just below or just above the poverty line, rather than to those who are well below it.

Impact differentials occur both within and between programs. In the Sri Lankan SANASA program borrowers from the relatively prosperous Kurunegala District, who had higher initial household incomes, experienced far greater post-loan income increases than the generally poorer borrowers from the remote and underdeveloped Moneragala District (Hulme et al 1996), and a survey of Indian rural bank clients found that while initially least-poor were the most likely to report substantial improvements in their incomes the poorest borrowers were by far the most likely to experience post-credit income stagnation or decline (Mosley 1996b). Higher post-credit income impacts are found in programs with higher-income target groups: across the twelve programs there was a consistent positive relationship between income impact and average borrower incomes relative to national poverty lines (Hulme and Mosley 1996). A comparison of two Bangladesh programs, one with a mostly extreme-poor membership base and one which targeted the less-poor, found that members of the former experienced far smaller average post-loan income increases than the latter (Montgomery et al 1996). Since the Hulme and Mosley study other research has produced further evidence of an income-related impact gap. A Bangladesh study found that credit was associated with a greater impact on income poverty among moderate-poor than among extreme-poor members, although initially extreme-poor members whose cumulative borrowings exceeded a certain cash threshold were also likely to benefit (Zaman 1999). A comparison of four Bolivian programs found that the net impact of participation on incomes was consistently higher for borrowers as a whole than for poor borrowers (Mosley 1999).



The poorest borrowers are the most likely to experience post-credit stagnation or decline. In some cases credit actually makes poor households poorer by exposing them to bankruptcy, asset seizure, and in extreme cases, borrower suicide (Hulme and Mosley 1996). The most likely outcome of credit for the poor, however, is not an absolute loss but simply a failure to transform a loan into a sustained improvement in income. Even when income impacts are positive, they may not be sufficient to enable exit from poverty. Increases in income for BRAC borrowers, averaging a modest 2.8 per cent in real terms, still leave the average household well below the poverty line (Montgomery et al 1996). In most programs poverty exit rates are modest, with a number of studies indicating that between 10 and 25 per cent of initially-poor borrowers exit poverty (Hulme et al 1996, Mosley 1999, Todd 2000).

Several studies indicate that microfinance has a cumulative effect on enterprise and household incomes, with greater impacts on long-term members and repeat borrowers (Sebstad and Chen 1996, Zaman 1999, Koopman 1998, Montgomery et al 1996, Copestake et al 1998). BRAC members whose cumulative borrowings cross a cash threshold of 10,000 taka are considerably more likely than others to experience income improvements, while newer borrowers experience a reduction in vulnerability but little if any income effect (Zaman 1999). Protectional microfinance, which by itself generates little improvement in incomes, may serve as a precursor to income enhancement, as repeat loans may assist poor households to reduce their vulnerability to a point where they can start to engage in higher-risk higher-return activities. There is evidence that initial loans are more likely to be used for protectional purposes such as consumption and debt retirement while subsequent loans are used for productive investment (Zaman 1999) and that repeat borrowers are more likely than first-time borrowers to make higher-risk investment decisions, purchasing equipment rather than working capital, and specialising in their microenterprises rather than diversifying their activities (Montgomery et al 1996). Cumulative borrowings are unlikely however to have a uniform positive impact across initial income categories. Evidence that poorer borrowers are more likely to drop out of programs (Todd 2000, Montgomery 1996), and where they continue to participate, take fewer and smaller loans, suggests that income improvements associated with repeat loans are restricted to the less-poor who experience higher pay-offs from credit and are therefore more likely to take multiple loans and to cross cumulative loan thresholds.

#### **2.4 Microenterprise performance**

While the Hulme and Mosley studies and subsequent work has established that an income-related impact gap exists, there has been relatively little close investigation of its underlying causes. The following section reviews recent research which indicates why microenterprise earnings are lower among poorer borrowers.

Poor borrowers take smaller loans than the less-poor, and use them less productively. The range and profitability of investment opportunities available to poorer borrowers is limited by their lack of the physical, human capital and financial resources needed to develop higher-value enterprises. They tend to live in areas which are economically underdeveloped, lacking infrastructure and vigorous markets, and often vulnerable to climate fluctuations and natural disasters. Their options are further limited by personal characteristics associated with poverty: social isolation and lack of information, limited human capital endowments including poor health and lack of education, and anti-entrepreneurial personal traits such as a low sense of personal efficacy, poor communication skills and reluctance to innovate which are characteristic of social disempowerment. Even with microcredit they remain disadvantaged in their access to financial resources as their low asset bases and lack of reliable income flows limit their ability to service large loans, especially in slowly-maturing investments, and to supplement their loans with additional capital. Furthermore, even when potentially profitable investment opportunities exist,

poorer borrowers tend to avoid them in favour of small investments in low-value low-risk activities, because their poverty both increases the severity of the consequences of a loss, exposing them at worst to dangerous reductions in consumption or forced sales of essential assets, and increases pressure to use funds for consumption and other non-productive purposes rather than for investment. Finally, at the program level lending practices may restrict the loan funds available to poor borrowers.

#### **2.4.1 Physical and economic variables**

The vast majority of microenterprises are rural, a reflection of relatively low rates of urbanisation in less-developed countries and a geographic distribution of wage employment which favours urban centres. Even studies which specifically exclude the farm sector find that rural microenterprises outnumber their urban counterparts by significant margins (Asian Development Bank 1997, Liedholm and Mead 1999). Many rural microenterprises are disadvantaged by location-specific physical characteristics and levels of economic development which affect microenterprises directly, through their impact on the quality and accessibility of infrastructure, inputs and markets; and indirectly, via their impact on local incomes and hence on demand for microenterprise products.

Nearly all studies which consider location-related variables find a significant relationship between location and microenterprise performance (Sebstad and Chen 1996). In Uganda location-based disparities in economic opportunity and effective demand for microenterprise products appear to be a key factor in income differences between rural and urban microentrepreneurs (Barnes et al 1998). Enterprises operating in urban and commercial districts are larger than their rural non-farm counterparts, grow more rapidly, are far more likely to survive their first year and have lower closure rates (Liedholm and Mead 1999). Because of their superior access to inputs, markets, infrastructure and business information, microenterprises located in relatively prosperous communities benefit more from microcredit programs and find it easier to survive, grow and repay their loans than those in remote, poor locations (Snodgrass 1996). Programs seeking to improve their financial self-sufficiency are increasingly targeting urban and semi-urban areas, where borrowers are able to use larger amounts of working capital more quickly, and program costs are reduced by their greater accessibility and the generally higher education levels of borrowers. By contrast, in the smaller, more isolated communities, average loan sizes are far smaller: "The goal of reaching the most disadvantaged and potentially food-insecure communities, usually the most remote, is compromised by the limited opportunities the most remote women have for making use of a working capital loan and the higher cost of extending financial services to them" (McNelly and Stack 1998:15).

The poorest areas are subject to severe physical obstacles to economic development, in the form of hostile or unpredictable climates; poor soils and lack of water, minerals and other natural resources; mountainous, desert or jungle terrain; remoteness from metropolitan centres; and high rates of malaria and other health hazards. These factors impose direct production and market constraints; and indirectly affect local demand as the populations of such areas tend to be sparse and very poor. In areas which are prone to severe climate fluctuations or natural disasters households are usually too poor to insure themselves against losses (Snodgrass 1996), and their inability to mitigate risk deters them from making large investments. Because of climatic fluctuations many enterprises are seasonal activities yielding irregular returns. The impact of climate on enterprise profitability is perhaps highest in the farm sector but affects non-farm enterprises as well through the impacts of natural disasters such as floods on destruction of assets and access to supplies and markets.



Over-exposure to any single sector concentrates risk, and agricultural performance in particular is notoriously unpredictable due to its dependence on the physical environment and increasingly on developments in global markets. The risks of farming are highest in the poorest farming communities which tend to be subject to unpredictable climates, lack risk-mitigating technologies such as irrigation and pesticides, and are least aware of market signals and least able to switch production in response to them. The slow growth of agriculture relative to the non-farm sector - a common feature of LIC economies - together with the dominance of agriculture in rural economies, subjects rural non-farm enterprises to higher risks and lower returns than their urban counterparts. As the principal source of rural income, agriculture generates the principal demand for rural non-farm goods. As they are often isolated from urban and export markets and trade most of their products locally, rural non-farm microenterprises are highly vulnerable to the changing fortunes of agriculture and consequent impacts on farm incomes (Osmani 1989, Montgomery et al 1996, Liedholm and Mead 1999). In addition to reducing demand for non-farm products, weakness in the farm sector may intensify competition: low agricultural growth has been linked to the expansion of the low-value non-farm microenterprise sector as farming households seek to diversify and augment their income sources; conversely, strong agricultural growth is associated with the demand-pull expansion of higher-value non-farm activities (Liedholm and Mead 1999).

Physical infrastructure is a key contributor to microenterprise development through its effects on both supply and demand. Reliable power supplies facilitate technological innovations which improve labour productivity and product quality, and enable expansion and diversification of output, and sound transport and communications services improve access to inputs, markets and information (Kessides 1993). Electricity, safe household water supplies and transport services increase household productive capacity by reducing morbidity, improving access to health and education services, extending available working hours through electric lighting (United Nations Development Program 1998) and labour-saving household appliances, and reducing time spent on unproductive activities such as collecting water from a non-household supply and travel by foot (Kessides 1993, World Bank 1997a). Sound infrastructure facilitates local economic growth which in turn generates employment and demand for microenterprise products (Kessides 1993, Liedholm and Mead 1999). A frequently-reported finding in poverty research is that LIC infrastructure services are unequally distributed between socioeconomic groups, being concentrated in more accessible locations and better-off communities (Ellis 1998, Kessides 1993).

Lack of a household electricity supply narrows the range of possible microenterprises and restricts borrowers to trading activities, particularly in rural areas which are more likely to lack electrical power (Barnes et al 1998). Among infrastructure services the transport sector is perhaps the most important single determinant of rural microenterprise performance (Sebstad and Chen 1996, Hulme et al 1996, United Nations 1993), affecting the availability and cost of inputs (Dawson and Jeans 1997, Snodgrass 1996), the quality of linkages with non-local markets (Liedholm and Mead 1999) and the relative competitiveness of remote and centrally-located microenterprises (Snodgrass 1996). In remote areas transport services are particularly important in enabling access to employment in nearby towns, creating additional local demand for microenterprise products, and integrating rural microenterprises with non-local markets (Liedholm and Mead 1999). An Indian study found that roads have a major impact on agricultural output through their effects on marketing opportunities and reduced transaction costs (Binswanger et al 1989, cited in Kessides 1993). In rural Sri Lanka distance and poor transport facilities restrict producers' access to non-local customers and create excessive competition in local markets (Hulme et al 1996, United Nations 1993).

Many studies identify market access problems, for inputs as well as products and services, as a major constraint (Dawson and Jeans 1997, Sebstad and Chen 1996, Liedholm and Mead 1999, Barton 1997). Because of their relative lack of financial, physical and human capital resources the poor cluster in occupations characterised by low levels of investment, skills and productivity. Low barriers to entry increase the risks of overcrowding and falling profit margins (Hulme and Mosley 1996, Dawson and Jeans 1997). Program portfolios are often dominated by two or three low-value activities in which the poorest borrowers are concentrated, while less-poor borrowers are more likely to select less crowded higher-value occupations (Montgomery et al 1996, Dawson and Jeans 1997). In saturated markets where expansion is limited by high transportation costs or other factors, expanding the supply of credit may produce negative consequences, at best displacing some producers in favour of others and at worst generating a crisis of over-supply with an aggregate fall in profits (Montgomery et al 1996, Osmani 1989, Snodgrass 1996, Khandker et al 1998).

There is evidence that the impacts of economic downturns and market-oriented policies are more severe for poor microentrepreneurs and very small microenterprises. Pressure on low-value microenterprise markets is likely to increase during periods of economic stress, which have been associated with expansions in low-value self-employment activities as households are "pushed" into microenterprises by a need to offset declining incomes, and the low barriers to entry in low-value microenterprises leave them vulnerable to flooding (Liedholm and Mead 1999, Asian Development Bank 1997, Dawson and Jeans 1997). Growth in higher-value microenterprise occupations by contrast is more likely to be associated with strong local economic activity and expanding opportunities and markets, indicating that those engaging in higher-value enterprises are often attracted by considerations of profitability (Asian Development Bank 1997, Liedholm and Mead 1999).

The inflation, price deregulation and public spending cuts which have been characteristic of LIC economies since the early 1980s have disproportionately negative effects on the poorest, who are least able to convert cash into inflation-protected assets or index their incomes to rising living costs, and prior to deregulation were likely to have derived the greatest benefits from subsidised essential goods and services. In poor households pressures on living standards may reduce levels of investment in their microenterprises. Profit margins may be reduced by increasing competition and also by the inability of poor microentrepreneurs to pass on rising input costs, found by several studies to be a major constraint on microenterprise growth (Dawson and Jeans 1997). As the enterprises of the poor are often low-value-added activities with little margin for productivity improvements they rely on maintaining turnover and are unable to reduce input volumes without reducing their sales. Given falling demand and saturated markets in which their customers are likely to be highly price-sensitive, they have no choice but to absorb increases in the costs of production. During an economic downturn in Kenya in the early 1990s, while there was a general decline in the profit margins of small microenterprises operated by shanty-town dwellers, many less-poor microentrepreneurs managed to preserve some profit growth, partly because the larger scale of their enterprises provided some flexibility for curtailing expenditure on inputs without affecting sales (Buckley 1996b). A Thai survey found that while most small and micro-level enterprises were severely affected by the national economic crisis of the late 1990s, the micro-level enterprises were far more likely than small enterprises (defined as operations employing between 5 and 50 workers) to report critical reductions in sales (Wasuntiwongse 1999).

Overcrowding may encourage unsustainable business practices. Where it is customary for retailers to extend credit to their customers without charging interest or higher prices, producers may be compelled to provide credit in order to maintain their customer bases, often at significant cost to their businesses (Barnes and Keogh 1999, Buckley 1996b, Buckley 1997, Liedholm and

Mead 1999). This is particularly a problem for rural microenterprises which rely on limited and impoverished local markets, rather than for urban activities which have wider and more cash-rich customer bases. Where barriers to entry are low the inexperience of new entrants may cause problems for others: "... problems are created when some people start selling and don't know how to price their goods. They may in desperation just sell at what they bought at, while these people go out of business in the end, they create serious difficulties for other operators along the way" (Copestake et al 1998:61).

#### **2.4.2 Political and regulatory environment**

To the extent that excessive regulation is a problem, it appears to bear more heavily on larger and urban microenterprises. As most microenterprises operate in the informal sector of the economy they can avoid taxation and labour regulations which affect larger firms, although they may be significantly affected by local regulatory requirements such as zoning, traffic control, business licensing and provision of public utilities (Snodgrass 1996). Most surveys find that government regulation is not seen as a major problem by microentrepreneurs, being ranked well below such factors as market constraints, access to finance and input costs as a business constraint or explanation for declining profits (Morrisson et al 1994, Steel and Webster 1990, Copestake et al 1998, Wasuntiwongse 1999). An African study found that urban businesses were more likely than others to report excessive regulation as a problem, but only 7 per cent cited it as their major difficulty, although the authors point out that as microentrepreneurs may have a limited understanding of marketing controls, foreign exchange controls and other regulations which can significantly influence microenterprise performance, owner surveys may understate the impact of regulation (Liedholm and Mead 1999). In Kenya local governments use their extensive regulatory powers to the detriment of microenterprises (DeGroot 1990, Parker and Torres 1994), and in Malawi and Zimbabwe micro-level producers experienced problems in obtaining raw materials due to government regulatory policies which gave priority to larger firms (Mead and Kunjeku 1993, cited in Liedholm and Mead 1999).

For microenterprises under-regulation associated with structural adjustment policies or weak enforcement may create more serious problems than over-regulation. A survey of black business owners in Zimbabwe found that most of the problems they reported, concerned mainly with the affordability and accessibility of finance, inputs and utilities, were related to the recent deregulation of the economy (Bradburd and Levy 1996, cited in Snodgrass 1996). All businesses are adversely affected by breakdowns in civil order resulting from war, local rebellions and crime. As the businesses which suffer most are often in peripheral regions where the operational reach of enforcement authorities is usually lowest, it is likely that non-metropolitan microenterprises are disproportionately disadvantaged by civil unrest. In Sri Lanka in the 1980s and 1990s, for example, the major metropolitan centres have remained relatively insulated from the civil strife which led to large-scale loss of life and property destruction in the north-eastern and southern regions of the country. The limited reach of regulation and high costs of legal action may reduce the access of small and rural businesses to legal avenues for the resolution of contractual disputes and protection against crime. Sporadic, corrupt or otherwise unpredictable enforcement of regulations may impose heavy unforeseen costs (Snodgrass 1996, Liedholm and Mead 1999, Buckley 1996b). In their relationships with regulatory authorities less-poor microentrepreneurs may have an advantage over poorer operators as they are more likely to have or be able to establish personal connections with officials and where corrupt practices exist, are better able to pay bribes.

#### **2.4.3 Human capital, skills and understanding of business environment**

Access to higher-value microenterprise opportunities is positively associated with higher levels of human capital development in the form of skills development and good health, which are

typically found in less-poor households (Rahman 1997). Poor nutrition reduces microenterprise earnings by increasing susceptibility to disease and reducing capacity for physical labour (Chambers 1983, cited in Montgomery et al 1996). African studies of micro- and small enterprises record stronger growth in enterprises whose owners have undergone vocational training, have seven or more years of relevant experience, or have completed secondary school (Liedholm and Mead 1999). A larger household labour supply has been associated with higher-value enterprises, as additional workers provide alternative income sources which reduce risk and increase the volume of capital available for microenterprise investment, and provide additional labour inputs for microenterprises (Rahman 1997).

Many microcredit agencies are "minimalist" programs which, following the Grameen Bank model, restrict their microenterprise services to credit with little or no advice or technical assistance in enterprise selection and development, an approach based on an assumption that lack of credit is the only binding constraint on microenterprise development, and that as the poor know their economic environment and opportunities best they need little direction on loan use or other non-financial support services. There is considerable evidence that reliance on 'survival skills' alone to identify investment opportunities, without information services or technical assistance leads poor borrowers to cluster in familiar low-risk low-return activities, in which "the basic mode of project identification by borrowers could be described as 'copying' what others are doing" (Hulme and Mosley 1996), exacerbating problems of limited growth potential and market saturation (Dawson and Jeans 1997, Smillie et al 1994). A minimalist credit-only approach may be appropriate for better-educated and less-poor borrowers but as the poor often have limited business and vocational skills and market awareness, and given the generally low profitability of the occupations which are most familiar to them, self-reliance on "peasant wisdom" may not serve the best interests of poor borrowers.

Enterprise market-orientation, profitability and sustainability has been positively associated with pre-existing knowledge of business and market avenues (Gunatilaka 1997). The poor start off with lower endowments of education, skills and information, and may lack access to technical services and information which are available to better-off households. Geographic and social isolation reduces the size and strength of extended social networks which are key providers of information resources, skills and business contacts for small-scale microentrepreneurs (Barton 1997). Evidence that poor farmers are disadvantaged in their access to state-provided agricultural extension services by their remote locations, commitments to off-farm wage labour and lack of political influence (Buckley 1996a, Ranasinghe 1997) highlights the existence of an information and skills gap between poor and less-poor borrowers. A number of studies have cast doubt on the assumption that microentrepreneurs have a good understanding of conditions even in the restricted local environments in which they operate. In rural Sri Lanka, for example, following a seminar on bicycle maintenance conducted by a foreign NGO, 30 borrowers obtained loans for bicycle repair businesses in a single village of around 2,000 inhabitants (Shaw 1999a). When asked to suggest appropriate enterprise-oriented training courses, nearly half of a group of Sri Lankan borrowers opted for training in sewing, an overcrowded occupation in which micro-level producers are uncompetitive with larger manufacturers. As an evaluation report noted, their choice

... reveals a very poor awareness and understanding among most beneficiaries of market needs and conditions, and calls into question the premise underlying most participatory poverty alleviation programs that poor people know best what is good for them in terms of available economic opportunities (Gunatilaka 1996:18).

An imperfect understanding of their business environment often leads to an incorrect identification among microentrepreneurs of the key constraints facing their businesses (Liedholm and Mead 1999, Buckley 1997). A study of microentrepreneurs in Ghana found that most had little understanding of the adverse impact on their businesses of the combination of stagnant demand, low barriers to entry and increasing competition from new entrants, and persisted in identifying poor access to credit as the main constraint (Dawson 1991, cited in Dawson and Jeans 1997). A cross-country African study found that many respondents believed that using credit to increase their stocks would automatically increase their sales, without reference to other limiting factors. Few had a clear idea of how they would use their loans, however, and among respondents who wanted to purchase fixed assets, it was not always clear

... whether such needs had been clearly thought through or whether particular respondents had simply seen or heard of a new piece of equipment that was available and they imagined that it would give them an advantage. Such problems as repaying the loan ... were seemingly not fully anticipated, nor was the possible need for training to use the new equipment properly; whether it was really compatible with existing levels of operations and the types of markets currently serviced; or of the potential difficulties of servicing or repairing the equipment (Buckley 1997:1087).

#### **2.4.4 Sociocultural factors**

The poor may be least suited in terms of opportunity, aptitude and aspiration to be entrepreneurs. Some argue that it is unrealistic to expect the poor to succeed as entrepreneurs in locations and occupations which are often avoided by larger-scale private investors (Gunatilaka 1997), and unreasonable to expect them to bear the risks and insecurities of self-employment while better-educated and better-off socioeconomic groups derive their primary incomes from wages (Wood 1997), and that the very poor may be better served by public works programs, measures to stimulate larger-scale private investment and other strategies aimed at generating wage employment, a means of livelihood more suited to their attitudes and abilities (Robinson 1996, Asian Development Bank 1997, Shaw 1999a). A 1994 evaluation of a poverty-focused microcredit program in Sri Lanka found that fewer than a third of borrowers had a "keen and enthusiastic" attitude to microentrepreneurship (National Development Trust Fund 1994). Many poor do not want to be microentrepreneurs, preferring the relative security and familiarity of wage employment to the risks and learning of unfamiliar skills involved in borrowing money to establish microenterprises, especially in non-traditional activities (Shaw 1999a). A large proportion of microenterprise operators are reluctantly self-employed: in a Kenyan sample over two-thirds of microentrepreneurs had established microenterprises only because they lacked access to wage employment, which they would have preferred (Cotter 1996), and a study of a Bangkok government program supporting microenterprise development among unemployed people found that almost half the operators would abandon their microenterprises if steady jobs with comparable incomes became available (Wasuntiwongse 1997).

Poor and rural households are more likely to have and be subject to role expectations and cultural standards which discourage risk-taking and entrepreneurial activity, and to base their transactions on traditional patron-client relationships rather than market considerations, especially in regions which are marginally integrated in the cash economy. A political culture in which the poor have become accustomed to soft government loans and high default rates, or where access to economic resources is mediated through patron-client networks with local politicians, may have a negative impact on both entrepreneurship and credit discipline (Smillie et al 1994, Shaw 1999a, Gunatilaka 1997, Buckley 1997). The low participation of landless agricultural wage labouring households in the Grameen Bank has been attributed in part to a "tradition of dependence" on large

landowners rather than one of self-employment (Osmani 1989). In Sri Lanka regions and villages which have traditions of manufacturing and trading activity show higher levels of entrepreneurship and have developed stronger microenterprises than more remote agrarian subsistence populations where cultural and economic links to the market economy are weaker (Gunatilaka 1997). In communities where kinship networks are strong and which lack established business traditions, demands from friends and relatives may drain resources from promising microenterprises (Barton 1997). A cross-country African study found that entrepreneurial activities are limited in societies which accord low status to economic individualism, and that the selection and management of enterprises is governed by a range of non-market considerations which include tribal ethnicity, superstition and considerations of social status, encouraging microentrepreneurs to seek to improve their social status through methods which directly reduced the profitability of their businesses, such as the taking on of unnecessary employees (Buckley 1997).

Unequal relations of power in village social hierarchies may restrict prospects for microenterprise development in poor households by discouraging the transgression of social boundaries and redefinition of economic relationships often associated with non-traditional activities, especially when undertaken by their poorest members. In itself microcredit may play a significant role in empowering poor households by reducing dependency on traders and moneylenders (Hulme et al 1996), but there may be quite restrictive limits on the extent to which the poor can improve their position at the expense of local elites. Attempts to bypass local traders or renegotiate established economic arrangements may generate counterproductive social conflict (Menike 1992, Montgomery et al 1996). In Sri Lankan villages, where patron-client relationships facilitate access to employment, land and state-provided benefits, the costs to poor households of disrupting exploitative relationships may outweigh the benefits. Traders may exert undue influence through their control of key inputs: coir-producers in Sri Lanka received below-market rates from the local traders who purchased their output but were powerless to negotiate improvements as they owned the ponds required for the soaking of coconut husks, and were able to extract rents for their use and control the supply and hence the local price (United Nations 1993). Poor and remote-area producers appear more likely to face disadvantageous relations with local traders: remote-area vegetable producers in Sri Lanka have less bargaining power with input suppliers and wholesale traders than those in the central commercial food producing areas (Menegay et al 1996). An Indian study found that grain merchants were able to dictate the terms of product sale to small-scale farmers but not to larger-scale farmers (Rogaly 1985, cited in Rogaly 1996).

#### **2.4.5 Gender**

As noted above, credit targeted at women may produce non-income dividends in the form of empowerment; but may also involve a trade-off as the non-income benefits of lending to women may be offset by the low incomes of women's enterprises: "When credit is invested in conventional women's activities . . . the increase in welfare to the household may be minimal, given the constraints to profitable expansion of most of these ventures" (Goetz and Sen Gupta 1996:53). Gender-based divisions of labour often confine women to a narrow range of low-value activities (Sebstad and Chen 1996, Liedholm and Mead 1999, Hashemi et al 1996). Their microenterprises grow more slowly than men's (Liedholm and Mead 1999, Dunn 1999), have lower capitalisation (Sebstad and Chen 1996), employ fewer people (Buckley 1996b), and fewer technical innovations (Mosley 1996b), and concentrate in sectors where barriers to entry are low and vulnerability to market fluctuations is high (Hulme et al 1996, Asian Development Bank 1997, Liedholm and Mead 1999). Their enterprises tend to have shorter life-spans, as low barriers to entry and high sensitivity to changes in economic conditions increase the likelihood of business failure; and their attachment to their businesses is lower because of their additional responsibilities for unpaid household work, and the often secondary role of their enterprises in the



household economy (Asian Development Bank 1997, Liedholm and Mead 1999). Their enterprises are more likely to be located at home, away from centres of commercial activity (Liedholm and Mead 1999). In cultures which restrict public interactions between women and men, women's customers and business associates may be limited to other women, whose purchasing power may be low (Snodgrass 1996).

Women may be reluctant to innovate if they believe that a new technology will lead to a takeover of their projects by men, thereby depriving them of control of the new income generated (Jeans et al 1990). They are less likely to take the risks associated with expansion of a single enterprise and more likely to diversify (Liedholm and Mead 1999), and to select activities which require minimal initial investments, are compatible with childcare responsibilities, and involve a subsistence component which allows them to combine income generation with family food provisioning (Horn 1994). Because women are usually responsible for providing the resources and labour for day-to-day household requirements they are more likely than men to spend part of their loans on consumption, to select flexible low-value projects which can accommodate fluctuating labour and investment inputs resulting from other demands on their time and money, and less likely to re-invest profits in their enterprises (Montgomery et al 1996, Asian Development Bank 1997).

Women take smaller loans than men (Hulme et al 1996, Buckley 1996b), and are less likely to invest their loans exclusively in their own microenterprises. Even when formal program requirements stipulate that loans must be used for income-generating purposes, the diversion of at least part of women's loans for consumption is commonplace (Mosley 1996b). When loans are used for consumption intra-household tensions are created by pressure to find a way of meeting instalments (Rahman 1999). Additionally, the use of women's loans for household consumption may lead men to reduce household contributions from their own income, putting women under pressure to repay the loan, but creating no net improvement in household consumption (Mayoux 1998). On the other hand, women's loans which are used for consumption may release men's funds for reinvestment in their higher-value enterprises, with overall positive effects on household income and women's well-being.

#### **2.4.6 Borrowing behaviour and loan use**

The connection between loan size and income is well-established. Cross-program comparative studies show a consistent positive relationship between average loan size and average client income (Morduch 1999, Micro-Banking Bulletin 1998) and a similar relationship is apparent within programs, with loan size being positively correlated with borrower income in each of the twelve programs in the Hulme and Mosley study. Some studies indicate that supply-side factors in the forms of lending policies may restrict the access of poor borrowers to larger loans, through such measures as the imposition of additional share ownership requirements for larger loans (Hulme et al 1996) and minimum floors on loan sizes (Rahman 1997). Poor borrowers may drop out of programs which insist on progressive increases in loan size, a standard practice in many microfinance institutions (Cohen and Sebstad 1999). The evidence suggests however that avoidance of large loans by the poor comes primarily from the demand-side. Reluctance to incur debt, which as noted above is a major factor in the self-exclusion of many poor households, also limits the size of loans taken by those who do participate. A Latin American study found that even in the absence of physical collateral requirements borrowers tend to limit the size of their loans to the value of family assets that can be sold in the event of repayment problems, and that poor members therefore took smaller loans (McNelly and Stack 1998). Some observers note an identity of interest between lenders and poor borrowers, as both seek to minimise their exposure to unserviceable debt (Hulme et al 1996).

As poverty heightens competition for alternative uses of funds, poor households spend a larger share of their loans on consumption (Zaman 1999, Dunn et al 1996). The extent of loan diversion for non-enterprise purposes may be understated in surveys of programs which stipulate that loans are to be used for microenterprises (Montgomery et al 1996). Studies indicate that most clients using loans for non-enterprise purposes are extreme-poor (Asian Development Bank 1997), and that poor target-group clients spend significantly higher proportions of their loans than less-poor non-target-group clients on consumption and the servicing of other debts (Sinha and Matin 1998). In Bangladesh women are more likely than men to divert loans for consumption, reflecting a gender-based division of responsibility in which the task of providing for daily household needs falls upon women (Montgomery et al 1996). The seemingly counter-intuitive findings of an Indian study, which showed that the diversion of loans for consumption is associated with higher rather than lower income impacts, were interpreted by the author to suggest that at very low income levels protectional uses of loans produce greater benefits than promotional uses (Mosley 1996b).

Less-poor borrowers generally have superior access to additional sources of credit, household assets and income flows, which reduce the risks of borrowing and increase the volumes of capital available to them. The non-microcredit capital sources available to poor borrowers are generally limited to very small or costly loans from relatives or moneylenders, while the less poor tend to have better access to larger and cheaper loans from banks, their better-off relatives, government lending schemes and other NGO programs (Buckley 1996b, Mosley 1996b, Hulme et al 1996). There is considerable evidence of the use of additional enterprise funding sources by the less-poor. Where program rules place low ceilings on loan size, opportunities to invest in fixed assets may be limited to borrowers who can raise additional capital (Hulme et al 1996). A Bangladesh study found that although higher-income borrowers were more likely than the poor to use their loans for working capital rather than asset purchases they had significantly larger enterprises and higher-value fixed assets, (Montgomery et al 1996), suggesting the use of additional means of financing their microenterprises. The less-poor are more likely than poorer borrowers to start their enterprises principally from personal savings (Buckley 1996b), and to contribute wage income to their enterprises (Mosley 1996b). Evidence of a strong correlation between increased post-credit household incomes and access to wage income suggests that successful microenterprise development is linked to wage incomes which can be invested in the enterprise and protect it through lean periods (Mosley 1996b). Access to alternative income sources or a sound asset base increases a household's ability to engage in high-risk high-return activities which may require lumpy initial fixed capital investments (Mosley and Hulme 1998) or generate negative returns in the early stages while markets are developed and fixed capital loans are repaid (Zaman 1999). Additional wage income sources support consumption and can be used to supplement loan repayments if necessary. Land and household assets may be traded, used to generate supplementary incomes or support subsistence consumption. They may also be employed directly in microenterprise activities: in Bangladesh for example the poorest landless families are disadvantaged by their lack of access to homestead land which enables maintenance of livestock and secure storage of assets (Rahman 1997). For the landless poor insecurity of tenure may reduce planning horizons and increase risk (Buckley 1997).

As they are less able to bear the higher risks, lengthy gestation periods and initial net losses which are often associated with larger investments and those which involve fixed capital components, higher-value microenterprise opportunities involving large initial capital investments or production costs may be inaccessible to poor borrowers (United Nations 1993). Studies of small enterprises in Tanzania found that technological innovations were limited to the relatively well-off Indian business community (Dawson and Jeans 1997). Due to the "lumpiness" of fixed capital investments and the incompatibility of the longer-term nature of the returns from such



investments with loan repayment schedules, poor borrowers are more likely to invest in low-value activities which require little or no fixed capital (Rahman 1997). Due to their inability to support loan repayments from non-enterprise sources they rely on their enterprises to do so, and consequently seek activities which provide immediate cash flows (Montgomery et al 1996). They are more likely to invest in semi-subsistence activities which combine income-generation with consumption and require low levels of investment and minimal fixed capital (Rahman 1997, Sharif 1997, Mosley and Hulme 1998). The emphasis on immediate returns rather than longer-term investments in enterprise growth accounts in part for the commonly observed preference of borrowers for serial short-term activities rather than the gradual expansion of a single enterprise (Dichter 1996, Buckley 1997).

## **2.5 The microenterprise in the national and household economy**

This section examines evidence regarding the contribution of microenterprises to national and household income and employment. The contribution of microenterprises to GDP is relatively small, but they employ a significant and growing share of the workforce. A minority of microenterprises generate high earnings but most are marginal low-value activities, and the principal dynamic underlying the expansion of the microenterprise sector is an influx of poor households pushed into survival-level activities by increasing economic pressures, rather than of entrepreneurial individuals attracted by considerations of profitability. Microenterprises generate a substantial proportion of household income but as they are usually insufficient by themselves to support their owners above the poverty line, most households supplement their microenterprises with additional activities. Microcredit is associated with an increase in the relative contribution of the microenterprise to household income. There is evidence of income-related variations in the relative importance of the microenterprise in the household economy: in general, the less poor the household, the more likely it is to specialise in a microenterprise, although at the bottom end of the income spectrum extreme poverty is also associated with microenterprise specialisation.

### **2.5.1 The contribution of microenterprises to employment and national income**

Despite their large numbers, the contribution of the microenterprise sector to national economies is generally reckoned to be small, with some observers reporting that "as agents of economic development, very small enterprises are, to put it bluntly, of little interest" (Biggs, Grindle and Snodgrass 1988, cited in Daniels 1999:55). Few studies have attempted to quantify the contribution of micro- and small enterprises to national income, a difficult task given a general lack of statistical information on the informal sector and not surprisingly, those that have produced widely disparate estimates. The evidence indicates that despite its low productivity relative to larger firms the microenterprise sector makes a substantial contribution to national income simply because of its size. In low-income countries an estimated 60 per cent of all enterprises are microenterprises (Asian Development Bank 1997). A survey in Laos estimates that micro- and small enterprises contribute 6-9 per cent of GDP (Minot 1996, cited in Daniels 1999), a Kenyan study found that non-farm microenterprises contributed about 13 per cent of GDP (Daniels 1999), and in Latin America non-farm microenterprises account for 10-50 per cent of GDP, depending on the country and method of estimation (Orlando and Pollack 2000). It is important to note that most studies of the microenterprises exclude the farm sector and therefore understate the overall contribution of microenterprises to the national economy, given that agriculture is a major generator of national income and employment in most LICs, and that their farm sectors are typically dominated by household-level microenterprises.

Estimates of employment in the microenterprise sector also vary, but there is general agreement that it far outweighs their contribution to national income. In Kenya an estimated third of the labour force is employed in non-farm microenterprises (Daniels 1999). A study of twelve Latin American countries found that non-farm microenterprises account for 54 per cent of workers

(Orlando and Pollack 2000), while a cross-country Asian study found that they account for about 50 per cent of total employment (Asian Development Bank 1997). In five of eight countries examined in an African study, employment in non-farm micro- and small enterprises is estimated at 17-27 per cent, nearly twice the level of employment in registered large-scale enterprises and the public sector (Liedholm and Mead 1999). The vast majority of microenterprises are very small operations. In Liedholm and Mead's study, which encompassed enterprises with 1-50 workers, fewer than 2 per cent employed more than 10 workers and about two thirds employed one or two workers, a finding consistent with those of other studies which report that well over three-quarters of enterprises employing up to 10 workers are one- or two-person operations (Daniels 1999, Orlando and Pollack 2000, Asian Development Bank 1997).

Microenterprises play a significant role in absorbing unemployment but as the vast majority of microenterprises are either self-employment activities or household-level operations which employ unpaid family members, their contribution to wage employment is low. An African study found that about 80 per cent of microenterprise employees are self-employed or unpaid household workers (Liedholm and Mead 1999). Similarly, in Kenya nearly three quarters of microenterprise employees are in one- or two-person operations and another 23 per cent are in 3-5 person establishments which are likely to employ only household members; only 4 per cent are in 6-10 person firms which are more likely to employ paid labour (Daniels 1999). Microcredit has a small but positive impact on paid microenterprise employment, with increases in employment being concentrated in about a quarter of enterprises, while most experience no change in paid employment (Sebstad and Chen 1996). The Hulme and Mosley studies indicate that microcredit generates an increased demand for family labour but has little impact on employment generation outside the household except among the larger enterprises of the least-poor borrowers, leading the authors to conclude that small loans to poor households do not generate indirect poverty reduction through wage employment generation, although there is evidence that larger loans to the non-poor may do so (Hulme and Mosley 1996). There is evidence that programs which focus on non-poor clients may indirectly reduce more poverty through their second-round employment impacts than traditional poverty-focused programs which offer small loans to very poor clients (Mosley 1999).

### **2.5.2 Microenterprises: a dynamic sector of employment or a last resort?**

There are two views on the development contribution of microenterprises. The first views microenterprises as a residual category of low-value employment which expands and contracts countercyclically with economic growth. According to this view, high poverty rates in the microenterprise sector and its tendency to expand during economic downturns indicate that microenterprises are a distress adaptation of poor households which are forced into low-value informal sector activities by the failure of the economy to provide more productive forms of employment. The second view regards microenterprises as a dynamic sector into which operators are pulled by the prospect of earnings opportunities rather than pushed by a lack of economic alternatives. The evidence suggests that both views are correct, but apply to two distinct categories of microenterprise. The first view corresponds to the majority of enterprises, which are low-value activities (LVEs), and the second to a smaller and more profitable sector of higher-value activities (HVEs) which are distinguished from LVEs by the entrepreneurial motivations of their owners; higher inputs of capital, skills and labour; a greater propensity to employ non-family labour; stronger markets; higher growth potential; reinvestment rather than consumption of profits; and their position in the household economy as a primary rather than supplementary source of income (Asian Development Bank 1997, Liedholm and Mead 1999, Cotter 1996, Ghate et al 1996).

In most countries the microenterprise sector is expanding, but employment growth has not been accompanied by income growth. Average microenterprise incomes remain low, suggesting that

the income impact of higher-value profit-seeking entrepreneurial initiatives is outweighed by that of a vastly larger number of low-value involuntary distress adaptations. In Latin America significant employment growth in the microenterprise sector, which generated 84 per cent of new jobs in the region between 1990 and 1995, has been accompanied by a widening income gap between microenterprise workers and workers employed in the non-microenterprise sector, and by the late 1990s microenterprise workers were twice as likely as other workers to be poor (Orlando and Pollack 2000). In Africa in the 1980s micro-and small enterprises were the fastest-growing employment sector, absorbing more than 40 per cent of new labour force entrants. While a minority of the new enterprise jobs took the form of wage employment generated by the expansion of larger existing enterprises, over three quarters were new self-employment activities, most of which were survival-level one-person operations "driven by a necessity of finding any source of income, even those providing only minimal returns, in situations where few alternatives are available" (Liedholm and Mead 1999).

A Kenyan study which compared microenterprise incomes with local wage rates found wide disparities in microenterprise incomes suggestive of a distinction between HVEs and LVEs. It found that about one quarter of microenterprises earn more than the monthly minimum wage rate, and 9 per cent earn more than the average wage. Among the latter group are some very high-earning enterprises: the top 44 per cent make more than three times the average wage and the top 10 per cent make more than eight times the average wage. The author concluded that while microenterprises earning more than the minimum wage are voluntary activities engaged in by profit-seeking entrepreneurs, most of the remaining three quarters of microenterprises represent a last resort for their poor owners who are unable to find better-paying wage employment (Daniels 1999).

There is considerable evidence linking low-value microenterprise growth with economic downturns (Asian Development Bank 1997, Liedholm and Mead 1999) and with policy-induced increases in unemployment associated with structural adjustment programs (Dawson and Jeans 1997). When the national economy is performing strongly, wage employment is the main contributor to employment growth in the micro- and small enterprise sector, as existing enterprises expand; but during economic contractions the majority of new jobs are generated by self-employment in LVEs due to the drying-up of more remunerative wage employment opportunities (Liedholm and Mead 1999). Closures of women's enterprises increase during periods of economic growth, attributed by the authors to the fact that most of them are marginal activities which the operators willingly abandon when household circumstances improve or better options become available (Liedholm and Mead 1999). During severe downturns LVEs may be the only sector of employment that is expanding: in the early 1990s in the Philippines, overall employment grew by 3 per cent, largely because of an expansion in LVEs at a time of declining per capita GDP and labour-shedding in larger enterprises (Asian Development Bank 1997).

Higher-value microenterprises may also experience increased competition through public sector retrenchments or, in regions where rates of labour migration are high, economic or political disturbances in host countries which prompt migrants to return home, may increase competition in the higher-value microenterprise sector through an influx of relatively resource-rich new entrants (Oldham et al 1994). In Zambia the micro-level carpentry sector has come under increased pressure from import competition and an influx of skilled carpenters retrenched from the formal sector (Copestake et al 1998). In the transitional economy of Mongolia there were increases in both LVEs and HVEs during the 1990s: growth in LVEs was generated by an influx of public sector workers seeking to protect their incomes against inflation and by female-headed households, the elderly and other vulnerable groups seeking to offset the erosion of state-provided support services; there was also an increase in the number of HVEs as the former employees of

small state-owned enterprises such as television repair shops, bakeries and hair salons became their owners. Most of Mongolia's new microenterprises are low-value activities: in the capital Ulaanbaatar, where about half of the country's registered microenterprises are located, only 16 per cent of microenterprise workers are employed in HVEs (Asian Development Bank 1997).

### 2.5.3 The microenterprise in the household economy

While the loan-assisted microenterprise is usually the main income source in microcredit client households it is rarely the sole means of livelihood. Nearly all studies which investigate the household economies of borrowers find that the majority combine microenterprises with additional income sources which commonly include wages, remittances, rent, subsistence farming and other non-farm microenterprises. On average, borrower households have 2-4 income sources, among which the loan-assisted microenterprise is reported by more than two thirds of participants to be the primary income source, accounting for around half of household income (Barnes and Keogh 1999, Dunn 1999, Buckley 1996b, Todd 2000, Montgomery et al 1996). Patterns of microenterprise specialisation and income diversification vary with household income and location, and the relationship between household income and the contribution of the loan-assisted microenterprise to the household economy is ambiguous and complex and needs further research. Microcredit appears to be associated with an increase in the relative importance of microenterprises.

According to the classical risk hypothesis, less-poor households tend to derive greater advantages from specialisation, while poorer households derive greater advantages from diversification of their income sources. Poor households have an incentive to diversify in order to spread risk, reducing their vulnerability to the failure of any single source of income by engaging in multiple independent activities (Dunn et al 1996). As the income from a diversified household portfolio may be lower than that which could be earned from specialising in a single activity, risk-motivated diversification may involve a trade-off between income enhancement and income protection. Poor households are more likely to accept this trade-off, sacrificing the prospect of greater income for greater security, while the less-poor and more risk-tolerant are more likely to concentrate on income enhancement by specialising in the most profitable activity available to them (Dunn et al 1996, Dunn 1997). Poverty provides another motive for diversification in poor households. The poverty motivation exists where the household cannot earn a minimally acceptable level of income from any single activity, and is compelled to engage in multiple activities to meet basic consumption needs. As the poor are more likely than others to rely on seasonal income sources which do not provide a sufficient surplus to sustain them through the off-season, seasonality is associated with poverty-motivated diversification as poor households seek to maintain income flows throughout the year (Ellis 1998).

Holding other factors equal, it would therefore be expected that higher rates of diversification would be found among poor households as they are more likely to lack any single adequate income source and are under pressure to mitigate risk. There are strong countervailing tendencies however which encourage diversification among the non-poor and specialisation among the poor. Diversification is not always prompted by desperation; it is associated with income expansion in conditions of economic growth (Ellis 1998), and may be an attractive option for non-poor households in response to new economic opportunities where their existing activities are approaching a ceiling, or as children reach adulthood and join the labour force (Dunn 1997). Poor households may be constrained in their diversification options by a lack of economic opportunities and their low resource endowments, particularly when they face a shortage of able-bodied adults. Perhaps because of these countervailing tendencies the literature reveals no straightforward empirical relationship between household income and the propensity either to specialise or diversify.

The following tentative conclusions may be drawn from the available evidence: first, specialisation is likely to be a voluntary process in non-poor households, given their generally superior access to alternative or additional income-generating activities; and an involuntary one in poor households, given the significant income and risk mitigation benefits they derive from diversification. Second, while diversification is particularly beneficial for the poor, the less-poor also benefit from the ability to spread risk and access additional income sources when the growth capacity of their existing activities is limited (Ellis 1998); and the income threshold at which specialisation becomes a more attractive option than diversification may be so high as to exclude many non-poor borrowers as well as the poor. Thus, given that diversification is positively associated with improvements in income at low income levels, we may expect to find a broad pattern of increasing diversification as incomes rise, until a relatively high threshold is reached, beyond which increasing rates of specialisation are found. The available evidence tentatively supports such a hypothesis but further research is needed.

A number of studies find that the contribution of the microenterprise to the household economy rises with household income, indicating a tendency towards microenterprise specialisation in less-poor households (Montgomery et al 1996, Buckley 1996b). A similar pattern is found when urban and rural microenterprises are compared, with higher rates of microenterprise specialisation occurring in urban households, in which microenterprises were found to contribute a larger average share of household income, and borrowers are far more likely to specialise solely in their microenterprises. Higher rates of specialisation in urban households are probably related to the higher incomes of their enterprises, which earn on average more than twice as much as rural enterprises (Daniels 1999). Economic pressures appear to be a key motivating factor in the decisions of poor households to diversify as they find it increasingly difficult to meet subsistence requirements from existing income sources (Barnes et al 1998, Buckley 1996b).

A Kenyan study found evidence strongly suggestive of different motives for microenterprise specialisation between poor and non-poor households. It found generally low levels of microenterprise earnings in households which specialise solely in their microenterprises. Among such households only 18 per cent of urban microenterprises, and none of the rural enterprises, generate incomes above the poverty line, and about two-thirds earn less than the prevailing minimum wage rate. Among the 18 per cent which earned above the poverty line, however, average earnings are more than 6.8 times the poverty line, and are well in excess of the minimum wage, suggesting that while specialisation is a matter of necessity rather than choice for the vast majority, particularly in rural areas, reflecting a lack of access to better-paying activities such as wage employment, it is a voluntary decision for a minority of non-poor households which are motivated by considerations of profitability (Daniels 1999).

A number of other studies however associate higher incomes and urbanisation with increases in diversification. Urban households have a wider range of income sources than rural households and are more likely to report income from wages, rent and remittances, while rural households are more likely to be solely dependent on farming (Barnes et al 1998). In rural areas higher incomes are associated with greater diversification into non-farm activities, with several studies reporting that non-poor households derive a greater proportion of their incomes from non-farm activities than the poor (Ellis 1998). In Bangladesh extreme poverty is associated with a greater reliance on agriculture, particularly agricultural wage labour, while less-poor households derive a greater proportion of their total income from non-farm microenterprises and a greater share of their agricultural income from self-employed farming (Asian Development Bank 1997).

Some studies have found very low levels of diversification among the poorest households, which may lack the labour resources and opportunities to engage in multiple activities. A Latin American survey found that households specialising in their microenterprises tend to be poorer than those which combine microenterprise and non-microenterprise income sources (Orlando and Pollack 2000). Female-headed households which have limited labour supply and a narrow range of socially sanctioned income-generating occupations are particularly likely to be involuntary microenterprise specialists. A Bangladesh study of a women's microfinance program found that borrowers who reported the loan-assisted microenterprise as the main source of household income were extremely poor; and were likely to have been female household heads (Koopman 1996).

Few studies have examined the impact of microcredit on changes in the relative importance of the microenterprise. One such study in Bangladesh found that credit generated substantial increases in the relative importance of the loan-assisted microenterprise. After a single loan the average contribution of the microenterprise to household income rose from 19 to 44 per cent among the generally very-poor BRAC participants, and from 40 to 50 per cent among the less-poor TRDEP clients. Increases in the importance of the microenterprise appear to level out after the first or second loan, with subsequent loans having a far smaller effect (Montgomery et al 1996). Other studies have found little difference between borrowers and non-borrowers in the contribution of the microenterprise to household income (Barnes et al 1998, Dunn 1999). Some studies indicate that non-microenterprise income sources are a significant contributor to increases in household income: a Zambian study found that while the loan-assisted microenterprise was the most commonly-cited source of improvements, only 44 per cent of borrowers whose incomes had improved cited their loan-assisted microenterprises as the principal source of their increased wealth, with considerable proportions citing "increased capital", changes in household composition and improvements in wage income as the main explanation (Copestake et al 1998). An Indonesian study found that non-microenterprise income sources are responsible for a significant share of post-loan income increases, and suggests that the relative importance of increases in non-microenterprise sources is greater for poorer borrowers (Mosley 1996c).

Several studies have found an association between microcredit and an increase in diversification, usually as a result of the loans being used to start a new enterprise. Not surprisingly, there is evidence suggesting that the loan-assisted enterprise is less likely to be the primary household income source in programs which target women's enterprises (Chen and Snodgrass 1999, Koopman 1996). Evidence from a series of USAID-supported baseline studies that longer-term borrowers have a higher average number of income sources than either new borrowers or non-borrowers suggests that microcredit may be associated with an increase in diversification, although it may reflect higher initial incomes of repeat borrowers (Barnes et al 1998, Barnes and Keogh 1999, Dunn 1999, Chen and Snodgrass 1999, McNelly and Dunford 1998). The former contention is supported by evidence that the additional income sources of repeat borrowers are far more likely than those of the other groups to be multiple microenterprises, and less likely to be rent or wages, suggesting that their higher rates of diversification may reflect new loan-generated microenterprises (Barnes and Keogh 1999, Dunn 1999, McNelly and Dunford 1998, 1999, Todd 2000).

## 2.6 Conclusion

On the whole, the research findings lend support to Hulme and Mosley's conclusion that "the poorest people have little access to (credit) schemes, are likely to take on unreasonable risks if they do participate, and the benefits are most likely to accrue to "middle"- and "upper"-income poor who have crossed an economic threshold that means a major part of their income is secure" (Hulme and Mosley 1996:134). Both the outreach and impact of microfinance are lowest among

the poorest households. Clients come predominantly from the better-off poor and the non-poor; below the poverty line participation declines with income and falls close to zero among the poorest destitute households. While there is evidence that very poor participants benefit considerably from protectional microfinance - although findings regarding its impacts on women's well-being are ambiguous - there is little doubt that the benefits of promotional credit, in the form of improved microenterprise and household incomes, are skewed heavily towards the upper end of the participant income spectrum. It appears to work well among less-poor populations but has generally low impacts on incomes which are well below the poverty line, raising doubts about its effectiveness as a poverty reduction strategy.

The research findings also highlight the significant role of non-credit variables in microenterprise performance. In the absence of suitable investment opportunities credit alone does not enable the building of microenterprises that generate substantial and sustained improvements in income. Barriers to successful microenterprise development include unfavourable macroeconomic, infrastructure and market conditions, a lack of suitable technologies and skills, social discrimination and risk-aversion. An income-related impact gap exists because such constraints disproportionately affect the poor, who are more likely to live in remote locations with poor access to resources and markets, and to possess low human capital endowments and other anti-entrepreneurial tendencies. Because the microenterprises of the poor tend to earn very low incomes, forcing their owners to seek additional income sources, their relative contributions to the incomes of poor households are low in comparison with those of non-poor households which are more inclined to specialise in their microenterprises. Socioeconomic and physical contextual factors are thus important determinants of microenterprise performance and of their relative importance to borrowers. The following chapter expands this argument, describing the Sri Lankan economic environment and differentials in the sectoral and regional distribution of incomes and economic opportunities.



## Chapter 3

### Poverty and economic opportunity in Sri Lanka

#### 3.1 Introduction

This chapter describes recent trends in poverty and income distribution in Sri Lanka and examines the economic opportunities available to Sri Lankan households.

Section 3.2 describes recent developments in poverty and social welfare. In the last two decades successive governments have adopted market-oriented economic reforms which have generated substantial increases in per capita income, but have had relatively little impact on the welfare of the poorest citizens, with rates of poverty reduction which are well below rates of economic growth. Poor and middle-class Sri Lankans are facing severe pressures from high inflation, the economic and social damage wrought by a two-decades-old civil war, and expenditure cuts which have undermined the accessibility and quality of social services and physical infrastructure, and widening disparities of income and economic opportunity.

Section 3.3 describes the regional and sectoral distribution of poverty, showing how economic growth has been concentrated in the non-farm sector and in the urbanised Western Province and to a lesser extent in regional towns, leading to widening income disparities between the country's metropolitan and peripheral regions and within regions, between urban and rural agrarian populations<sup>1</sup>. In the 1980s and 1990s the sectoral distribution of economic growth has been uneven, with substantial growth in the non-farm sector, particularly in large-scale factory industry, and a relative stagnation of agriculture. Incomes from farming, the principal employer of about half of the population, are in long-term decline due to a combination of factors which include excessive pressure on finite land and water resources, policy reforms which have reduced the value of input subsidies and exposed farmers to competition from imports, and the falling world price of rice. As the infrastructure and market conditions needed to support non-farm activity do not exist throughout much of the countryside, growth in non-farm activity has been slow.

Section 3.4 describes the Sri Lankan labour market and examines the uneven distribution of economic opportunities between regions and socioeconomic groups. Secure non-farm wage employment, scarce outside the Western Province, is confined largely to better-educated non-poor households in regional towns. The poorer inhabitants of regional urban and semi-urban communities, and those in remote and economically underdeveloped rural areas, rely on a combination of low-value income sources which include farming, non-farm microenterprises and casual labour. Faced with the failure of the local non-farm sector to offset falling farm incomes, rural and regional households have become increasingly reliant on non-local income sources in the form of government transfers and remittances from family members employed in the defence forces, the Western Province manufacturing centres, or abroad. Such non-local forms of employment yield higher returns than locally-available opportunities but are associated with high personal and social costs.

#### 3.2 Welfare and poverty in Sri Lanka

Until the mid-1970s Sri Lanka was a poor country with a remarkably highly-developed welfare state, underpinned by a universal food subsidy and large expenditures on health and education, which provided its citizens with living standards characteristic of much wealthier countries<sup>2</sup>. In a 1977 election the left-leaning government was replaced by the pro-business, pro-Western United National Party, the signal for a revival of interest in Sri Lanka from major donors, and the beginning of a long and arduous process of market-oriented economic reform. Assisted by IMF stand-by loans and



generous contributions from a donor consortium led by the World Bank, the government adopted a standard package of structural adjustment measures, devaluing the rupee, removing restrictions on foreign trade and agricultural price controls and dismantling the universal food subsidy, which had absorbed a fifth of government spending. Both major political parties in Sri Lanka share a commitment to a market economy and since a 1994 change of government there has been a further acceleration of privatisation, liberalisation of trade and other policy measures aimed at encouraging private foreign and domestic investment.

Since the late 1970s the Sri Lankan economy has experienced strong GDP growth, averaging 4.2 per cent annually in the 1980s and around 6 per cent in the 1990s. At the same time expenditures on welfare, education, health and public infrastructure have fallen significantly in relative terms. The government's ongoing commitment to fiscal stringency, together with a weakening of its revenue base through the removal of tariffs and provision of generous tax holidays for manufacturers, and a massive increase in military spending with the intensification of the 18-year-old civil war in the mid-1990s - defence absorbing a fifth of recurrent expenditure in 1998 - have combined to place enormous pressure on the social sector. At 1.6 and 2.7 per cent of GDP respectively, levels of health and education spending are well below those of countries with similar per capita incomes, and capital expenditure has reached its lowest level for many years (World Bank 1998a). Welfare-based transfers fell from about 6 per cent of GDP in the 1970s to less than 2 per cent in the early 1980s following the removal of the food subsidy, and remain at about 2 per cent in the late 1990s (Central Bank Annual Reports: various years). The government's current Samurdhi scheme, the principal vehicle for welfare transfers, is ineffective in helping the poor, as it transfers small sums to a large section of the population rather than adequate amounts to the poorest (World Bank 1998b). In 1998 the World Bank warned that the well-established human resource development gains of previous decades "are likely to be difficult to protect in the future" (World Bank 1998a:1).

**Table 3.1: Social indicators: Sri Lanka and countries with comparable per capita incomes, 1999-2000**

Country	Per capita GNP (US\$)*	Female life expectancy	Infant mortality (deaths per 1,000)	Fertility rate	Female adult illiteracy (per cent)
Cote d'Ivoire	700	47	140	5.1	66
Honduras	730	72	48	4.3	30
Sri Lanka	810	75	19	2.2	12
Bolivia	1,000	63	96	4.4	23
Philippines	1,050	70	41	3.6	6
Low income country average**	520	58	130	4.4	47
Lower-middle income country average	1,710	71	47	2.5	18

\* Per capita GNP is calculated by converting GNP to US dollars using purchasing power parities rather than exchange rates, thereby minimising the effect of exchange rate movements on currency values expressed in US dollars and enabling better cross-national comparisons of average incomes and consumption.

\*\* Excluding China and India

Source: World Bank (2000)

Sri Lanka established a comprehensive state-funded health system in the 1950s and by the end of the 1970s had reached developed-country standards in female life expectancy, fertility and maternal mortality. In the 1980s and 1990s however under-resourcing has led to a significant

deterioration in the quality of the country's health services, with growing problems of overcrowded hospitals, pharmaceutical shortages and inadequate maintenance and replacement of equipment. Most importantly for poor and rural households, there has been a decline in community outreach with a skewing of the budget towards high-technology tertiary care in urban hospitals and away from primary health care delivered in regional dispensaries, and low public sector pay rates aggravating difficulties in attracting medical staff to remote areas (World Bank 1998b). As Table 3.1 shows, on key social indicators Sri Lanka continues to perform better than countries with comparable income levels, due in part to a lag effect from high levels of public investment in past decades. On other health indicators, however, notably undernutrition-related conditions, tuberculosis, malaria, access to safe water and sanitation, number of doctors per capita, alcoholism and drug addiction, and with the world's highest suicide rate, Sri Lanka is well below the lower-middle income country average (World Bank 1998b).

Sri Lanka established free universal school education in the 1940s, with strong investment in infrastructure and an extensive delivery network in which a primary school was established within 3.5 miles of every village, and subsidies to encourage school enrolments among the poor. High levels of public investment have contributed to the country's strong performance on standard education indicators which, like its performance on key health indicators, is above that of most countries with comparable incomes. The adult literacy rate is 90 per cent; the proportions of the relevant population groups enrolled in primary, secondary and upper secondary school are 90 per cent, 86 per cent and 38 per cent respectively; and the proportion of female enrolments is about 50 per cent at all levels, even in universities (World Bank 1998b). While enrolments remain high, there has been a marked deterioration in the quality of education since the 1980s, reflecting dramatic reductions in expenditure which at 2.7 per cent of GDP in 1998 is well below the developing country average of 3.9 per cent. The school system suffers from an inappropriate and outdated curriculum, poor quality textbooks, acute shortages of teaching materials and equipment and human resource deficiencies, a problem which has been aggravated by the politically-motivated mass recruitment of untrained teachers in the 1990s (World Bank 1997b). Attainment in mathematics and science is unsatisfactory and there is a general consensus that a lack of appropriate vocational and conceptual skills among Sri Lankan secondary school and university graduates has discouraged high-technology investment and contributed to high levels of graduate unemployment (Institute of Policy Studies 1996, World Bank 1997b, World Bank 1998a). A 1995 survey of Sri Lankan employers indicated that a shortage of appropriate employee skills is a major constraint on growth (World Bank 1995b). The Sinhala language is the medium of instruction; while English is a compulsory subject on the public school curriculum few teachers are fluent in the language. A lack of English language skills among graduates is a major barrier to upward mobility as it bars their access to the privileged English-speaking white-collar sector of the labour market. The technical and vocational education sector is also weak and under-resourced, with a shortage of trained instructors and a limited number of places (Aturupane 1999). School education prerequisites and tuition-related costs make vocational training inaccessible to the majority of the poor.

Falling expenditure on irrigation, power and transport infrastructure affects household income through its negative impact on economic activity; and has also created a significant public inconvenience factor, particularly in the recently privatised bus transport system. Although bus transport is of major importance to Sri Lankan households, accounting for 85 per cent of passenger-kilometres, deteriorating stock, poor rural services, and increasing pollution and congestion have contributed to a very poor standard of services in terms of travel time, safety, reliability, comfort and convenience (Institute of Policy Studies 1996).

The evidence indicates that for most of the population, post-liberalisation gains in private household wealth have failed to offset the hardships associated with reductions in social spending. The household incomes of the poor have not benefited from increased national wealth to the extent that might have been expected. Changes over the last two decades in the distribution of household wealth have followed a familiar post-liberalisation pattern, with the bulk of benefits from the new growth going to a small urban elite. Income inequalities have widened considerably: between 1973 and 1995/96 the richest population decile increased its share of total household income from 28 to 40 per cent, while over the same period the share of the poorest third of the population fell from 13 per cent to 9 per cent and that of the poorest tenth fell from just under 3 per cent to just under 2 per cent (World Bank 1995a, Department of Census and Statistics (DCS) 1996a).

Table 3.2, based on data compiled by the World Bank, indicates that since the mid-1980s absolute poverty incidence has fallen. While some observers have questioned the Bank's interpretation of poverty trends in the 1980s<sup>3</sup>, there is broad agreement on the contemporary dimensions of the problem. Rates of poverty reduction have slowed, and have fallen well behind rates of economic growth in the 1990s: poverty incidence fell by less than 2 per cent between 1990/91 and 1995/96, about a third of the GDP growth rate. There is a persistent hard core of absolute poverty, in the sense of deprivation of essential minimum subsistence requirements, which affects between 20 and 25 per cent of the population. A further 13 per cent are living on the margins of poverty, with consumption levels just above the absolute poverty line (Aturupane 1999).

**Table 3.2: Incidence of Poverty in Sri Lanka 1985/86 - 1995/96 (per cent)\***

	1985/86	1990/91	1995/96
Urban	16.4	18.3	12.3
Rural	31.7	24.4	22.9
Sri Lanka	27.3	22.4	21.1

\* These estimates do not include the Northern and Eastern Provinces, which account for about 15 per cent of Sri Lanka's population, as the civil war precludes data collection in the north-east, in which the poverty incidence is probably significantly higher than in the rest of the country, due to widespread displacement of civilian populations, destruction of infrastructure and property and disruption of trade.

Source: World Bank 1995a, Aturupane 1999.

It is a matter of concern that post-liberalisation reductions in income poverty have had little effect on the seemingly intractable problem of food poverty. The poorest households experienced significant declines in food consumption during the early 1980s (Sahn 1987, Edirisinghe 1987, Anand and Kanbur 1995), consistent with a scenario in which rising household incomes failed to offset the adverse effects of post-liberalisation price increases and in particular the removal of the food subsidy in the late 1970s. Since the mid-1980s there has been little evidence of an underlying improvement in per capita calorie consumption (DCS 1996a). Calorie intakes among the poorest 40 per cent of Sri Lankans, at 2,049 for the lowest quintile and 2,193 for the second quintile, are below the minimum standard daily nutritional threshold of 2,260 recommended by the FAO (Central Bank 1999). More than one third of adults suffer from micronutrient deficiencies, close to half of women and young children are iron-deficient (Aturupane 1999), a third of children are severely underweight and stunting caused by chronic undernutrition affects a fifth of infants under the age of three (DCS 1995).

The partial withdrawal of the state from its role as provider and regulator of public services, combined with high inflation throughout the 1990s, has contributed to a decline in living standards for much of the population. A number of other recent developments, mostly associated directly or indirectly with the government's economic programs, have had a corrosive effect on the social fabric. The general social malaise is vastly aggravated by the ongoing civil war, to which no end is in sight, which has taken an estimated 60,000 lives since 1983, displaced thousands of civilians and diverted expenditure from development programs. Even outside the war zone in the north east the war has a strongly adverse impact on citizens' daily lives through the constant threat of random suicide bomb attacks and long delays for commuters while buses are checked at police road-blocks, and has contributed to a reduction in the scope of civil society and weakening of human rights standards, with growing state reliance on the use of force against civilians, media censorship and periodic curfews.

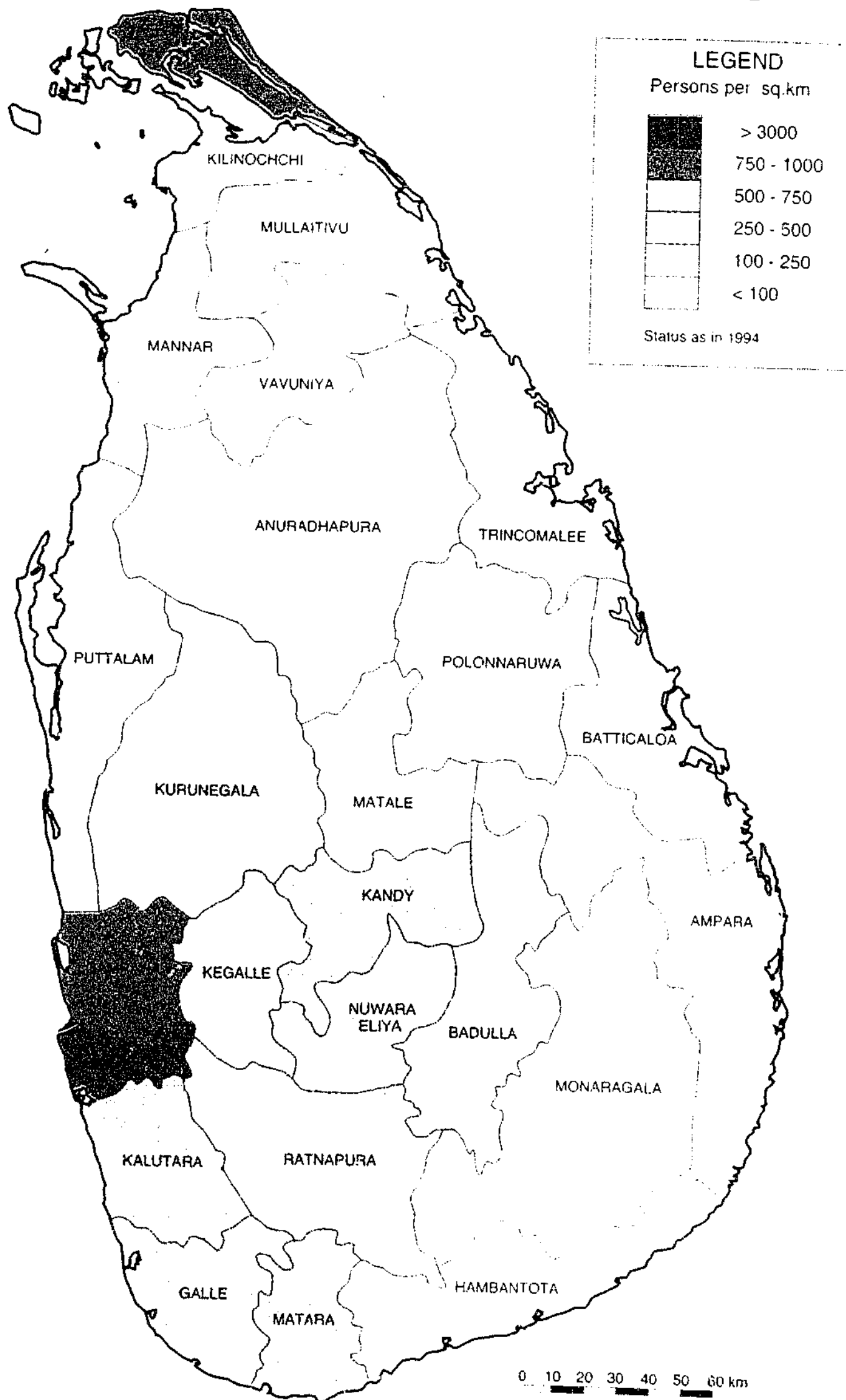
The failure of Chandrika Kumaratunga's new government to check the corruption and abuses of political power which became endemic during the 17 years of United National Party rule, and perceptions that some senior politicians and army chiefs are personally profiting from the war, while the costs are being borne by the rural poor households from which the bulk of military recruits are drawn, have given rise to considerable public contempt for the country's political elites. The failure of the non-farm labour market to accommodate an expanding labour force and a growing gap between the aspirations of young people and the opportunities which are in fact available to them, and widening disparities of opportunity and income between the Colombo elite and the rest of the population, have led to a perception that for most Sri Lankans, the promised benefits of years of structural adjustment have failed to materialise, and have heightened social tensions:

Since liberalisation, the material benefits of a deregulated economy have become widely known, raising the aspirations of rural youth in particular. They are no longer content with the basic standards of living of the rural life that their parents had. They see the situation in rural areas to be in stark contrast to the aggressive consumerism of the *nouveau riche* in metropolitan Colombo. The latter's life-style has been highly visible; it has been increasingly resented, and it is all too often interpreted as the ill-gotten gains of the urban rich and opportunistic and self-serving politicians. In such situations the lower incidence of absolute poverty that has recently been recorded in large-scale surveys seriously understates the frustrations and pressures building up in Sri Lankan society. Release takes various forms - from despair and suicide to mass desertions from the army, to increased levels of crime and to armed insurrection (Dunham and Jayasuriya 2000:106-7).

### 3.3 Regional distribution of poverty

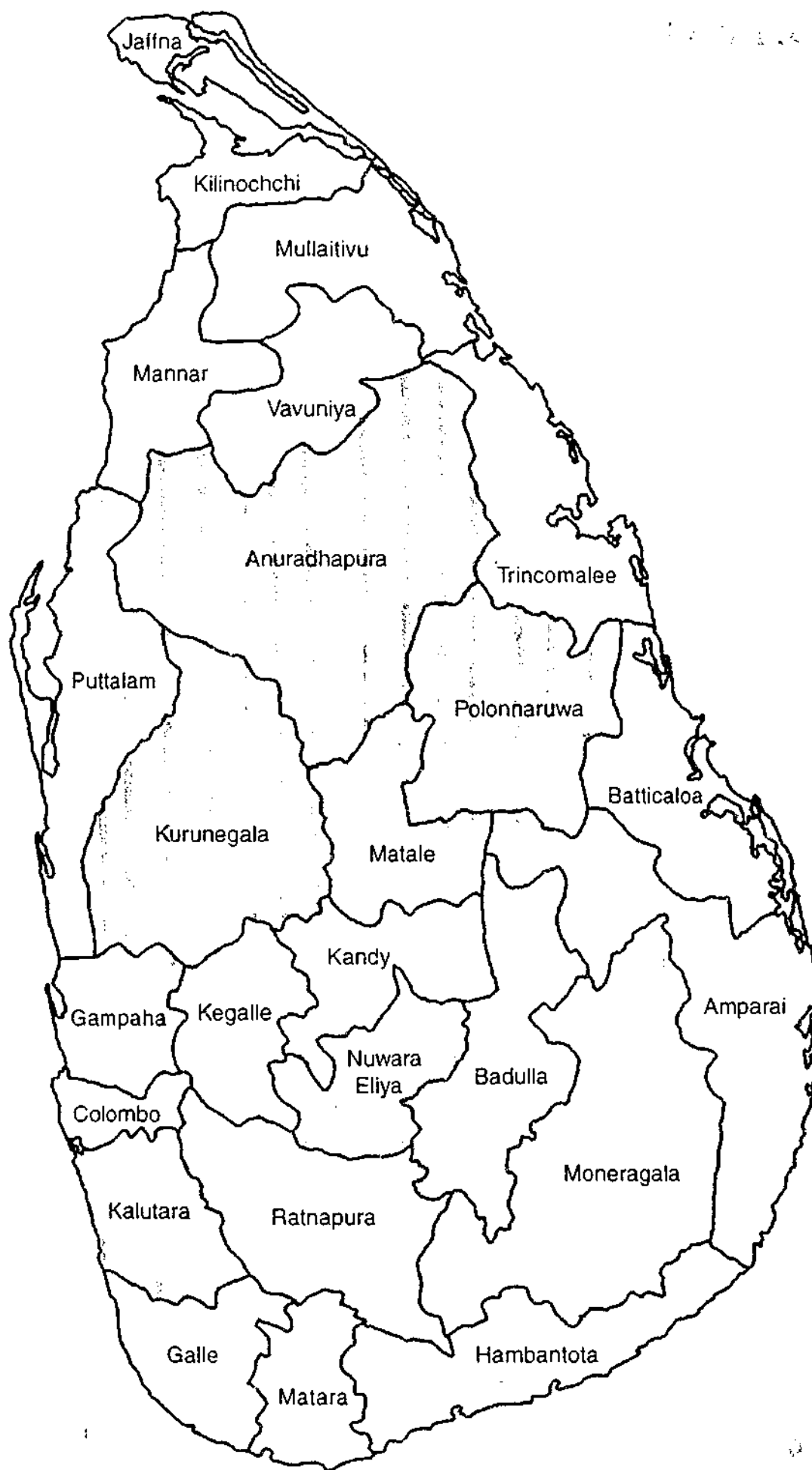
Sri Lanka has a population of 18.7 million. Just over a quarter of Sri Lankans live in the metropolitan Western Province which includes the national capital and the districts of Gampaha, Colombo and Kalutara. With the exception of the densely-populated Jaffna Peninsula in the north, the commercial and administrative centre for the country's north-eastern Tamil community, population densities decline with distance from the Western Province, as Map 3.1 shows, and are lowest in the most remote districts. Outside the predominantly urban Western Province the majority of the population is rural and agrarian but a significant and growing proportion live in and around regional towns and along the heavily built-up arterial transport routes linking Colombo with the southern coast and the regional cities of Kandy and Ratnapura. In the absence of reliable official data on the extent of urbanisation, it is estimated that up to a

# POPULATION DENSITY



Source: Arjuna's Atlas of Sri Lanka (1997)

# MAP 3.2 : PER CAPITA GDP BY DISTRICT



## CENTRAL PROVINCE

Kandy  
Matale  
Nuwara Eliya

## EASTERN PROVINCE

Trincomalee  
Batticaloa  
Amparai

## NORTH CENTRAL PROVINCE

Anuradhapura  
Polonnaruwa

## NORTHERN PROVINCE

Vavuniya  
Mannar  
Mullaitivu  
Jaffna  
Kilinochchi

## NORTH WESTERN PROVINCE

Kurunegala  
Puttalam

## SABARAGAMUWA PROVINCE

Ratnapura  
Kegalle

## SOUTHERN PROVINCE

Galle  
Matara  
Hambantota

## UVA PROVINCE

Badulla  
Moneragala

## WESTERN PROVINCE

Colombo  
Gampaha  
Kalutara

Per capita GDP (Rs.)

> 13,000

8,500 - 13,000

< 8,500

quarter of the regional population outside the Western Province is semi-urban and urban, while the remainder live in the rural hinterland.

Sri Lankan poverty is principally a rural and peripheral phenomenon. It is lowest in urban and industrialised areas where the non-farm labour market is strongest and where infrastructure and markets exist to support non-farm microenterprises, and highest in the agrarian smallholder sector where farm incomes are stagnating or declining, and where non-farm activity is constrained by low population density, lack of infrastructure and inadequate transport linkages with urban markets. As investment and employment are concentrated in the industrialised densely-populated Western province there is a pronounced metropolitan bias in income distribution, and a widening gap between the mean incomes of the Colombo municipality and the rest of the country has been a conspicuous trend in geographical income distributions in the 1990s (Dunham and Jayasuriya 1998). Outside the Western Province there are significant income variations between regions. Regional urban and semi-urban communities are less poor than those in the countryside (World Bank 1995a). In the rural agrarian sector there are also regional income disparities which are related to the extent of non-farm development and agricultural productivity: agrarian poverty is lowest in major irrigation schemes and in commercial agriculture enclaves such as the Nuwara Eliya district and the Kalpitiya Peninsula in Puttalam district, and highest among semi-subsistence farmers in the south-west where population pressure has led to land fragmentation and in the remote arid south-east where low rainfall and poor irrigation constrain productivity.

**Table 3.3: Poverty incidence by province, 1995/96**

	Poverty incidence (per cent)
Western Province	13
North Central Province	17
North Western Province	18
Uva Province	22
Southern Province	23
Central Province	30
Sabaragamuwa Province	32
Sri Lanka	21

Source: Aturupane 1999

Table 3.3 shows the 1995-96 incidence of poverty by province, and Map 3.2 describes the district-level distribution of per capita GDP. Poverty incidence is by far the lowest in the Western Province, which accounts for three of the four highest-ranking districts in terms of GDP. While there are pockets of extreme poverty in and around Colombo, particularly in the slum settlements which accommodate refugees from the war in the north-east, and evidence of growing income inequality within urban areas (Dunham and Jayasuriya 1998), the concentration of economic activity and employment growth in the Western Province, which contributes 40 per cent of GDP, has kept urban household incomes relatively high and poverty incidence low. Per capita GDP is also relatively high in the productive agricultural regions of the North Central province, much of which receives continuous irrigation and where most of the country's commercial paddy is produced, in the temperate commercial OFC-producing region of Nuwara Eliya, and in Kurunegala district, another highly productive farming region which borders the industrial region of Gampaha and benefits from good transport networks and access to electrical power and its proximity to the manufacturing centres in the Western Province (Aturupane 1999). The lowest per capita incomes occur in regions where the local economy is based on the stagnating semi-subsistence farm sector and where remoteness and lack of infrastructure inhibit non-farm development: in the overcrowded Wet Zone regions of the mountainous Sabaragamuwa

and Central Provinces and the two western-most districts of the Southern Province, and in the remote and underdeveloped south-eastern Dry Zone regions of Hambantota and Monaragala.

Due to a lack of recent data and definitional inadequacies, official data sources provide little information on the extent of urbanisation in Sri Lanka. According to the most recent data on the urban/rural distribution of the population, based on the 1981 census, 22 per cent of Sri Lankans live in urban areas (DCS 1997a). The rural sector is a residual category which covers the remaining 78 per cent of the population, including the Indian Tamil population in the export-oriented tea estates in the country's central highlands, who comprise about 7 per cent of the population and are sometimes treated statistically as a third sector<sup>4</sup>.

Official data collection agencies define the urban sector as areas under the control of municipal or urban councils (DCS 1996a). This definition is manifestly inadequate for two reasons: firstly, the distinction between communities governed by urban councils, which are considered part of the urban sector, and those under town councils, which are not, appears arbitrary, having little to do with population size or density: some very small towns with populations well below 5,000 are under urban councils and are therefore counted as "urban", while many substantial and growing towns are excluded. Thus densely-populated and economically vigorous towns along the country's main transport routes - such as Warakapola on the Kandy Road and Kuruwita on the Ratnapura Road, and the tourist resorts of Hikkaduwa and Bentota on the south-west coast, as well as the emerging service centres in the irrigated settlements, are excluded from the DCS definition. On the other hand, some designated "urban" areas such as Kadugannawa (pop. 1,598) are little more than villages (Arjuna 1997). Secondly, as settlement patterns do not conform to administrative boundaries, which typically extend about a kilometre from a town centre, this arbitrary distinction fails to capture their complexity. Significant population growth is occurring on the semi-urban peripheries of regional towns and cities, in newly-established shanty communities and in the linear settlements which have developed along the country's main highways, and many formerly rural households are becoming semi-urban as their outlying villages become integrated with nearby towns by urban sprawl. In terms of population density, composition of economic activities and infrastructure development these semi-urban communities have more in common with regional towns than with remote rural populations, but as they fall outside administrative boundaries they are considered "rural" by official data collection agencies.

The evidence suggests strongly that regional Sri Lanka is becoming increasingly urbanised. Not only has there been significant growth in regional semi-urban settlements; populations within narrowly-defined urban boundaries are also growing. Nearly 50 per cent of designated urban settlements recorded annual population growth rates of 2 per cent or more between 1981 and 1994 (Arjuna 1997), well in excess of the national population growth rate of less than 1.5 per cent over the same period (Central Bank 1998b). Data enabling a reliable estimate of the rural/urban population distribution is unavailable but outside the Western Province the proportion of semi-urban and urban households is certainly considerably higher than the 13 per cent estimated by the 1981 census and may be as high as 30 per cent.

There are significant inequalities in the geographic distribution of social and physical infrastructure. Telecommunications services are heavily concentrated in the Western Province and particularly in the Colombo metropolitan area, which contains two thirds of the country's telephone subscribers and where about one in eight households have telephones, while outside the Western Province scarce telecommunications facilities are confined to a handful of government agencies, banks, NGOs and private firms in regional towns (Central Bank 1998b). The Colombo area is serviced by a relatively new cable network but outside Colombo telephone services are unreliable (World Bank 1995b). Similarly, access to electrical power is concentrated in the Western Province, where 65 per cent of



households are connected to the national grid, in comparison with 44 per cent of households nationally. Outside the Western Province mains electricity is confined to main roads, regional towns and the larger villages. The extension of electricity services to the regions has been very slow and in mountainous areas and remote Dry Zone districts fewer than 30 per cent of households are connected to a mains supply (UNDP 1998). Moreover, electricity supplied by the national grid is unreliable: inefficiencies in the hydroelectric generation system and in power transmission and distribution cause capacity to fluctuate, particularly in dry seasons and when monsoons are poor, and contribute to frequent power failures, with reports of up to five stoppages a day (World Bank 1995b). Reliable industrial power supplies are confined to the Export Processing Zones in the Western Province and to some large Colombo manufacturers which maintain their own generating capacity.

The Western Province has an extensive and mostly well-maintained road network and reliable public transport services (although pollution and congestion are significant problems in the Colombo municipality) but in the rest of the country regional road and transport infrastructure is underdeveloped. The country's railway network, which is seriously under-capitalised with decrepit rolling stock and poorly maintained tracks and control systems, leading to frequent delays and cancellations, has lost most of its freight market share to road transport (Central Bank 1998a). With the economic growth of the 1990s there has been a massive increase in vehicular traffic, new motor vehicle registrations having nearly doubled between 1986 and 1997 (Central Bank 1998b), leading to a significant deterioration in road and traffic conditions in the 1990s on the country's arterial road network, which is not adequately designed to carry large volumes of traffic and heavy vehicles, and traffic is slow due to congestion and poor surface quality. Transport linkages between outlying villages and farming areas and main roads and regional towns are typically in a very poor state, presenting significant difficulties of access to heavy vehicles and in some areas altogether cut off from vehicular traffic during rainy seasons. In the most remote areas in the mountainous Central Province and the south-eastern Dry Zone, outlying farms and hamlets may be several kilometres from a vehicular road and accessible only on foot or by bicycle. The underdevelopment of regional rural-to-urban linkages is compounded by the poor quality of the recently-privatised bus network, the sole means of public transport for most Sri Lankans. Under-capitalisation, poor road conditions and under-regulation (which allows operators to avoid unprofitable rural bus routes) have reduced access to bus transport in remote areas.

The uneven sectoral distribution of the country's strong post-liberalisation economic growth has magnified economic disparities between the metropolitan Western Province and peripheral regions, and between regional urban and rural populations (Table 3.4). The strong growth of the non-farm sector has been concentrated overwhelmingly in the Western Province, and to a lesser extent in regional towns, while the stagnation of agriculture has impacted most strongly on the rural economy. By far the strongest GDP growth has occurred in large-scale manufacturing, which in the 1990s has grown by over 10 per cent annually, twice the GDP growth rate, and has become a dominant force in the Sri Lankan economy, contributing three quarters of the country's exports and a fifth of GDP. The manufacturing sector is dominated by export-oriented garment production, which accounted for 40 per cent of industrial output in 1998. Other non-farm activities - including trade, construction, small-scale manufacturing and services - have also grown strongly in absolute terms while maintaining or slightly increasing their overall share of GDP.

Agriculture however has fared poorly, with growth rates well below those of the non-farm sector and a declining share of GDP, its contribution having fallen by about a third since 1982. The export-oriented tea, rubber and coconut plantation sector, a minor contributor to employment but a major source of foreign exchange, has stagnated in the 1990s with growth rates marginally below the annual population growth rate of 1.4 per cent. The non-plantation smallholder farm

sector includes a variety of production types: numerically it is dominated by semi-subsistence paddy farms, which cover 85 per cent of non-plantation arable land (Central Bank 1998a); it also includes a small and geographically confined but economically significant group of commercial OFC growers; and a third group of very poor farmers who, lacking access to the irrigation facilities needed for paddy cultivation, practice a primitive and low-value form of slash-and-burn OFC cultivation known as *chena* on marginal lands. Smallholder cultivation is a minor and declining contributor to the national economy, its share of GDP having fallen from 15 per cent in 1982 to just over 10 per cent in 1998, but is of major domestic significance, being the primary income source of about half of the country's households. Paddy cultivation in particular has come under intense pressure from falling producer prices, rising input costs and the impacts of population growth on finite land and water resources, leading to a generalised decline in farm incomes. Paddy cultivation is the only sector of the Sri Lankan economy which has experienced negative growth in the 1990s.

**Table 3.4: Sectoral composition of GDP 1982-1997 and average sectoral annual growth rates**

Sector	1982	1990	1997	Average annual growth rate 1990-97
<b>Agriculture, forestry and fishing</b>	<b>26.4</b>	<b>23.2</b>	<b>17.8</b>	<b>2.1*</b>
Plantation crops	6.8	5.4	4.1	1.3
Paddy	5.8	4.9	2.6	-1.4
Other food crops (OFCs)	9.3	9.6	7.9	2.6
Forestry and fishing	4.2	3.3	2.8	3.2
<b>Manufacturing</b>	<b>14.4</b>	<b>17.4</b>	<b>21.5</b>	<b>11.2</b>
Factory industry	12.3	15.9	20.1	11.5
Small industry	2.1	1.4	1.4	7.3
<b>Wholesale and retail trade</b>	<b>20.8</b>	<b>20.5</b>	<b>21.7</b>	<b>7.4</b>
<b>Other n.e.s**</b>	<b>38.4</b>	<b>38.9</b>	<b>39.0</b>	<b>6.6</b>
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>6.2</b>

\* Growth rates in the agricultural sector refer to the 1992-98 period

\*\* Includes transport and communications (11.7 per cent of GDP in 1997), construction (6.8 per cent), finance and banking (6.3 per cent), public administration and utilities (5.8 per cent), personal services (3.7 per cent) and mining (2.5 per cent).

Sources: Central Bank Annual Reports, World Bank 1998a

### 3.4 The Sri Lankan labour market

The distribution of the income sources available to Sri Lankan households is described in Table 3.5. The main income sources include the small and relatively privileged formal sector of the labour market; the much larger informal sector which covers smallholder agriculture and most non-farm enterprises, and in which household microenterprises are the single largest employment category; employment overseas and in the military. In addition about 60 per cent of households receive government welfare transfers which in most cases are small and make a minor contribution to household income. In practice most households have multiple income sources, often combining remittances and transfers with two or three sources of informal sector income, such as the common rural combination of self-employed farming with casual wage labour. Due to a lack of local economic opportunities there is an increasing dependence on non-local sources of income in non-metropolitan areas. The World Bank estimates that between 40 and 50 per cent of the incomes of the rural poor are derived from income transfers in the form of overseas and domestic remittances from relatives, and social welfare programs (World Bank 1998a). Dunham and

Jayasuriya (1998) estimate that transfers from government welfare programs, overseas employment and military employment comprise up to 70 per cent of the incomes of the rural poor.

**Table 3.5: Principal occupations of Sri Lankan income earners by major employment category**

Employment category	Frequency ('000)	Per cent
<b>Formal sector</b>	<b>1,781</b>	<b>26.2</b>
Public sector (civilian)	997	14.7
Private sector	784	11.6
<b>Informal sector</b>	<b>4,156</b>	<b>61.2</b>
Household microenterprises*	2,600	38.3
Wage employees	1,556	22.9
<b>Military**</b>	<b>150</b>	<b>2.3</b>
<b>Overseas***</b>	<b>700</b>	<b>10.3</b>
<b>Total</b>	<b>6,787</b>	<b>100.0</b>

\* Includes own-account workers and unpaid household workers on microenterprises

\*\* Official data on the size of the military is unavailable. The figure of 150,000 was the estimate provided by most experts interviewed during the course of this study, and given a reliable estimate that the defence forces numbered 80,000 in 1993 (Dunham and Edwards 1997), is consistent with the substantial expansion in military recruitment following the intensification of the secessionist conflict since the mid-1990s.

\*\*\* As discussed below, official figures on out-migration, which put the number of overseas workers at 600,000 in 2000, underestimate the true dimensions of the phenomenon because they do not include unregistered overseas workers who may account for up to a third of all overseas workers. Thus the estimate of 700,000 given here is a conservative one.

Source: DCS 1998a, Central Bank 1998a, Central Bank 1999

As in many other LICs, wage employment opportunities have not kept up with labour force growth in Sri Lanka. The transfer of labour into the emerging industrial and service sectors has been low because of low rates of regional non-farm development and the capital-intensive nature of the fast-growing factory sector, while the stagnating over-populated farm sector is unable to absorb more workers. As Table 3.6 shows, the sectoral composition of employment is changing at a far slower rate than the changes in GDP composition described in Table 3.4. Moreover, the movement of labour into the non-farm sector, pronounced in the early 1990s, appears to have slowed since 1994. Employment growth rates in the factory sector have been strong, with average annual job growth of around 30,000 in the 1990s, but as large industry employs a small fraction of the labour force it has had a minor impact on aggregate employment. In 1998 large-scale manufacturing accounted for about 410,000 jobs: about half the manufacturing workforce and about 7 per cent of total employment (Central Bank 1998a).

Unemployment stood at 11 per cent in 1998 and there is significant underemployment, with nearly 40 per cent of employed persons working less than 40 hours a week<sup>5</sup> (DCS 1998a). Although the unemployment rate has fallen significantly the early 1990s, much of this decline was due less to genuine economic growth than to outward migration, military recruitment and unsustainable politically-motivated public sector intakes (World Bank 1998b). The Sri Lankan economy faces a formidable task finding remunerative jobs for new entrants to the labour market (about 100,000 annually) as well as its current unemployed and growing numbers of retrenched public sector workers. In the late 1990s the World Bank predicted that national economic growth rates, although high, will be insufficient to absorb the unemployed in the medium-term (World Bank 1998b).

**Table 3.6: Employment composition by industry 1990-98\***

Industry category	1990	1994	1998
Agriculture	46.8	42.6	41.6
Non-farm sector	53.2	57.4	58.4
Manufacturing	13.3	15.2	15.4
Public administration	15.7	16.0	16.9
Hospitality and trade	9.6	12.9	10.0
Construction	3.9	3.3	5.2
Finance, insurance and real estate	1.3	1.9	2.0
Transport and communication	4.2	4.0	4.5
Other n.e.s.	5.2	4.1	4.4
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
<b>Unemployment rate</b>	<b>16.2</b>	<b>12.0</b>	<b>10.6</b>

\* Tables 3.8 and 3.9 refer to in-country civilian employment only.

Source: DCS Labour Force Surveys (various years)

As Table 3.7 indicates, there are significant regional disparities in the sectoral distribution of employment, with significantly higher rates of non-farm employment in the Western Province. In very remote districts such as Hambantota close to two-thirds of the labour force are employed in agriculture and unemployment is well above the national average.

**Table 3.7: Regional distribution of employment by industry category and unemployment rate (per cent)\***

Industry category	Western Province	Outside Western Province	Hambantota District	Total
Agriculture	14.1	52.5	64.4	41.6
Non-farm sector	85.9	47.5	35.6	58.4
Manufacturing	20.7	10.1	9.0	15.4
Public administration	24.7	14.6	11.0	16.9
Hospitality and trade	15.6	9.3	7.4	10.0
Construction	5.6	3.9	3.5	5.2
Finance, insurance and real estate	3.3	-	-	2.0
Transport and communication	6.6	3.1	2.5	4.5
Other n.e.s.	9.4	6.5	2.2	4.4
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
<b>Unemployment rate</b>	<b>10.7</b>	<b>10.5</b>	<b>13.5</b>	<b>10.6</b>

\* Columns 2 and 3 are based on the 1993 Regional Labour Force Survey which contains the most recent available province-wise disaggregation of employment by industry. Column 4 is based on the 1998 DCS survey of Hambantota District and column 5 is based on the March 1998 DCS Labour Force Survey. Unemployment rates are based on 1998 data.

Source: DCS 1993a, DCS 1998a, DCS 1998b

### 3.4.1 The formal sector

About one quarter of Sri Lankan workers are employed in the formal sector of the economy, in which wages and conditions are protected by legislation, rates of pay are usually higher than those in comparable informal sector jobs, and employees have security of tenure and access to retirement benefits. The largest formal sector employer is the government, which through the civil service, semi-government agencies and state-owned enterprises accounts for about 18 per cent of in-country civilian jobs. The formal private sector consists of the country's small white-collar corporate sector, in which employment is virtually restricted to members of the English-speaking Colombo elite. In theory, manufacturing firms with establishments of 15 or more are

part of the formal sector, but in practice wages and conditions in much of the nominally organised manufacturing sector are unregulated. As the under-resourced Department of Labour lacks the capacity to monitor the multitude of small workshops it restricts its operational reach to larger establishments of 100 or more; and the large-scale export-oriented factories, which account for about 5 per cent of jobs, are effectively exempt from labour regulations and practices, including job security regulation (World Bank 1999).

Because they are relatively well-paid and have job security households with one or more members employed in the public sector are rarely poor, although those which rely on a retirement pension may fall below the poverty line (Aturupane 1999). As Table 3.8 shows, households whose principal income earners are employed in white collar occupations which are almost exclusively located in the formal sector have far lower rates of poverty, averaging less than 5 per cent, than those whose members are employed in services, manual trades and agriculture, located primarily in the informal sector.

**Table 3.8: Household poverty incidence by main occupation of principal income earner, 1995/96 (per cent)**

Occupation	Poverty Incidence
<b>Formal sector</b>	
Professional	3.7
Managerial	0.0
Clerical	4.5
<b>Informal sector</b>	
Sales and service	15.2
Agriculture	26.8
Non-farm production	27.1

Source: Aturupane 1999

Rates of pay in the formal sector vary from around Rs.3,000 for junior and unskilled workers to Rs.10,000 or more for professionals and senior public servants and upwards of Rs.30,000 at senior levels in the corporate private sector. Real public sector wages have fallen in the 1990s and compare unfavourably with those in the white collar private sector<sup>6</sup>, but remain superior to those available in the informal sector and in most manufacturing jobs, the only realistic alternative sources of civilian in-country wage employment for the vast majority of Sri Lankans.

Because the government is a source of high-status jobs with relatively advantageous wage and non-wage benefits, public sector jobs are highly sought after. The gap between public and private sector conditions is believed by some observers to contribute to unemployment by creating "queues" in which secondary school graduates remain unemployed, often for several years, in the hope of finding a public sector job rather than accepting lower-status lower-paid work in the informal sector or in a factory (World Bank 1996b, World Bank 1999). The actions of successive governments have encouraged the practice of "waiting for a job": youth unemployment is a politically volatile issue which has been a key underlying factor in the violent civil uprisings of the last three decades, and since the 1980s governments have resorted to periodic mass public sector recruitment campaigns to defuse unrest among unemployed secondary school graduates. Between 1994 and 1998, 90,000 non-military public sector jobs were created, mostly through the politically-motivated recruitment of teachers' assistants and Samurđhi animators (Central Bank 1998a). Politically-motivated intakes have failed to offset an overall decline in public sector employment through the privatisation of state-owned enterprises and retrenchments in the postal service and other government departments, and between 1992 and 1998 the proportion of the in-country labour force employed in the public sector fell from 22 to 16 per cent.

About 40 per cent of public sector jobs are located in the Western Province (DCS 1993a). Most of the remaining 60 per cent are in regional district centres which contain the administrative headquarters of provincial authorities, the local offices of government departments, state-owned banks and health services. Formal private sector employment is even more heavily concentrated in the Western Province. The white-collar private sector is insignificant outside Colombo, and as Table 3.9 shows, large-scale manufacturing is overwhelmingly concentrated in the Western Province, which contains more than 80 per cent of factories with establishments of 100 or more.

**Table 3.9: Regional distribution of large industrial enterprises, 1998**

Location	Number of factories	Per cent
Western Province	2,612	82.1
Wet Zone	352	11.1
Dry Zone	218	6.8
Total	3,182	100.0

Source: Central Bank 1998a

In an effort to reduce rural unemployment governments since the early 1990s have offered tax concessions and other incentives to encourage manufacturers to locate in the countryside. The most important of these initiatives is the Two Hundred Garment Factory Program (THGFP), established in the early 1990s, with the ambitious target of generating 100,000 regional manufacturing jobs through the establishment of 200 factories (one in each *Pradeshiya Sabha*, or local government unit). The program's performance has been disappointing: according to data supplied by the Sri Lankan Board of Investment (BOI), the agency responsible for export-oriented manufacturing industry, by the end of 1998 only 128 THGFP factories had been established outside the Western Province, generating 59,000 jobs.

The THGFP added to garment exporting capacity at a time when export quotas were close to full utilisation, thereby placing excessive pressure on an already overcrowded market. It is likely that inexperienced operators were drawn to the program by the financial incentives package and politicised selection of manufacturers (Dunham and Kelegama 1997). Nearly half the factories were opened by exporters with no previous experience in the garment industry (Edwards 1996). Political pressure was exerted on the banks to finance THGFP enterprises, many of which were doubtful investments which would probably not have been financed otherwise (Edwards 1996). There are indications that many garment factories are in financial difficulties, with high rates of default on the payment of statutory employee provident fund contributions (Edwards 1996), and widespread late payment and non-payment of wages (Heward 1997). The up-front payments which are part of the financial incentives package may encourage the proliferation of short-term unsustainable operations. In 1996 six factories closed; there was a revival in 1997 with the opening of ten new factories but in 1998 another four have closed (Central Bank 1998a). During the survey period at least one of the five THGFP factories in Hambantota district was temporarily closed, and workers laid off, due to a "lack of orders", while at the same time another factory less than 20 kilometres away was under construction and preparing to open within a few months.

The fact that the employment targets set by the government's regionalisation programs are modest - the THGFP, together with other recent initiatives such as the establishment of regional industrial centres, aims to generate about 150,000 jobs which would employ about 3 per cent of the labour force - indicates that the government is aware of the limitations of such programs. In practice regionalisation programs have had little impact on the concentration of manufacturing employment: 80 per cent of the new factories established between 1995 and 1998 are located in the Western Province (Central Bank 1998a). The THGFP faces a range of problems connected

with the politicisation of administrative processes, the global market environment (including uncertainty created by the pending termination in 2005 of the Multi-Fibre Agreement which allows LIC garment exporters privileged access to OECD markets (Edwards 1996) and low levels of business skills among Sri Lankan entrepreneurs. There is a general consensus however that the main barriers to regional industrialisation are imposed by a lack of infrastructure. Industry surveys indicate that the poor quality of regional telecommunications, electricity supplies and transport linkages are significant constraints on the expansion of private sector activity outside the Western Province (World Bank 1995*b*, Central Bank 1998*a*), and a key reason for manufacturers' reluctance to participate in the THGFP (personal communication, BOI staffer).

The regional garment factory workforce is composed primarily of young unmarried women. A recent survey found that 64 per cent of THGFP workers had never married and nearly 80 per cent were under 30 years of age (Heward 1997). As alternative local employment opportunities for rural women are extremely scarce, local garment factories reduce unemployment and provide an additional household income source. However the aggregate poverty reduction value of the regional garment industry is reduced by the small number of available jobs, the low wages (between Rs. 2,000-2,500), the insecure and intermittent nature of employment in some factories, and the skewing of employment towards the politically connected less-poor and those in urban and semi-urban areas (Heward 1997). According to some estimates between 60 and 75 per cent of THGFP jobs go to the poorest 25 to 30 per cent in rural areas (Dunham and Jayasuriya 1998, Dunham and Edwards 1997). These estimates rely on an assumption that rural income groups are represented in garment factory jobs in proportion to their distribution throughout the population. It is more likely however that a disproportionate share of THGFP employment goes to the less-poor. As factories established under the THGFP are heavily subsidised by the government employment in them is, like rural public sector employment, a political patronage resource (discussed further in chapter 5). The other factor limiting access by the rural poor is location, as transport limitations reduce the access of those in remote areas to factories which are necessarily located in regional towns and on major roads which provide power, transport networks and a nearby labour supply.

### **3.4.2 Internal labour migration**

While Sri Lanka has been free from the massive rural-to-urban population shifts which have occurred in other LICs in recent years, the relative stability of the rural population gives a misleading impression of the importance of non-local income sources in the rural economy. There is little evidence of any significant outflow of whole families from the countryside to the cities, but the migration of individual primary income earners and young single adults to work in the Western Province, remitting part of their wages and returning to their homes weekly or monthly, is a common phenomenon. There is little empirical data on the extent of rural-to-Western Province commuting, but anecdotal evidence and extensive boarding house development for migrant workers in the industrial zones indicate that a substantial proportion of the metropolitan workforce is drawn from the provinces. There is some evidence that domestic migration rates are higher in the more centrally located provinces than in remote regions. It has been estimated that up to 80 per cent of Colombo employees are commuters, but most are probably from elsewhere in the Western Province (Dunham and Edwards 1997). According to a recent household survey in Krunegala district nearly 20 per cent of households were in receipt of in-country remittances (Shaw 1999*b*) but as chapter 5 below shows, only 10 per cent of the Hambantota sample households were receiving remittances from family members employed in-country at the time of the survey.

As employment in the small urban white-collar private sector is restricted to members of the English-speaking Colombo elite, it is insignificant as a source of income for rural households.



An indeterminate but substantial number of urban public sector employees are commuters. As access to public sector jobs generally requires the completion of secondary school and is often dependent on political connections remittances from government employees tend to be directed to middle-class regional households rather than the rural poor. Remittances from household members working in the Western Province Export Processing Zones (EPZs), particularly from young female garment factory workers, who at 190,000 constitute two thirds of the export-oriented manufacturing workforce (Central Bank 1998a), are a significant source of rural income. As the unattractiveness of garment factory jobs deters many less-poor, remittances from this source are more likely than public sector remittances to flow to poorer families. With substandard accommodation arrangements and because they are effectively unregulated, with low wages, long working hours, poor working conditions and without job security, EPZ jobs are considered "bad" jobs<sup>7</sup>. Furthermore prospective workers are deterred by a pervasive social stigma which attaches to unmarried women who leave home to work in the EPZs. During the survey a frequent response among unemployed young Hambantota women and their families was that the economic benefits of Western province employment were outweighed by the costs of a compromised reputation and consequent damage to their marriage prospects. The size of garment factory remittances is limited by low wages and the high living costs associated with boarding house accommodation to an average of about Rs.1,000<sup>8</sup>.

The other main source of regular in-country employment available to the rural poor is the military. Unlike other areas of public sector employment, jobs in the defence forces are available to the rural poor, who are believed to constitute 80 per cent or more of military recruits (Dunham and Edwards 1997). The salaries of Rs.8,000 per month for recruits, with compensation for families in the event of death or disablement, are far higher than those offered by alternative forms of employment for young men and for some poor families outweigh the risks of this hazardous occupation.

### 3.4.3 Overseas labour migration

Overseas employment has become a major source of income for households and for the national economy. Remittances from overseas accounted for more than 7 per cent of GDP in 1998 - up from 3.4 per cent in 1980 and 5.3 per cent in 1993 - and after garment and tea exports are the country's third largest source of foreign exchange (Central Bank 1998a). The number of officially-registered workers overseas increased from about 250,000 in the mid-1980s (Dunham and Edwards 1997) to 460,000 in 1994 (Gunatilleke 1995) and 600,000 in 2000 (Gulf News, 23 December 2000). Because of the widespread use of unofficial overseas employment agencies, and the relaxation in 1996 of the requirement for migrating workers to register with the Bureau of Foreign Employment, the precise number of overseas workers is unknown. Evidence that over a third of migrant workers obtained their jobs through unofficial channels suggests that official estimates significantly understate the true dimensions of overseas labour migration (Eelans and Speckman 1992). It is likely that the number of overseas workers is between 700,000 and 900,000, indicating that around 15 per cent of Sri Lankan households have a member currently working overseas.

Not all remittances go to the rural poor. About one quarter of the value of total remittances from abroad comes from a numerically tiny group of Sri Lankan expatriates in the OECD countries (Central Bank 1998a). Their remittances go mostly to well-off Colombo families and are insignificant as an income source for the poor. By far the most important migrant worker destination is the Middle East, which accounted for over 60 per cent of total remittances in 1998 and 90 per cent of officially registered migrant worker departures (Central Bank 1998a). Between 12 and 15 per cent of migrant workers to the Middle East are male skilled manual workers and white collar workers (Patrick 1997). As these workers are unlikely to have come



from poor households their remittances are of limited significance for poverty. This is supported by evidence that in rural areas male migrants come from the middle layers and women migrants from the lower layers of the village social hierarchy (Hettige 1992). Overseas demand for male workers is highest in the skilled and semi-skilled categories. Recruitment fees charged by employment agencies, a substantial cost for all migrant workers, are two to three times higher for semi-skilled and skilled male workers than for unskilled workers (Mook 1992, Patrick 1997). Skill requirements and the higher recruitment fees restrict the access of males from poorer backgrounds to overseas employment.

About 80 per cent of labour migrants to the Middle East are housemaids, whose remittances are more likely to flow to poor households than those from skilled workers or expatriates in the OECD countries. Female employment in the Middle East involves hazards which reduce its attractiveness for the non-poor. Female domestic servants in foreign countries are among the most vulnerable of all workers, entirely dependent on their employers for their basic needs, with no avenue of redress. Excessive workloads, isolation, physical abuse and the withholding of pay by unscrupulous employers or agents are common problems faced by housemaids which are widely reported in the Sri Lankan media (Patrick 1997, Spaan 1992). Middle-class women are further deterred from seeking overseas employment by the low social status of domestic service, and although a small number migrate it is usually considered a matter of shame by the women and their families (Brochman 1992).

Female employment overseas involves high personal and social costs in its disruptive effects on family stability and children's welfare (Patrick 1997, Lakshman 1998). Female household heads and the mothers of children under 15 are over-represented among migrant workers, for a number of reasons: the additional economic pressure imposed by dependent family members, a lack of alternative income-earning opportunities, a household propensity to send married women due to fear of moral corruption and damage to the marriage prospects of single women, and the existence of age restrictions in some Middle East countries. Saudi Arabia, for instance, only admits domestic servants aged between 30 and 43, an age group dominated by married women with young children (Eelens and Schampers 1992). There is evidence that the children of women working overseas bear a disproportionate share of the social costs of such employment. Children whose mothers are working abroad are among the most nutritionally at-risk of all children (DCS 1995), and their educational performance is lower (de Bruijn et al 1992). Another important social cost of female migration relates to very high family breakdown and divorce rates among migrants. There is some evidence that the cause-and-effect relationship is reciprocal, as many women migrate following a separation or to escape an unsatisfactory marriage (Patrick 1997). However migrant workers' families are far more likely to break up during the twelve months after return than at any other time, indicating that the majority of marital break-ups in migrant workers' families are in part a consequence of the migration itself (De Bruijn et al 1992).

While most female migrants are poor, they are not from the poorest groups. A study of migration in a Hambantota village found that the migration rates were highest among the highest *govigama* (farmer) caste, lower among the lower *navandanna* (artisan) caste, and fell to zero in the very poor and socially isolated *rada* (washermen's) caste (Mook 1992). Although there are no formal education or literacy requirements for housemaids, their educational status is slightly higher than the national average (Patrick 1997, Mook 1992). For the poorest, a combination of social isolation and lack of education act as barriers when negotiating the pre-migration red tape. They are more likely to lack birth certificates and other papers required for passport applications (Mook 1992), and are less likely to meet the requirements of employers in terms of health and physical presentation. The high costs of recruitment and travel, which are borne by the migrant worker, are an additional deterrent for the poorest households.

Housemaids are paid between Rs5,000-7,000 per month: far more than they could expect to earn locally, and enough to lift their families above the poverty line. Most housemaids remit between 50 and 100 per cent of their salaries (Eelens and Schampers 1992). Given the large population of overseas workers and their relatively high earnings, overseas employment could be expected to have a substantial impact on rural poverty. Yet at the household level the impact on poverty has been muted. Not all migrants receive their full pay entitlements: reports of fraud by bogus migration agents are common (Brochman 1992, Eelens and Speckman 1992), and one study found that 16 per cent of housemaids had their pay arbitrarily cut or withheld by their employers (Spaan 1992). Many women cut short their stay for personal or family reasons: a small group of housemaids remain in the Middle East for many years but the average length of stay for housemaids is 24 months, compared with 38 months for other workers, and 40 per cent of housemaids return within 24 months (Eelens 1992).

Furthermore, overseas employment is usually a short-term survival measure which temporarily raises the family's living standards but has little long-term impact on income poverty. Most earnings from the Middle East do not finance the productive investments which may provide a basis for long-term poverty reduction: such investments are limited largely to initially non-poor households and to a small number of women who have spent extended periods overseas. About two thirds of housemaids borrow to cover their recruitment costs and a significant proportion of remittances is used to repay loans (Eelans and Speckman 1992). It has been estimated that the repayment of interest and principal on such a loan from a moneylender consumes about six months of a housemaid's pay (Patrick 1997). The repayment of recruitment loans is a significant financial burden and in cases where a migrant returns early can result in a net financial loss from the migration (Eelens and Speckman 1992).

Remittances are used largely to finance day-to-day consumption, housing improvements and other expenditures which contribute substantially to social status, health and comfort, but do not generate sustained improvements in income. A significant portion of remittances is spent on "status goods" such as television sets and jewellery: one village study found that migrants did not remit their final six months' pay, spending it instead on consumer goods and taking some home in the form of cash (Mook 1992). On the migrant's return weddings, funerals, contributions to village festivals and similar social obligations may absorb a substantial share of accumulated savings (Brochman 1992). There is considerable evidence of poor budgetary management by male recipients of remittances, many of whom are unaccustomed to cash-in-hand, and of expenditure on alcohol, gambling and other wasteful consumption (Patrick 1997, Hettige 1992, Mook 1992, Brochman 1992). Female migration also has the pernicious effect of leading to increased household dependency on remittances: a number of studies report that in households receiving regular money from abroad, other family members stop working or trying to find work, relying instead on their monthly "petro-dollar cheques" (Mook 1992, Brochman 1992). Consequently many women make two or three repeat journeys to the Middle East without breaking out of the "consumption trap" (Brochman 1992).

One study concluded that apart from contributing to an improvement in housing conditions,

. . . the long-term effects of migration are meagre. This often leads to dependency on Middle East remittances, compelling women to again find employment in the Gulf. Indeed 54 per cent of all housemaids indicated that they were hoping to migrate again . . . while the household was able to have a higher standard of living during the period of migration, this could not be maintained after the migrant's return (Eelens and Schampers 1992:35)

### 3.4.4 The informal sector

In theory the informal sector consists of smallholder agriculture and non-farm enterprises employing fewer than 15 workers. As noted above, given weaknesses in the administration of labour and business regulation, most private enterprises employing fewer than 50-100 workers are effectively part of the informal sector (personal communication, Department of Labour staffer). The informal sector is by far the country's largest employer, being the primary income source of over 60 per cent of Sri Lankan workers. It is dominated by small-scale agriculture, which accounts for 52 per cent of informal sector jobs (Table 3.10). Just over a third of informal sector workers are wage employees; the remainder are self-employed or unpaid family workers in household microenterprises which employ fewer than 5 workers. In the 1990s there has been no change in the distribution of informal sector employment between microenterprises and wage employers (DCS 1998a), indicating that employment growth has been evenly spread across micro- and small enterprises. Microenterprise employment is far more common in the farm sector, where nearly 80 per cent of workers are self-employed (although many are heavily reliant on supplementary agricultural wage labour), than in the non-farm sector, where the majority of workers are wage employees (Table 3.10).

**Table 3.10: Informal farm and non-farm employment by type of employment ('000)**

Type of employment	Agriculture		Non-farm sector		Total	
	Number of workers	Per cent	Number of workers	Per cent	Number of workers	Per cent
Household enterprise	1,701	78.2	899	45.4	2,600	62.6
Wage employee	474	21.8	1,082	54.6	1,556	37.4
Total	2,175	100.0	1,981	100.0	4,156	100.0

Source: DCS 1998a, Central Bank 1999

#### 3.4.4.1 The non-farm informal sector

The informal non-farm sector includes micro-level to medium manufacturing enterprises, which employ between half and two-thirds of the manufacturing workforce, and the bulk of jobs in the trade, construction, transport and non-government services sectors. Like the formal sector, non-farm informal sector employment is concentrated in the Western Province, where between 50 and 60 per cent of manufacturing SMEs are located (World Bank 1997c) and which accounts for an estimated 41 per cent of employment in construction, transport and trade (DCS 1993a). There has been strong employment growth in the construction, transport and trade industry categories which are major informal sector employers, with annual job growth of 7.1 per cent, 3.7 per cent and 2.8 per cent respectively during the 1990s, in comparison with an overall rate of job growth of 2.2 per cent (DCS 1998a). In manufacturing strong annual job growth of 4.6 per cent is probably attributable mainly to the expansion of factory industry, but it is likely that small-scale manufacturing employment has also increased.

While the Western Province has been a major beneficiary of employment growth, the expansion of the non-farm informal sector has also generated substantial employment growth in regional pockets of economic activity. Outside the Western Province there are marked variations between rural and urban areas in the size and composition of the non-farm sector. Non-farm activity is concentrated in regional towns and along the densely-populated south-west coast and the country's main transport routes, where businesses are close to transport and infrastructure facilities and can take advantage of spillover effects. As the infrastructure and market conditions which are necessary for businesses to grow beyond the microenterprise level are confined to these regional centres, nearly all regional non-farm wage employment is located in semi-urban and urban settlements. In remote rural areas nearly all non-farm activities are marginal

microenterprises which employ household labour and generate virtually no wage employment. A 1994 survey found that non-farm enterprises employed on average less than 1.2 full-time workers, and that 387 enterprises generated a total of only 42 non-family jobs, of which 19 were part-time (National Development Trust Fund (NDTF) 1994).

At the top of the informal sector non-farm labour market a national shortage of skilled manual workers (Aturupane 1999) is reflected in a modest increase in the real wages of carpenters and masons between 1990 and 1997, at a time when real wages in other formal sector occupations and among unskilled non-farm informal sector occupations were either stable or falling (Central Bank, various years). Evidence from the Hambantota sample, discussed in chapter 5, indicates that mechanics, carpenters, barbers and other skilled manual workers can obtain regular employment at wage levels of Rs.5,000 or more. For most informal sector employees, however, who are unskilled part-time or casual labourers, wages are low and employment is insecure and intermittent. Small manufacturing workshops have a very high failure rate: a recent review of a World Bank credit program targeting small and medium enterprises found that within eight years of receiving a loan 40 per cent of beneficiaries no longer exist (World Bank 1997c). Many regional small firms are inefficient low-technology enterprises in sub-sectors such as garment-making and the production of coir and rubber products which face competition from more efficient larger producers. Such firms are unlikely to be integrated in the process of industrialisation and face an uncertain future (World Bank 1997c).

Wages and conditions in small firms compare unfavourably with those available in larger factories. A 1997 survey showed that manufacturing employees in firms with establishments of less than 25 earn on average less than half the wage of workers in larger factories (DCS 1998c). Low labour replacement costs and the financial and personnel constraints faced by the Department of Labour allow smaller firms to ignore basic labour standards, and in the manufacturing sector serious breaches of health and safety provisions are widespread, with commonly-reported problems of excessive heat, noise, exposure to chemicals, dust and dangerous equipment, and the failure of employers to provide protective gear, toilets or first-aid facilities (Institute of Policy Studies 1998).

As Table 3.10 shows, microenterprises occupy a considerable share of informal sector employment. As in other LICs, governments and donors in Sri Lanka have launched a number of initiatives aimed at promoting microenterprises through include various government schemes and an increasing number of NGO-led programs. Much of the available research on the performance of the microenterprise sector consists of evaluations of microcredit programs (see for example National Development Trust Fund (NDTF) 1994, Gunatilaka 1996, 1997, Hulme et al 1996). Most microenterprises earn very low incomes: a nationwide 1994 survey of 1,000 microenterprises found that most failed to provide an adequate primary source of household income: only twenty per cent of owners reported net profits in excess of 1,500 rupees, the household poverty line in 1994; nearly half reported profits below 500 rupees and fifteen per cent reported that they received no income from their projects (NDTF 1994). There is evidence that microenterprise performance varies across regions. A comparison between microenterprises in the relatively prosperous and centrally-located Kurunegala district and the remote and underdeveloped Monaragala district found that the Kurunegala producers earned higher incomes than the Monaragala producers (Hulme et al 1996). In the Hatton National Bank's *Gami Pubuduwa* scheme, which targets the non-poor owners of small-to-medium non-farm enterprises, clients are concentrated in regional urban centres which are the only locations outside the Western Province capable of supporting such activities (Gallardo et al 1997).

The fact that most microcredit lending portfolios continue to be dominated by farming reflects the extremely unfavourable environment for rural non-farm development that prevails throughout much of the countryside. Although it is widely recognised that support for smallholder farming is unlikely, given its limited economic potential, to lead to significant improvements in living standards, Sri Lankan microenterprise development programs have had little success in promoting rural non-farm projects. Farm incomes are generally low, but the returns from rural non-farm microenterprises are significantly lower than those from either farming or agricultural wage labour (Dunham and Edwards 1997). It is estimated that between two-thirds and three-quarters of microenterprises are cultivation projects (NDFF 1994, Hulme et al 1996).

#### 3.4.4.2 Smallholder agriculture

Despite its low and declining macroeconomic significance, smallholder agriculture is still by far the largest employment category, being the principal occupation of 41 per cent of Sri Lankan households, and a subsidiary source of income for another 10 to 12 per cent which earn their primary incomes off-farm (Central Bank 1999). In remote and Dry Zone regions between two-thirds and three-quarters of households derive their primary incomes from agriculture (DCS 1993:81). A significant proportion of agriculture-reliant households are landless or near-landless<sup>9</sup>. Most smallholders grow paddy and paddy remains by far the largest smallholder crop, occupying over 80 of non-estate cropland (World Bank 1996a). The remaining land is under other food crops (OFCs), a broad category which includes low-value subsistence-oriented cereal crops grown by poor Dry Zone farmers, and higher-value commercial fruit and vegetable crops grown in the major irrigation schemes and in the temperate highlands of Nuwara Eliya district. The incomes of most farmers are under severe pressure from declining access to land and water resources and recent policy and economic developments.

Sri Lanka contains two distinct climatic regions: the Wet Zone in the south-western corner of the country, which receives two annual rainy seasons, the *maha* season in December and the *yala* season in June, enabling farmers to grow two annual crops; and the Dry Zone, which covers most of Sri Lanka's agricultural land, where reliable rainfall is confined to the *maha* season and cultivation of a second crop is dependent on irrigation facilities. There are wide variations in the quality of irrigation infrastructure available to dry zone farms. Reliable continuous water supplies are confined to the Mahaweli and Uda Walawe major irrigation schemes, which cover parts of the North Central Province and the central southern region respectively, and the headwaters of some smaller major irrigation schemes. The highly productive farms in the Mahaweli and Uda Walawe schemes cover only 20 per cent of the total area under paddy, but account for about half of the country's paddy production, as well as most commercial non-paddy crops (Central Bank 1998a).

Outside the major schemes most Dry Zone farmers receive their water supply via canals connecting their fields to small communally-maintained village reservoirs or "tanks". Usually rainfall combined with tank water supplies is sufficient to support a single paddy crop during *maha*, but as most village tanks are dry for part of the year farmers relying on village systems lack the access to stored water necessary to cultivate a second annual crop. In the poorest Dry Zone regions on the outskirts of irrigated systems and in jungle areas, where the tank-fed irrigation necessary for paddy cultivation does not exist, farmers rely on rainfall to carry out marginal *chena* cultivation of cereals and other low-value food crops.

Very low rates of rural out-migration and population growth are exacerbating an acute land shortage. Land fragmentation through population growth is most acute in the densely-populated Wet Zone regions of the Sabaragamuwa Provinces, Kandy and Matara districts, and is a key factor in the high poverty incidence in these areas. In the more sparsely-populated Dry Zone,

where landholdings tend to be larger, a lack of water rather than a lack of land has traditionally been the main cause of low farm incomes. Increasingly however the Dry Zone farming has come under pressure from the landless descendants of local farmers and in-migration from overpopulated Wet Zone regions.

Even in generally prosperous major irrigation schemes, the fragmentation of holdings among settlers' children is emerging as a significant poverty factor in the older Mahaweli settlements (Dunham and Edwards 1997, Uyangoda and Wilson 1994). In the smaller and more fragile tank-irrigated Dry Zone settlements the expansion of cultivation into increasingly remote and marginal areas on the peripheries of canal networks imposes significant environmental and socioeconomic problems. The poorest farmers and newcomers are forced on to eroded, hilly, forested and other marginal land in the most remote locations around their villages. In the absence of official statistics on the extent of illegal encroachment reliable measures of its prevalence are not available, but evidence from recent studies suggests that it is a significant and growing problem (Institute of Policy Studies 1998). The extension of paddy cultivation into more and more marginal areas eventually exceeds the capacity of the village tank, with a consequent general decline in yields. At this point farmers either postpone the crisis by diverting water from nearby streams, or abandon their most recently-cultivated fields, a process which accelerates deforestation and evaporation (Institute of Policy Studies 1998). Land which is unsuitable for paddy is used for *chena* cultivation, a form of slash-and-burn agriculture which generates extremely low returns and is environmentally harmful, contributing to aridity by encouraging accelerating winds, increasing surface evaporation from irrigated fields and tanks and lowering the groundwater level (Institute of Policy Studies 1998).

There is evidence of widening income disparities within farming communities. The increasing commercialisation of smallholder agriculture, weakening of customary land tenure arrangements and breakdown of a traditional consensus on the use of communal resources have had damaging effects on the poorest farmers (Ranasinghe 1997, Brow 1996). A recent study of a Dry Zone community found that wealthier farmers who control village decision-making treat the village tank as a private asset rather than a shared village resource and cultivate the fertile tank bed during the dry season, polluting the ground with agro-chemicals. With the disintegration of the traditional *bethma* system in which all farmers cultivated equal shares of commonly-held tank-fed land, poor farmers have lost what access they had to fertile land. The wealthier farmers, monopolising the best land and dominating the village farmers' organisations which are the formal conduit for state assistance, capture access to subsidised inputs and extension services. The landless and near-landless are ignored by most agricultural extension programs, which focus on high-value cash crops rather than the low-value crops cultivated by the poor (Ranasinghe 1997). The increased production of some higher-value OFCs owes more to the intensive use of inputs rather than expansion in cropped area, with increased output being accompanied in some cases by an absolute decline in acreage, indicating the possible displacement and pauperisation of *chena* cultivators and other poor farmers who are unable to afford the higher production costs of OFCs (Abeygunawardena and Kudaligama 1989).

Paddy producer prices are in long-term decline. Under pressure to reduce public spending and liberalise trade policy, the government has withdrawn many measures to protect producer prices. The state-run Paddy Marketing Board, which was set up in 1971 to provide a guaranteed floor price and act as a buyer of last resort, was allowed to run down during the 1980s and was dismantled altogether in 1999. During the last few years of its operation it provided little support for farmers as the floor price was well below the farmgate price. Sri Lanka is not self-sufficient in rice production and for several decades has relied partially on imports. With an increase in domestic production in the Mahaweli settlements imports fell during the 1980s and early 1990s,

but in 1995 import restrictions were removed, significantly depressing producer prices. At the same time there has been a long-term decline in the price of rice on the world market (Dunham and Edwards 1997). The consequence of these developments has been a 40 per cent fall in the real farmgate price of paddy since the early 1980s, with most of the decline occurring since 1991 (Gunawardana and Somaratne 1999). Between 1997 and 1998 alone the average producer price fell by 7 per cent (Central Bank 1998a).

At the same time farmers are facing sharp rises in costs of production. While irrigation in the Mahaweli program and other major schemes remains free to farmers, providing a massive subsidy for the minority who benefit from it, other input subsidies, on fertiliser in particular, have been scaled back, leading to sharp increases in input costs. During the 1980s there was a threefold increase in the real costs of fertiliser and pesticides (Abeygunawardena and Kūdaligama 1989), with further increases during the 1990s with the scaling back of subsidies and privatisation of input distribution networks (Central Bank 1998a). An increase in agricultural labour costs during the 1980s and 1990s (Dunham and Edwards 1997, Central Bank 1998a) has benefited an extremely disadvantaged segment of the rural population in the form of landless households which rely heavily on seasonal farm labour for their livelihoods. The contribution of higher agricultural wages to rural poverty reduction is partly offset however by an overall decline in farm employment (Dunham and Edwards 1997). For the poorer farm-owning households, which combine farming with labour on other holdings, the impact of the higher wages they earn as labourers is cancelled out by the higher labour costs they incur as employers.

A combination of falling producer prices, pressure on land and water resources and rising input costs has made the cultivation of paddy "unremunerative", particularly in the Wet Zone (Central Bank 1998a) and poverty rates among farmers are well above average (World Bank 1995a, Aturupane 1999). Small farmers regularly go into debt to finance each season's working capital requirements, mortgaging their harvests to buy inputs and finance consumption during the growing season. A study of farmer suicides found that the escalation of input prices was trapping farmers in a precarious cycle of indebtedness, in which a single crop failure or even a decline in producer prices is a potentially catastrophic event which forces distress sales of essential assets and damaging reductions in consumption. After the failure of the 1994 *maha* crop moneylenders reported a dramatic increase in the number of farmers mortgaging bicycles and household goods, but that very few farmers returned later to redeem their goods (Uyangoda and Wilson 1994).

Once the harvesting is over, the first thing the farmer has to do is dispose of a sizeable share of his paddy crop as loan and interest payment. Shopkeepers and suppliers of inputs are there to take their own share of the paddy crop, in order to recover the value of goods they have given on credit . . . After all these loans and credit are settled, the producer is left with only a few bushels of paddy to take home. The final share of the harvest to which the producer is thus entitled is hardly sufficient for the family's consumption for the next six months. Some of it would invariably be sold in the market to meet family emergencies. Once that stock of paddy is over, the farmer's family is compelled to obtain new loans, or to mortgage jewellery, furniture, bicycles and even agricultural implements . . . In order to purchase and apply the inputs needed for a better harvest, investment has to be increased. Increased investment invariably means a greater degree of indebtedness, which will ultimately result in a greater share of the harvest being appropriated by moneylenders and input suppliers (Uyangoda and Wilson 1994:8).



Although the potential returns per hectare from commercial OFCs are more than twice as high as those from paddy (World Bank 1996a, Gunawardana and Somaratne 1999), government efforts to encourage paddy-farmers to switch to commercial OFC production have met with little success. Due to irrigation constraints the option of rotating *maha* paddy crops with *yala* OFCs, a major source of growth in OFC production in the Wet Zone and irrigated areas (Dunham and Edwards 1997) is not available to most Dry Zone farmers who are limited to a single annual crop. OFC production is associated with high costs and risks which for most farmers outweigh the prospect of higher cash incomes and deter them from replacing their single annual paddy crop with OFCs. Food security is a key consideration: rice contributes around half the average daily calorie intake of rural households (Central Bank 1999) and in an uncertain price environment subsistence paddy cultivation has the important advantage over OFCs of providing a nutritious staple which can support household food needs. OFCs are also more labour- and capital-intensive than paddy, requiring the farmer to work on the crop full-time, and creating a disincentive for the risk-averse poor who may prefer to spread risk by combining paddy cultivation with off-farm work, and are unwilling or unable to make large capital outlays.

Real producer prices for OFCs have fallen from their 1980s levels, and risks have increased since the liberalisation of imports in 1996, which has sharply reduced growers' profit margins, leading to precipitous declines in OFC output in the late 1990s. Since the mid-1990s massive destabilising price and output fluctuations have become characteristic of the Sri Lankan OFC sector. Domestic production of key OFCs is not competitive with Indian and Pakistani imports, and a combination of increased domestic output and international competition has led to large fluctuations in the prices which fell by 23 per cent between 1996 and 1997 (Gunawardana and Somaratne 1999). In the following year the acreage under the key higher-value OFCs potatoes, onions and chillies fell by 64 per cent, 52 per cent and 10 per cent respectively (Central Bank 1998a). Between 1995 and 1998 the acreage under OFCs fell by nearly 20 per cent, although the decline has not been uniform: the production of higher-value commercial OFCs has declined, while production of lower-value subsistence-oriented cereal crops has increased (Central Bank 1998a).

Paddy production is sensitive to short-term fluctuations in economic, climatic and domestic security conditions but overall it has shown remarkable resilience to long-term sectoral deterioration. In 1994 and 1995, with good weather conditions and a general mood of optimism following the election of a new government and the prospect of an end to the civil conflict, a record acreage was sown with paddy (Central Bank 1997 Annual Report). A severe drought reduced 1996-97 output but in 1998, partly as a consequence of the collapse in key OFC prices, paddy production bounced back, rising by 20 per cent over 1997 output, despite a 7 per cent fall in producer prices over 1997-98. At the same time there was a fall in production of OFCs which are commonly grown in paddy fields during *yala*, as improved climatic conditions led to an increased use of these fields for year-round paddy cultivation (Central Bank 1998a). There is little evidence that deteriorating economic conditions in the paddy sector have dampened farmers' preference for paddy. The continuing popularity of paddy, together with recent increases in production of low-value chena crops such as mung beans and millet (Central Bank 1998a), suggests rather that many poorer farmers are withdrawing from unstable commercial OFC markets in favour of paddy and other semi-subsistence crops. The combination of increased risk, unfamiliarity and higher initial outlays may well explain the finding that "only the few farmers with significant assets were inclined to experiment and to diversify production substantially" (Dunham and Edwards 1997).



### 3.5 Conclusion

Significant and growing disparities in the distribution of infrastructure and investment between the metropolitan Western Province and the regional periphery, and within regions, between rural agrarian and urban non-farm sectors have given rise to disparities in the access of households to economic opportunities. Access to non-farm wage employment and the more remunerative non-farm self-employment activities tends to be confined to urban and semi-urban populations. In rural areas, where the non-farm sector has failed to offset underemployment resulting from labour force growth and the stagnation of smallscale agriculture, local sources of income are often insufficient to support poverty-clearing income levels, and have led to increasing dependence on non-local income sources which are associated with high personal and social costs.

There is a clear need for an expansion of income-generating opportunities for rural households but microenterprise development may not be the answer. A central paradox facing poverty reduction strategies based on microenterprise development is that they are least effective in the neighbourhoods where they are most needed. Although microenterprises are of considerable importance to households, being the primary income source of nearly 40 per cent of Sri Lankan workers and a secondary income source for many more, they do not provide sustainable poverty-clearing incomes for most of their owners, especially in rural areas where, given low and falling incomes from agriculture, the shortage of off-farm employment opportunities is a major contributor to rural poverty. Most rural non-farm enterprises are marginal low-value activities, offering little prospect of poverty exit, into which rural households have been pushed by deteriorating farm incomes.

Most of the poorest households are poor because they are located in remote and underdeveloped regions where wage employment and other economic opportunities are scarce and unremunerative. It is precisely in these areas however that microenterprise development strategies are least successful, as location-related disadvantages of low population density and lack of infrastructure which discourage other forms of economic activity also restrict the scope for high-earning microenterprises. As microenterprises are least likely to succeed where they are most needed, microenterprise development may not be an effective poverty reduction strategy when the causes of poverty are structural physical and economic conditions. As one observer has put it,

The need to push microenterprises arises mainly because the economic environment is not sufficiently attractive to create the necessary larger-scale investment and employment to reduce poverty levels. But if large-scale investors hold back because of the unfavourable climate, can microenterprises succeed in the same environment? It seems that the economic chances are likely to be against them as well. Microenterprises can spring up only in the background of a rapidly growing economy, and interventions to develop them in the absence of such an environment may rarely succeed (Gunatilaka 1997:48)

## Chapter 4

### Targeting and participation

#### 4.1 Introduction

Outreach is as important as impact in evaluating the poverty reduction effects of microfinance. A program may have a high positive impact on the incomes of its participants but unless a substantial number of them are initially poor or at risk of becoming poor it has little direct effect on poverty. As discussed in chapter 2, the clients of broad-based microfinance programs tend to cluster around and above the poverty line, with lower participation rates among the very well-off and - more importantly - the poorest, leading observers to question the effectiveness of microfinance as a poverty reduction strategy for the extreme-poor. Not only do programs have difficulty reaching the poorest households; there is also evidence of tendency over time for "mission drift" as they shift away from their original constituents towards less-poor client groups. As it cannot be assumed that microfinance clients are poor, and as the impact of microfinance varies between poverty groups, it is important to determine the extent to which programs are reaching the poor, and which poor are being reached.

This chapter examines the socioeconomic composition of participants in the Hambantota microcredit programs. The sample borrowers are considerably poorer on average than the Hambantota population at large. While most borrowers are just below or just above the poverty line, both NGOs include some well-off clients as well as extreme-poor borrowers although there are significant social and economic deterrents to the participation of the latter in credit programs. The borrower economic profile is changing: recent first-time borrowers are less poor and more urban than those who joined before 1995. Since the mid-1990s the NGOs' targeting focus has shifted away from their original constituencies among rural villages and the semi-urban poor, towards a more prosperous client base composed of urban and semi-urban traders and skilled artisans, and farmers in the productive irrigated settlements of the Uda Walawe scheme. The shift towards urban and non-poor borrowers was motivated by financial pressures on the NGOs to reduce their exposure to high-risk single-season smallholder farming, and was facilitated by the removal of donor requirements for poverty-targeting which previously had largely excluded the urban non-poor.

#### 4.2 The NGOs: background

The sample NGOs, SEEDS and the WDF, are the two largest microfinance-providing NGOs in Hambantota District and two of the three largest in the country.<sup>1</sup> Their microfinance components expanded enormously in the 1990s with massive inflows of donor funding. Both agencies continue to operate a range of community development, health promotion and other non-financial programs (in the case of SEEDS, through its parent organisation, Sarvodaya), but microenterprise development - and in particular microfinance - has become the undisputed centrepiece of the programs, consuming the vast bulk of their resources.

The WDF had its origins in 1989, with the establishment by a local government official of a network of village-level women's societies in Hambantota District to support the activities of the Janasaviya Program, a state-led poverty alleviation program which targeted poorer households in selected local government areas. As membership of a village society was compulsory for all women in Janasaviya-recipient households, which constituted about 45 per cent of the population in the areas where the program was administered, the organisation gained an instant membership of 25,000, making it by far the largest NGO in Hambantota district. The women's societies federated under the umbrella of the WDF in 1990.

SEEDS is the microfinance arm of the Sarvodaya Shramadana Movement, Sri Lanka's largest and best-known development NGO. Sarvodaya was founded in 1958 as a movement of volunteers working to involve rural villagers in the development of local physical infrastructure and social resources, and by the end of the 1980s had established societies in 2,000 villages. SEEDS, established as a branch of Sarvodaya in 1986 to coordinate its "economic empowerment" function which consisted primarily of financial and non-financial assistance for microenterprise development, has taken on a life of its own, expanding from a minor element of Sarvodaya's holistic development program to become its largest component.<sup>2</sup> Although SEEDS is operationally autonomous, having been reconstituted as a separate legal entity in 1998, with its own policy-making and management structure, it continues to operate in parallel with its parent organisation, drawing its members and local organisational resources from the Sarvodaya village societies.

Within the limited geographic areas in which they operate both agencies have extensive coverage. The WDF is a coalition of 67 intermediate organisational structures known as Janashakthi Bank societies which are in turn composed of six or seven of the original village societies and contain around 400 members each. Janashakthi Banks have been established in five of the district's eleven local government divisions, in which close to half of the district's population live. The WDF membership of 28,000 includes about half of the households within its areas of coverage. SEEDS draws its membership from the village societies established by its parent organisation, Sarvodaya, operating only in societies which it considers are sufficiently well-developed to be able to manage savings and loans facilities. Hambantota district contains about 500 villages; 220 have Sarvodaya village societies and 125 have established microfinance services through SEEDS which are available to the 10,000 households which are members of these societies (SEEDS 1999). In villages where SEEDS societies exist between a quarter and a third of households are Sarvodaya members.

While the bulk of donor funds and staff resources in both agencies are allocated to promotional microfinance, neither is exclusively a microfinance institution. Both operate non-financial enterprise development services, particularly SEEDS which provides training programs in vocational and business skills and technical and marketing assistance (which are further discussed in chapter 8). In addition to their microenterprise lending programs both NGOs engage in a range of protectional financial and non-financial services and community development activities. Both offer short-term consumption loans and the WDF offers loans for housing improvements. In addition, the small groups of 4-6 members who constitute the basic loan approval units offer very small loans to members from their pooled savings. Non-microenterprise loans account for between 10 and 15 per cent of the NGOs' lending activities and are very widely used by poorer borrowers, nearly all of whom had used the service at least once. They are less widely used but still popular among non-poor borrowers, about 60 per cent of whom had taken a consumption loan. The NGOs operate compulsory savings programs, in which members make monthly contributions to a group savings account which is used as a loan loss reserve and for short-term loans to members, and offer individual voluntary savings facilities which are also popular, 80 per cent of the sample borrowers having opened individual savings accounts.

The non-microfinance services of both organisations reflect their origins as community development agencies. Since its establishment four decades ago Sarvodaya's guiding principles have been Buddhist norms of ethical conduct which emphasise the sharing of resources, upholding of human rights, protection of the physical environment, and the importance of non-economic dimensions in the improvement of well-being (Perera 1997). SEEDS restricts its activities to microfinance and some non-financial microenterprise assistance, but as members of Sarvodaya SEEDS borrowers have access to the community development services operated by

the Sarvodaya societies. The initial purpose of the WDF was to encourage social mobilisation and community development by providing a forum for women from poor households to meet and discuss issues of common interest, and act as a conduit for the transmission of health, nutrition promotion and community development activities organised by government officials under the Janasaviya Program. Both agencies continue to offer a wide range of non-financial services which receive dedicated funds from donors. Among the non-financial services provided by the WDF are the training of volunteer health workers to work with members on infant nutrition, malaria control, hygiene, first aid and family planning; a latrine-building program, the provision of food supplements and weight monitoring for infants; awareness-raising on drug and alcohol issues; leadership training for volunteer office-holders; a bulk purchasing program in food and essential household goods for group members; training in livestock-rearing and home-garden development; and a "barefoot library" program. Sarvodaya provides similar health and nutrition services and in addition is engaged in environment-friendly activities such as reforestation, training in composting and reduction of agro-chemical usage, and the promotion of fuel-efficient kitchen stoves. Both agencies operate rotating labour exchanges, where members spend up to one day a month taking turns to contribute their labour to each others' projects, and community labour-sharing arrangements for the construction and renovation of local infrastructure such as school buildings, access roads and village tanks.

Not all NGO members are borrowers. Discussions with NGO staff and members indicated that among those who are eligible for loans by virtue of their membership, about a third of WDF members and about one half of SEEDS members have never taken a microenterprise loan. Non-borrowing members are poorer than borrowers, suggesting that notwithstanding their membership the very poor may be barred from taking loans by higher-order loan eligibility criteria which discriminate against them. The main reason for the lower participation of poorer members in the microenterprise lending program, however, appears to lie in the limited demand for loans. Interviews with non-borrowing members indicated that many are not interested in taking loans, having joined the NGOs in order to participate in their non-financial services.

Less-poor borrowers value the microenterprise lending services more highly than poorer members. While nearly all borrowers reported some improvement in their well-being as a result of NGO membership, the better-off were far more inclined to attribute the improvement to microenterprise credit, and poorer borrowers were more likely to cite non-financial services. Among the better-off borrowers in both SEEDS and the WDF the credit program was seen as by far the most important benefit of NGO membership. The better-off members of the WDF attributed improvements in their well-being to their ability to access loans, while the social mobilisation and education activities of the WDF played a secondary role. Most of the urban and non-poor SEEDS members surveyed regarded their access to microcredit as a far more important benefit of membership than non-financial social and community development activities, in which many participated reluctantly<sup>3</sup>. Newer, less-poor and urban members of both NGOs were far more likely to report that they had joined "to get loans" while longer-term, poorer and rural members were more likely to emphasise the value of community development activities, leadership training, education and nutrition programs, and the benefits of group membership in establishing social and mutual assistance networks. Similarly, in relation to financial services, urban and less-poor members tended to value microenterprise credit more highly than other services, while poorer and rural members who had taken microenterprise loans were more likely to attribute relatively equal values to microenterprise credit and protectional consumption loans and savings facilities.

### 4.3 Profile of participants

Table 4.1 describes the income distribution of the sample borrowers at the time of taking their first microcredit loan. Borrowers are poorer on average than the wider Hambantota population from which they are drawn: as Table 4.1 shows, close to 45 per cent were initially below the poverty line, in comparison with 23 per cent of the general population of the Southern Province (Aturupane 1999). As with other microfinance programs, participant incomes cluster around the poverty line: the two largest pre-loan income categories, which together comprise over half of the total sample, are the poor who are just below the poverty line and the near-poor who are just above it. The extreme-poor, whose household incomes are less than two-thirds of the poverty line, appear to be represented roughly in proportion to their distribution in the population, although the very poorest destitute households are under-represented. The wealthiest groups are under-represented: between 35 and 40 per cent of Sri Lankan households, but only 12 per cent of the pre-loan sample households, have incomes which more than double the poverty line (Central Bank 1999).

**Table 4.1: Pre-loan economic status of borrowers**

Income group	Typical household characteristics	Frequency
Extreme poor	Rural landless and female-headed households, semi-urban slum dwellers	28
Poor	Single-season farmers on less than 1 hectare, semi-urban casual labourers, rural petty traders and operators of low-value unskilled self-employment activities	83
Near-poor	Single-season farmers on 1-2 hectares, semi-urban casual labourers and low-grade and part-time regular wage employees, semi-urban petty traders and operators of low-value unskilled self-employment activities, small skilled artisans, remittance recipients	71
Non-poor 1	Farmers on single-season holdings above 2 hectares or on irrigated holdings, three or more adults engaged in casual employment, semi-urban and urban public sector employees and other higher-status wage employment, operators of more successful trading activities, skilled artisans, remittance recipients.	41
Non-poor 2	Farmers on irrigated holdings, urban "business families" with multiple self-employment activities, urban high-status regular employment, skilled artisans employing non-family labour, specialised urban retail and rural wholesale farm produce traders.	30
Total		253

\* Expressed in 1999 currency values

Rural borrowers and the poor and near-poor continue to dominate the NGOs' lending portfolios, but since the mid-1990s, following the removal of donor requirements for poverty targeting and the imposition of restrictions on single-season cultivation loans, there has been a clear drift towards urban and non-poor clients and away from single-season agriculture. Table 4.2, which compares the profiles of pre- and post-1995 members, shows that since 1995 the proportion of borrowers who were below the poverty line at the time of taking their first loan has fallen from over half to a third, a rate which remains well above the province-level poverty incidence of 23 per cent but indicates a significant dilution of poverty focus.

Table 4.2: Comparison of pre- and post-1995 first-time borrowers

	First loan before 1995 (N= 145)	First loan 1995-98 (N=108)	Total
Location (percentage distribution)	Urban: 13.8 Semi-urban: 20.0 Rural: 66.2	Urban: 29.6 Semi-urban: 34.3 Rural: 36.1	Urban: 20.6 Semi-urban: 26.1 Rural: 53.4
Pre-loan poverty profile (percentage distribution)	Extreme-poor: 11.7 Poor: 40.1 Near-poor: 31.0 Non-poor 1: 12.4 Non-poor 2: 4.8	Extreme-poor: 10.2 Poor: 23.1 Near-poor: 24.1 Non-poor 1: 21.3 Non-poor 2: 21.3	Extreme-poor: 11.1 Poor: 32.8 Near-poor: 28.1 Non-poor 1: 16.2 Non-poor 2: 11.8
Cultivation loans as percentage of total microenterprise loans	36.6	18.5	29.2

The post-1995 changes in borrower income profiles have been brought about by the recruitment of less-poor borrowers in new geographical target areas, rather than increasing participation among the less-poor in pre-existing target areas. Until the mid-1990s the NGOs drew most of their members from rural villages and the poorer semi-urban settlements: their membership consisted principally of farmers in semi-irrigated and rainfed regions, with a smaller number of very poor rural landless families and non-farming households from semi-urban coastal fishing communities and on the outer fringes of regional towns. The relatively small pre-1995 contingent of initially non-poor borrowers consisted mostly of middle-class farmers. Since 1995 the NGOs have broadened their geographic reach to include previously untargeted urban areas and irrigated farming settlements. The majority of members joining since 1995 are urban borrowers living in town centres or on the main coastal road, semi-urban borrowers from the better-off suburbs, and farming households from the irrigated Uda Walawe settlements. Some of the most prosperous new urban middle-class borrowers are from families with a history of successful small business activity, and their projects are well-established activities which employ non-family labour and straddle the divide between microenterprises and SMEs. They are not among traditional Sri Lankan NGO constituencies and many have joined as a result of NGO recruitment campaigns specifically targeting successful small businesses.

Two events in the mid-1990s have played a part in the shift towards a more urban, less-poor borrower profile. The first was the decision of both NGOs to reduce their exposure to cultivation lending outside fully-irrigated settlements, following a long-term deterioration in the risk profile of single-season farming, and precipitated by the general failure of the 1996 *maha* harvest and consequent crisis in repayments. The second was the relaxation of donor poverty-targeting requirements following the winding-down in the mid-1990s of the National Development Trust Fund, the NGOs' major source of lending capital. The lifting of targeting restrictions provided the NGOs with an opportunity to reduce their exposure to cultivation lending by targeting a new and highly receptive market of urban non-poor who had previously been excluded from borrowing.

#### 4.4 Shift away from cultivation lending

The regional economy in Hambantota district is overwhelmingly agrarian: agriculture is the principal source of income for 60 per cent of households (DCS 1998b) and a secondary income source for an estimated further 15 per cent (Central Bank 1999). In the irrigated settlements of the Uda Walawe scheme where, as described in chapter 3, a year-round water supply enables cultivation of two annual paddy crops and diversification into higher-value OFCs, incomes from

farm production are usually sufficient to sustain their owners above the poverty line. In semi-irrigated regions which rely on village tanks, however, and in the most remote rainfed areas which have no irrigation infrastructure, farmers are limited for the most part to a single annual crop and most farm incomes are well below the poverty line. While all paddy-farmers have been adversely affected by falling prices and the removal of subsidies on key inputs, the higher productivity of Uda Walawe farms and the ability of their owners to switch to OFCs have provided them with a measure of protection against the downward pressures on farm incomes described in chapter 3. Farmers in semi-irrigated and rainfed regions however face severe obstacles in switching to OFC production, and are subject to the additional impediments of poor market access, climatic fluctuations, crop damage from wild animals and increasing pressure on land and water resources.

Agriculture in rainfed and semi-irrigated Dry Zone regions is thus an increasingly unprofitable and risky undertaking. Risks to both borrowers and lenders are magnified by the fact that paddy-farmers are frequent borrowers of relatively large sums due to the high production costs of paddy-farming, which are more than twice those of non-farm occupations with comparable net incomes. The cost of cultivating a hectare of paddy-land for a season ranges between Rs.30,000-40,000, and returns a net profit equivalent to a monthly income of around Rs.2,500. In comparison, the annual capital requirements of brick-making projects, which yield average net profits of Rs.2,500-3,000, are between Rs.10,000 and Rs.15,000.

In 1996 the failure of the *maha* harvest following a severe nationwide drought led to a crisis in repayments which threatened the viability of some rural branches in which up to a half of microenterprise loans fell into arrears. The higher risks of single-season agricultural lending are reflected in the NGOs' cumulative loan recovery rates of 80-90 per cent for cultivation loans outside the Uda Walawe scheme, comparing unfavourably with those of non-farm lending, at 95 per cent. As an indicator of loan performance, recovery rates appear to understate the gravity of the situation with respect to single-season cultivation loans, as the NGOs repeatedly reschedule non-performing loans and do not write them off as unrecoverable until all avenues have been exhausted, a process which takes several years. The 1996 crisis created long-term destabilising effects which at the time of the survey, three years later, were still being felt in many rural branches. Nearly a quarter of SEEDS Hambantota cultivation loans were more than 90 days in arrears in 1999; including some cultivation loans dating back to 1996 (SEEDS 1999). An independent source estimated that in Hambantota and Monaragala districts, which were the worst affected by the drought, 44 per cent of SEEDS cultivation loans were still at risk two years later (Poudyal 1998). Similarly, in the two sample rural Janashakthi Bank branches approximately one third of loans were in long-term arrears, and over 80 per cent of long-term arrears consisted of cultivation loans, many of which dated back to 1996.

The 1996 crisis generated a domino effect which extended well beyond individual farmers whose crops had failed, leading to a district-wide decline of about 25 per cent in microenterprise loan disbursements between 1996 and 1997<sup>4</sup>. Both NGOs utilise the solidarity group model pioneered by the Grameen Bank, which replaces physical collateral with a group guarantee system in which small groups of five to six borrowers are collectively liable for the debts of each member. Thus where a single member falls behind with repayments, other group members lose their eligibility for further loans. Furthermore rural non-farm borrowers were adversely affected by the impact of the crop failure on local demand, leading to some project failures and a consequent decline in non-farm lending in some rural branches. By mid-1999 annual disbursements had returned to levels approaching those of 1996, but where cultivation loans and to a lesser extent rural non-farm loans had accounted for the bulk of the 1996-97 decline, most of the post-1997 recovery in



disbursements took the form of non-farm urban and semi-urban loans and an increase in cultivation lending in the low-risk irrigated settlements.

Until the mid-1990s both NGOs were primarily providers of agricultural credit. Cultivation loans, primarily for paddy, accounted for 61 per cent of the microenterprise lending portfolios of both agencies, and up to 90 per cent in their rural branches. Since 1996 both NGOs have dramatically reduced their exposure to single season cultivation loans, which in the WDF fell to 28 per cent of its microenterprise lending portfolio between 1996 and 1999 (WDF financial reports various years), and in SEEDS to 17 per cent (Poudyal 1998, SEEDS 1999). Both have introduced restrictions on single-season cultivation lending, introducing a ceiling of Rs.20,000 on loan sizes; and SEEDS has imposed additional restrictions including a 50 per cent interest surcharge on paddy cultivation loans, limiting loans for *yala* cultivation to farmers with a reliable year-round water supply, and restricting non-financial technical assistance to Uda Walawe farmers and a small number of non-paddy cultivators. As a condition of eligibility for SEEDS cultivation loans households must produce evidence of the legality of their tenure of the land they intend to cultivate, a policy which effectively excludes the poorest *chena* farmers and marginal paddy-growers who encroach on government land on the peripheries of village tank systems.

The volume of cultivation lending is likely to increase slightly over the next two or three years as rural group members clear their collective debts and regain eligibility for loans, but it will not resume its pre-1996 importance in the NGOs' portfolios. The restrictions imposed by the NGOs, together with the inability of some borrowers to clear their arrears, have led a number of farmers to drop out of the programs altogether, and others to limit their participation to non-credit activities. The NGOs are unable to eliminate their single-season cultivation lending altogether, although they would like to, because of the continuing high demand for cultivation loans among their rural members, who remain a significant constituency. Paddy cultivation is a key provider of household food security in an environment where undernutrition is endemic, and despite its low profitability it remains the most remunerative source of cash income available to remote rural households, a fact which is privately conceded by NGO field staff, notwithstanding the official policy of both NGOs which aims to "steer beneficiaries away from paddy". Efforts to encourage paddy-farmers to switch to non-farm microenterprises have had little impact because, as chapter 6 will show, underdeveloped infrastructure and low rural population densities present formidable obstacles to the development of non-farm activities.

#### **4.5 The relaxation of poverty targeting**

The National Development Trust Fund (NDTF) was an apex body established in 1991 by a donor consortium led by the World Bank. Its mandate was to promote the role of NGOs and local government agencies in poverty reduction by providing financial and technical support, and its major component was a revolving microenterprise credit fund which issued loans to partner organisations for on-lending to the poor. During its six-year life the NDTF microcredit program provided funds for on-lending to over 300 agencies. It was subject to a number of problems which included, in addition to an unfavourable political environment, a lack of management capacity in the Sri Lankan NGO sector which was the primary recipient of funds (Shaw 1999a). The vast majority of its NGO partners were small, poorly-managed organisations, many of which had formed opportunistically to gain access to NDTF funds and disappeared following its closure in 1996 (Gunatilaka 1996). A handful of partners however - including SEEDS and the WDF - were well-established NGOs with large membership bases and strong management capacity which enabled them to use NDTF funds to develop ongoing lending programs.

Prior to joining the NDTF both Sarvodaya and the WDF were community development organisations which were experimenting with microfinance but neither had developed a



substantial lending program. The Janashakthi Bank branches operated very small-scale savings and loans services which were mainly consumption-oriented and were funded entirely from members' savings. After its establishment in 1986 SEEDS had received some funding for microfinance from a consortium of bilateral donors, but in the late 1980s became the subject of hostile political attention, which reduced all of its operations including microfinance to a minimum during the period of the Premadasa presidency between 1989 and 1993 (Perera 1997, Shaw 1999a). The NDTF played a key role in the expansion of both agencies' microfinance programs. For the WDF, which became an inaugural NDTF partner in 1991, the NDTF was the sole source of loan capital apart from its very small pool of members' savings. Due to the problematic political environment SEEDS did not join the NDTF until after Premadasa's assassination in 1993. Unlike the WDF, SEEDS was not entirely dependent on NDTF funding for its lending program, but between 1993 and 1996 the NDTF was by far its largest donor, particularly after 1994 when differences between Sarvodaya and its donor consortium led to a 42 per cent reduction in funding (see 2n).

Among the many conditions which the NDTF imposed on its partners was the imposition of a borrower household income ceiling in an attempt to ensure a poverty focus. The ceiling was initially set at Rs.1,500, a low limit even in 1990/91 given that the per capita poverty line was estimated at Rs.471 (World Bank 1995a). As it was not adjusted for cost of living increases its value eroded with inflation and by 1995, when the household poverty line had risen to about Rs.3,600 (Aturupane 1999), only the destitute poorest would have qualified for assistance under a strict application of the NDTF's income criteria. As the NDTF's very low poverty ceiling was impractical it was not strictly adhered to: as Table 4.2 above shows, just over 30 per cent of pre-1995 borrowers were nominally ineligible near-poor and about 17 per cent were non-poor. The existence of poverty targeting criteria did however lead the NGOs to concentrate their lending activities in their established rural and poor semi-urban areas of operation, in which poverty incidence was relatively high, rather than seeking out less-poor target areas. While some middle-class farmers and other non-poor borrowers were able to access loans during the pre-1995 period, the high poverty profiles of the NGOs' target areas restricted leakage to the non-poor, and particularly to the very well-off: fewer than 5 per cent of pre-1995 borrowers were in the prosperous non-poor 2 category. It was not until the NGOs broadened their geographical reach to include urban areas and the better-off semi-urban suburbs that the non-poor began to participate in large numbers.

The NGOs began to expand into less-poor target areas following a change of government at the end of 1994, which led to a de facto relaxation of the NDTF's poverty criteria. The involvement of government officials in beneficiary selection was curtailed, and NDTF staff and partners came under increasing pressure from the World Bank to increase disbursements, which were well below target (Shaw 1999a). In a related development, the WDF's selection criteria, which had hitherto limited membership to Janasaviya recipients, were broadened to include all women within the WDF's geographical target areas. When the NDTF terminated at the end of 1997 the revolving fund which financed its lending to partner organisations was placed under the administration of a government-owned commercial bank, and continued to be available for on-lending to a small group of NGO partners, including SEEDS and the WDF, which had demonstrated consistently high loan recovery rates. At this point poverty-focused restrictions on loan eligibility were removed entirely and the NGOs were free to determine their own target groups. After the termination of the NDTF both NGOs also gained additional lending funds from bilateral donors who imposed no specific eligibility criteria.

In the late 1990s both NGOs have actively sought out urban non-poor borrowers through recruitment campaigns and the development of services targeting better-off borrowers. While

maintaining their group-based lending programs, both have introduced schemes offering non-poor borrowers larger loans at cheaper bank lending rates, which are not subject to the usual peer-group guarantee but require physical collateral and are appraised and approved by staff in the NGOs' district offices. In addition SEEDS offers a variety of subsidised non-financial enterprise development services, discussed further in chapter 8, including training and technical and marketing assistance, which are focused almost exclusively on the higher-value microenterprises operated by non-poor urban and Uda Walawe borrowers.

#### **4.6 Participation of the poorest**

On the supply-side, the credit programs impose a number of barriers to the participation of the extreme-poor. Less-poor borrowers regard the extreme-poor as high credit risks and potential threats to the financial stability of their groups, and are most reluctant to admit members of "problem families" with a history of financial instability or whose creditworthiness is limited by low income-earning capacity. Extreme-poor households are disproportionately affected by the SEEDS policy of restricting eligibility for cultivation loans to those with legal tenure of their land, as many rural extreme-poor families are landless newcomers to the area, having migrated from overpopulated Wet Zone farming regions. Requirements for borrowers to contribute to compulsory group savings accounts are most onerous for the poorest participants. Village society officials reported that difficulty in meeting compulsory savings requirements, usually set at Rs.50 per month, deterred the poorest local families from joining the credit programs; and extreme-poor borrowers themselves regarded the savings contributions as a burden. Compulsory attendance at weekly group meetings and monthly society meetings is a further deterrent to the extreme-poor, who are more likely than other borrowers to be in poor health and to live in remote and difficult-to-reach areas which may be several kilometres from village society headquarters.

In highly-stratified rural communities the extreme-poor are usually lower-caste families who are subject to various forms of social discrimination. They usually live separately from higher-status households and interaction between status groups is limited. Social status and caste considerations contribute to the mutual reluctance of extreme-poor households and higher-status less-poor members to participate in joint activities, and have a considerable impact on the participation of lower-status groups. While the small joint-liability groups are usually socioeconomically homogeneous, there are considerable variations in social status within the NGOs' societies. In one village society meeting observed by the author, extreme-poor borrowers from a low-caste fishing community sat silently on footstools by the door while the discussion was dominated by high-caste paddy-farmers who sat on chairs in the centre of the room. The incivility of higher-status members was cited by some extreme-poor borrowers who expressed reluctance to attend society meetings.

On the demand side, the extreme-poor are highly risk-averse and reluctant to incur debt. As the following chapters will argue, their negative appraisal of the costs and benefits of microcredit has considerable justification. As unfavourable external conditions and low human and physical capital endowments inhibit opportunities for microenterprise development among the extreme-poor borrowers, their projects are almost invariably marginal activities which generate minimal net earnings and are subject to high failure rates. Most extreme-poor households are either landless rural or semi-urban slum dwellers who experience acute disadvantages in access to economic resources. In many cases their income-generating capacity is further limited by human capital deficiencies in the form of old age, disability, alcoholism and drug addiction, or female-headedness in a society where women are severely disadvantaged by labour market discrimination.

Despite the existence of significant demand-side and supply-side deterrents to their participation the extreme-poor were well-represented among the sample borrowers. As Table 4.2 above shows, about 10 per cent were initially extremely poor, a proportion which roughly reflects their distribution in the population at large. Furthermore, while there has been a significant post-1995 decline in the participation of initially-poor borrowers, the proportion of initially extreme-poor borrowers has remained relatively stable. This is largely because of a special SEEDS initiative supported by the Canadian International Development Agency (CIDA), which provides dedicated funding for loans to the "poorest of the poor". Under the CIDA program each SEEDS village society is required to recruit and issue microenterprise loans to ten extreme-poor households in its locality. As village societies contain on average between 70 and 80 members, the CIDA program has led to a substantial increase in the proportion of extreme-poor members.

The disappointing performance of the CIDA program, while due in part to design and implementation problems, suggests strongly that many extreme-poor are not suitable candidates for microenterprise credit, and their recruitment may be neither in their interests nor in the best interests of lenders and existing borrowers (see case study 1). CIDA participants were exempted from the normal six-month "social mobilisation" period during which new members are required to participate in savings programs and group activities before being issued loans, an exemption which would appear unwise given that extreme-poor families are most in need of basic training in financial management and credit discipline. They were often ill-prepared for their microenterprise "projects", which in some cases had been selected by SEEDS officials with little or no input from the borrowers themselves. In one case in which a near-destitute extreme-poor family was selected for CIDA participation, a SEEDS official took their Rs.10,000 loan on the day it was issued and used it to buy six goats which he delivered to the borrower's house, located on a lagoon salt flat unsuitable for grazing. The borrower, a fisherman who had no experience in goat-rearing and showed little interest in participating in a credit program, sold the goats within a week and used the proceeds to finance consumption, leaving the household with no means of repaying the loan. The CIDA program is unpopular with existing SEEDS members, who resent the concessionary interest rates attached to CIDA loans and are reluctant to include the extreme-poor in their societies for the reasons described above, and with local SEEDS officials, who see the program as an ill-judged initiative originating in Colombo with little regard for local conditions. Not surprisingly the CIDA program has been plagued by poor meeting attendance on the part of its participants, a high rate of project failures and low recovery rates of around 75 per cent. As one local official put it, "They take the loans and then disappear". Given its inauspicious beginnings it is unlikely that the CIDA initiative will be successful in its longer-term aim of integrating the extreme-poor into the mainstream SEEDS program.

#### 4.7 Conclusion

High costs and risks to the lender coincide with low impact on borrowers' welfare. The problematic relationship of the programs with extreme-poor borrowers, together with their "mission drift" from rural and semi-urban poor to semi-urban and urban less-poor and from farm to non-farm lending following the removal of externally-imposed targeting restrictions, reflects institutional pressures on the lending agencies to minimise risk and maximise returns by targeting low-cost, low-risk clients. Risks to the lender are highest when microenterprise profit margins are low and the prospect of project failure relatively high. When the owners are poor - as they usually are - and have difficulty covering project losses, poorly-performing projects may threaten loan recovery and, if they occur en masse, jeopardise the lender's financial stability<sup>5</sup>. On the other hand enterprises which operate in a favourable external environment, have considerable growth potential and are able to use loans to facilitate growth, and are sufficiently profitable to ensure regular and timely loan repayments, present the lowest lending risks and respond most positively to inputs of microcredit. As the programs depend on donor funds which are to some

extent contingent on the production of measurable results, they are under pressure to be seen to be effective, and are inclined to target their services where they produce unequivocal improvements. These pressures lead the organisations towards a "natural" constituency of low-risk urban and less-poor clients whose projects derive clear benefits from microfinance, and to seek to minimise their exposure to poor borrowers whose projects earn very low incomes or run a high risk of failure.

On the demand-side, the composition of the NGOs' client bases reflects disparities in the impact of microcredit on borrowers in different locations, occupations and socioeconomic groups. Not only are high costs and risks associated with lending to poor operators of low-value projects; the borrowers themselves derive relatively little benefit from microcredit: credit-generated additions to their incomes are usually small and are rarely sufficient to enable them to exit poverty. For reasons which are discussed in the following chapters, microfinance has relatively little impact on microenterprise earnings in locations and occupations which face unfavourable demand and production conditions. Consequently demand for microcredit is higher among better-off borrowers in environments which offer favourable conditions for microenterprise development and lower among poor households which lack access to the productive resources needed for successful microenterprise development. Thus a certain identity of interest between microcredit programs and poor and rural households calls into question the efficacy of microenterprise credit as a poverty reduction strategy, as their mutual desire to minimise their risks and avoid the prospect of unserviceable debt provides each with an incentive to steer clear of the other. The following three chapters examine the relationship between poverty and the impact of microcredit household incomes.

## Chapter 5

### The impact of location and socioeconomic variables on the composition of the household economy

#### 5.1 Introduction

Few borrowers rely solely on their microenterprises: in most households the loan-assisted microenterprise is one of a number of income sources which include additional self-employment activities, local wage employment, remittances from migrant workers and government transfers. This chapter describes the economic status and various income sources of the sample borrowers and examines the underlying causes of differences in the size and composition of household economic portfolios.

As chapter 3 showed, regional disparities in development and economic activity are reflected in household incomes: poverty is lowest in the country's well-served urbanised industrial and commercial regions, and highest in underdeveloped rural areas where few non-farm economic opportunities exist and the principal source of local income is the stagnating smallholder farming sector. On a more localised scale, as section 5.2 describes, in Hambantota district there are considerable disparities in access to physical and economic resources and the composition of local economic activity between urban and rural areas, and within rural areas, between irrigated farming settlements and remote arid regions, which are reflected in location-based variations in average household incomes and economic activities. While the non-poor are concentrated in or near towns or in irrigated farming settlements, the rural poor are clustered in remote underdeveloped regions; and even in urban and semi-urban areas, where physical conditions are far more favourable for economic development, poor borrowers tend to live in the most remote and poorly-served suburbs away from centres of commercial activity.

While household location is the principal determinant of income, access to income-earning opportunities is also linked to non-location poverty-linked variables including household size and social, health and educational status, described in section 5.3. For many poor households primary disadvantages of location are compounded by other poverty-linked disadvantages which restrict their access to the more secure and well-paid forms of employment. Their low social status, low education levels and lack of political connections exclude them from highly sought-after public sector jobs, and the poorest households have difficulty in raising the initial financial outlays required for work overseas. As extreme-poor households are more likely to be female-headed and to lack able-bodied workers, they are subject to household-level labour shortages which restrict their access to the local seasonal and casual jobs which are a mainstay for most poor and near-poor borrowers.

Section 5.4, which describes the income sources available to the sample households, shows how the composition of household economic portfolios varies with location and socioeconomic status. Non-poor and urban households are more likely to specialise in their loan-assisted microenterprises, and also to rely on stable and relatively remunerative income sources such as regular wage employment, while rural and poorer households face labour market disadvantages which lead them to rely more heavily on intermittent, low-value income sources such as government welfare transfers and seasonal wage labour. Poor and near-poor households are the most likely to spread their economic activities over a range of occupations, while the tendency to specialise is highest at each extreme of the income spectrum. With the exception of extreme-poor households, in which an absolute lack of capacity compels many to become involuntary specialists, arid rural households are less inclined to specialise in their loan-assisted

microenterprises because incomes from that source are too low to sustain them above the poverty line.

## 5.2 Location and household income

Household income levels reflect variations in local economic conditions and consequently in the depth and variety of income sources. They are highest in locations where sound infrastructure and strong markets support high-value microenterprises and offer opportunities for wage employment, and are lowest in the most remote and underdeveloped areas which lack the demand and infrastructure conditions to support high-value microenterprises, where local non-farm wage employment opportunities are virtually non-existent and distance and lack of public transport prevents workers from commuting to local towns for employment. Table 5.1 indicates significant location-based variations in poverty distribution. Average household incomes are highest in regional town centres, semi-urban areas in close proximity to the towns and the coastal road, and in the Uda Walawe farming settlements; lower in poorly-serviced settlements on the outer fringes of regional towns, where pockets of acute poverty exist; and lowest of all in semi-irrigated and rainfed rural inland regions. As Table 5.1 shows, among the sample 57 per cent of non-Uda Walawe rural households were below the poverty line at the time of the survey, in comparison with 32 per cent of semi-urban and only 15 per cent of urban and Uda Walawe households.

**Table 5.1: Distribution of sample income groups by location (per cent)**

Household income category	Location				Total (N=253)
	Urban (N=52)	Semi-urban (N=66)	Rural (Uda Walawe) (N=33)	Other rural (N=102)	
Extreme poor	3.8	7.6	-	12.7	7.9
Poor	11.5	24.2	15.2	44.1	28.5
Near-poor	23.1	28.8	24.2	25.5	25.7
Non-poor 1	28.8	16.7	21.2	10.8	17.4
Non-poor 2	32.7	22.7	39.4	6.9	20.6
Total	100.0	100.0	100.0	100.0	100.0
Median monthly household income	8,875	6,850	8,200	4,550	6,250

Hambantota district is one of Sri Lanka's poorer regions, ranking thirteenth in per capita GDP of the seventeen districts outside the Northern and Eastern Provinces (UNDP 1998). Like other remote Dry Zone regions, the district is experiencing rates of economic growth well below the national average due to the stagnation of smallholder agriculture, together with the failure of the non-farm sector to offset slow agricultural growth. The growth of the non-farm sector is inhibited by demand constraints imposed by the district's low population and household income levels, its distance from the country's ports and commercial centres, the poor quality of local infrastructure, and its absence of any outstanding competitive advantage in non-farm production relative to other parts of the country. These disadvantages make the district an unattractive location for industrial investment, as map 5.1 indicates, in comparison with the more densely populated and better-resourced western regions.

Within the district non-farm SME development is confined to five or six regional towns with populations of 10,000 or more and along arterial transport routes. The poor quality of rural infrastructure limits the expansion of non-farm industry into the rural inland regions. Mains electricity is restricted to towns, the larger villages and along the main roads, and telecommunications services are restricted to offices and a handful of private dwellings in the larger towns. Within the district location-based economic disparities are magnified by the poor

# MAP 5.1: MAJOR INDUSTRIES OF SRI LANKA

115

## VALUE OF OUTPUT BY DISTRICT

(in Rupees Million)

45,000

30,000

15,000

5,000

2,500

1,000

500

100

Gampaha (Rs. 30,000 MN)

Northern and Eastern Districts

Anuradhapura

Puttalam

Poionnaruwa

Kurunegala

Matale

Kandy

Kegalle

Badulla

Eliya

Monaragala

Kalutara

Ratnapura

Hambantota










Galle

Matara

Colombo (Rs. 45,000 MN)

## MAJOR INDUSTRIES

### LEGEND

-  Food, Beverages and Tobacco
-  Textile, Wearing Apparel and Leather
-  Wood, Wood Products and Furniture
-  Paper Products, Printing and Publishing
-  Chemicals, Petroleum, Rubber and Plastic
-  Non-Metallic Mineral Products
-  Basic Metal Industries
-  Metal Products, Machinery and Equipment
-  Other Manufacturing Industries

Scale 1:1,850,000

Source: Ariyaratne's Atlas of Sri Lanka (1997)



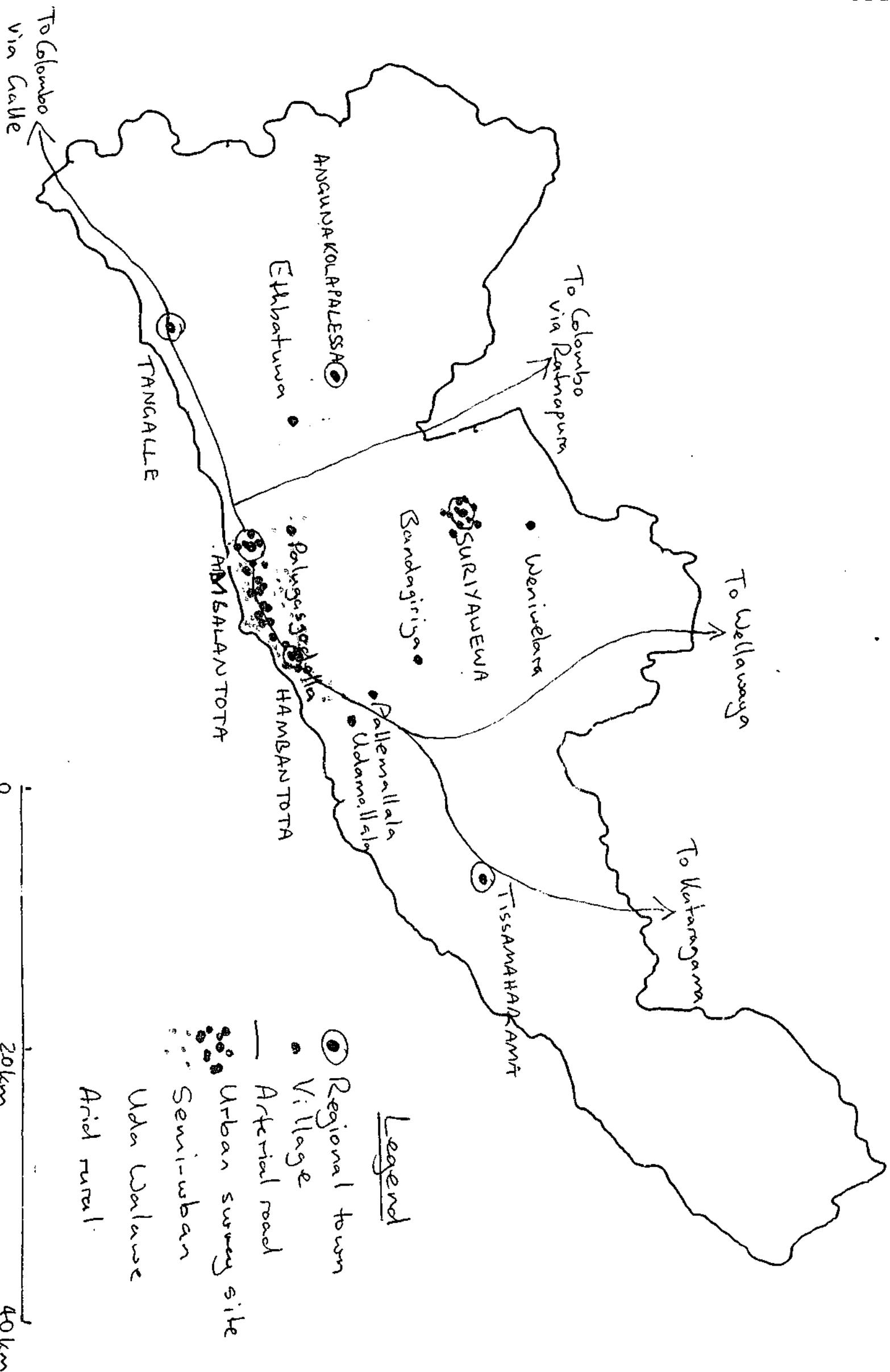
# MAP 5.2:

HAMBANTOTA

STRATEGIC

LOCATION

Map 5.2





quality of rural transport networks which limits the development potential of local rural-urban linkages and reduces the access of rural households to urban employment.

The sample households fall into four geographical categories, described in Table 5.2 and Map 5.2.

**Table 5.2: Key location characteristics**

Location	Definition	Socioeconomic mix	Major income sources
Urban	Households within a kilometre of town centres in regional towns with populations of 10,000 or more, or on the main coastal road between Hambantota and Ambalantota	Mostly non-poor	Specialised retail trade, services, skilled manual production, wage employment in public sector and local non-farm unorganised sector.
Semi-urban	Households 1-5 kilometres from regional town centres or up to one kilometre from coastal road between Hambantota and Ambalantota	Mostly non-poor in inner suburbs, near-poor to extreme-poor in peripheral settlements	Inner suburbs: skilled and unskilled production, petty retail trade, regular wage employment in public sector and local non-farm unorganised sector. Outer settlements: brick-making, other low-value unskilled production, fishing, small-scale livestock-rearing, seasonal and casual wage labour
Uda Walawe	Agricultural settlements receiving year-round water supply from Uda Walawe irrigation scheme	Mostly non-poor	Two-season paddy-farming, commercial OFC cultivation, wholesale fruit and vegetable trade
Other rural	Rural areas outside Uda Walawe scheme relying on rainfall or village tanks for single-season water supply. Includes some lagoon salt flats unsuitable for agriculture.	Near-poor and poor paddy-farming households, poor to extreme-poor landless households	Paddy and chena farming, fishing, small-scale livestock, low-value production

The urban sector comprises the larger towns which function as the commercial and administrative centres for outlying farming and fishing communities, and households located on the main coastal road which is the key arterial route connecting the district with the national capital 250 kilometres to the west, and with the major pilgrimage centre of Kataragama to the east, and along which considerable economic activity is generated by passing trucks and private vehicles and weekend bus-loads of pilgrims. Around the towns and close to the main road are clusters of semi-urban villages in varying degrees of physical and economic integration with the towns. Most villages within one or two kilometres of a town centre have been absorbed by the spread of urban boundaries and have become in effect outer suburbs whose inhabitants depend on the economic activity of the town for their livelihoods. Among urban borrowers and those in the more centrally-located semi-urban communities, which are similar to urban regions in socioeconomic composition and access to infrastructure, high-value self-employment activities and regular wage employment feature prominently in the typical household economic profile. Urban borrowers,

with considerable advantages of position which are further described in chapter 6, are the most likely to specialise in their microenterprises, while among inner semi-urban borrowers, whose microenterprises yield slightly lower returns, regular wage employment is more important and is often the primary income source.

Peripheral semi-urban settlements located between three and five kilometres from a town, and in some cases separated from town centres by a physical barrier such as a lagoon or a stretch of jungle, are poorer and less economically integrated with towns. In terms of access to infrastructure the more remote semi-urban settlements bear a closer resemblance to rural areas than to more centrally-located semi-urban areas: they are more likely to lack mains electricity; the quality of local roads is often poor and public transport services may be scarce and unreliable. Economic activity in many outer semi-urban settlements is dominated by low-value seasonal caste-based occupations such as fishing or brick-making, the incomes from which are usually insufficient for poverty exit. Because they are located relatively close to towns which can be reached by bicycle or on foot, remote semi-urban dwellers have better access to urban labour markets than rural households, but their prospects of securing regular wage employment are limited by sociological and human capital factors, and households in the poorer peripheral semi-urban settlements rely heavily on income from seasonal and casual labour. The economic profiles of peripheral semi-urban borrower households consist typically of a mix of low-value microenterprises and casual wage employment, sometimes augmented by low-grade regular employment. Income sources fluctuate according to seasonal variations; as seasonal labour usually provides higher returns than self-employment for these households, many rely principally on seasonal labour, resorting to their microenterprises during off-seasons when wage employment is unavailable.

Rural households fall into two distinct categories: those located within and outside major irrigation schemes. Most of Hambantota district is located in the country's Dry Zone, which receives one annual monsoon and restricts cultivation to a single annual season for most farmers. Parts of the district, however, benefit from the Uda Walawe major irrigation scheme which provides a year-round water supply, enabling farmers to cultivate two annual paddy crops and higher-value OFCs. Irrigation-enhanced agricultural productivity not only increases the incomes of cultivation-based microenterprises, it also provides an indirect boost to non-farm activities by increasing local demand and providing a sound income base from which farming households can launch non-farm enterprises. Villages in the major schemes also have access to good transport infrastructure which provides them with a significant advantage over other villages, as reliable bus services enable individuals to commute to local towns for trade purposes and wage employment.

The rural sample outside the Uda Walawe scheme was focused on the Pallemalala and Bandagiriya regions which cover an area of about 75 square kilometres to the north-east of Hambantota town. Most people live along thinly-populated unsealed roads up to ten kilometres from the main road which bisects the area. Reliable public transport and piped water are confined to households located along the main road. In the most arid areas the only water sources are communal roadside wells located at two-kilometre intervals along access routes. While an electricity supply has been extended to parts of the village of Bandagiriya and the secondary road connecting the village with the main road, most of the area lacks electricity. Few rural households are more than 15 kilometres from a regional town or 10 kilometres from a main road, but the effects of distance are aggravated by low local population density and the extremely poor quality of minor roads and limited public transport. The arterial roads connecting the district with the western metropolitan centres are generally of good quality, as are the sealed roads and reliable bus services in the district's irrigated agricultural regions and between regional towns, but in arid

rural areas poor transport infrastructure curtails labour mobility and economic development. The secondary and tertiary roads which link semi-irrigated rural villages with towns and main roads are inadequately maintained, with poor surfaces which limit access by trucks and buses. During rainy seasons some minor roads are inaccessible by bus, isolating remote settlements for up to four months annually. Although many secondary roads are nominally on bus routes, in practice buses are infrequent and unreliable due to inadequate road maintenance and poor regulation of the privatised public transport industry. In the most remote arid areas dwellings may be located up to a kilometre from a road and can be reached only by foot or bicycle.

The main economic activity, agriculture, is overwhelmingly dominated by paddy-growing, with some rainfed chena cultivation in the most remote areas. About two-thirds of rural households have access to 0.5 - 1 hectare of land on which they cultivate paddy once a year. Despite the difficulties facing the paddy sector diversification into OFCs or rural non-farm activities has been limited among farmers. Paddy cultivation remains the preferred economic activity for the vast majority of rural borrowers, even those who engage in non-farm enterprises: when households can grow paddy, they do. The fact that farm incomes compare favourably with those of rural non-farm activities accounts in part for the continued popularity of paddy-farming. Food security is also a key consideration, rice being an essential staple in the Sri Lankan diet. As most single-season paddy-farmers are able to meet 60-100 per cent of their rice requirements from home production, a small landholding is a key asset in an environment where undernutrition is endemic. For this reason many paddy-producing households hover around or just above the poverty line despite their low cash incomes. Not having to "buy rice from the store" is a point of pride among paddy-farmers; subsistence production enables substantial savings and provides a measure of relief from personal and household stresses associated with food insecurity.

In addition, paddy-growing has a significance in Sinhalese culture which provides farming households with a recognised social status and secure sense of their place in the community. Although caste does not rigidly determine occupation in Sri Lankan society, farming - particularly paddy-growing - is the occupation associated with the highest *govigama* caste, and is reflected in the higher status and self-confidence of paddy-farmers relative to other equally poor borrowers, observed during the course of the survey. The extent to which this non-economic value is prized by rural households should not be under-estimated.

The ability to engage in subsistence food production provides farmers with a major advantage over landless rural and semi-urban poor households, which lack basic food security, having neither the means to grow food nor the purchasing power to meet minimum food requirements. Landless rural fishing households, concentrated around the difficult-to-reach coastal lagoons where the land is too salty for either agriculture or the grazing of cattle or goats, were the poorest group in the sample. Their access to wage employment is limited by their remoteness; and their physical environment offers little potential for the development of viable microenterprises as low population densities, poor transport infrastructure and lack of electricity rule out higher-value non-farm activities. Their microenterprises are confined mostly to fishing, small-scale poultry-rearing and unskilled production activities, among the smallest and weakest of all the sample microenterprises. Their main income sources are marginal self-employment activities, seasonal agricultural labour and government welfare transfers.

### 5.3 Non-geographic poverty factors

The poor are disadvantaged in access to economic opportunities by non-location factors relating to gender, household labour supply and health and education levels. As Table 5.3 shows, household income is positively associated with the number of household income sources, except at the highest income levels. Poor and extreme-poor households have significantly fewer income

sources than higher income groups, partly because of a shortage of income-generating opportunities in poor regions; and partly because of household labour shortages. The number of adult earners, particularly males, is a key factor in household poverty status among landless rural and poor semi-urban households, in which seasonal labour is a major economic activity and where the wages of two or three adult male labourers are usually sufficient to raise incomes close to the poverty line (compare case studies 3 and 7). Poor households contain fewer able-bodied adults: as Table 5.3 shows, the average number of income-earners per household is lowest, and the dependency ratio highest, among the poorest groups. The poorest households are also far more likely than others to be headed by a single female whose earning capacity, given gender inequalities in economic opportunity, is relatively low, or by a disabled or elderly adult (see case study 2). Other human capital deficiencies and sociological characteristics associated with poverty - low education and skills, poor health, low self-esteem and lack of motivation, low social status, alcoholism and drug addiction, problems with law enforcement authorities and family instability - play an additional role in restricting access to employment (see case study 1).

**Table 5.3: Key demographic indicators by income group**

Current living standards	Mean dependency ratio	Mean number of economically active adults*	Mean number of income sources**	Percentage of female-headed households
Extreme poor	2.5	1.5	2.6	9.5
Poor	2.5	1.7	2.9	10.7
Near-poor	2.4	1.7	3.2	3.1
Non-poor 1	2.1	1.9	3.1	2.3
Non-poor 2	1.8	2.0	3.0	3.0
Total	2.3	1.8	3.0	7.1

\* Includes unpaid household workers on microenterprises

\*\* Earnings from a household microenterprise are counted as a single income source even if multiple household members are engaged in the activity, but each externally-sourced income stream is counted as a separate income source. The wages of three household members working in the same non-microenterprise occupation - as seasonal labourers, for example - are counted as three separate income sources; similarly the earnings of a single household member engaged in two or more economic activities are also counted as multiple income sources.

#### **5.4 Household income sources**

The loan-assisted microenterprises are borrowers' principal income source, contributing on average about 53 per cent of household income (Table 5.4). Location and socioeconomic status are key determinants of access to and remuneration from the four largest income sources - the loan-assisted microenterprise, additional self-employment activities and local regular and seasonal wage employment - which contributed on average about 90 per cent of the income of the sample households at the time of the survey. Location and socioeconomic status have somewhat less influence on access to remittances and government transfers - although extreme-poor households are at a disadvantage in accessing these income sources - however location and socioeconomic status do influence households' ability to save and invest remittance income in productive activities.

**Table 5.4: Mean percentage contribution of income sources to total household income and number of households receiving income from income sources**

Income source	Mean percentage contribution to household income (all of sample)	Number of households in receipt of income source
Loan-assisted microenterprise	53.4	238
Other self-employment	12.4	92
Regular wage employment	9.2	54
Seasonal/casual wage employment	14.8	97
Remittances	4.3	31
Government transfers	6.0	165
<b>Total</b>	<b>100.0</b>	<b>253</b>

#### 5.4.1 The loan-assisted microenterprise

Absolute microenterprise earnings, and the relative importance of the loan-assisted microenterprise in the household economy increase with household income and the level of local economic development (see Tables 5.5 and 5.6). Non-poor and urban borrowers earn much higher incomes from their microenterprises, which also contribute on average a greater share of their total incomes, whereas among poor and rural borrowers the microenterprise tends to be a less important contributor, being one of a number of low-value income sources.

**Table 5.5: Contribution of loan-assisted microenterprise to household income, propensity to specialise and median earnings from loan-assisted microenterprise by household income category**

Household income category	Median percentage contribution of loan-assisted microenterprise to household income	Percentage of specialist households*	Median income from loan-assisted microenterprise
Extreme-poor	38.1	30.0	1,150
Poor	45.3	19.4	1,850
Near-poor	52.2	22.7	3,000
Non-poor 1	58.4	31.8	5,000
Non-poor 2	72.0	46.2	9,000
<b>Total</b>	<b>54.5</b>	<b>28.9</b>	<b>3,000</b>

\* Households deriving 75 per cent or more of total income from the loan-assisted microenterprise.

**Table 5.6: Contribution of loan-assisted microenterprise to household income, propensity to specialise and median earnings from loan-assisted microenterprise by location**

	Median percentage contribution of loan-assisted microenterprise to household income	Percentage of specialist households	Median income from loan-assisted microenterprise
Urban	74.3	50.0	4,000
Semi-urban	53.1	35.4	3,000
Rural (semi-irrigated)	41.9	14.7	2,000
Rural (Uda Walawe)	63.2	27.3	5,200
<b>Total</b>	<b>54.5</b>	<b>28.9</b>	<b>3,000</b>

For the purposes of the survey a specialist household was defined as one which derives 75 per cent or more of its total income from the loan-assisted microenterprise. Specialisation may be a

voluntary process in which a household chooses to forgo other activities in favour of the microenterprise; or it may be an involuntary process reflecting the absence of alternative economic opportunities. Non-poor and urban households are the most likely to specialise in their loan-assisted enterprises, and are almost invariably voluntary specialists. Some voluntary specialists decide that they can best maximise their earnings by concentrating on a single activity, and forgo alternative economic opportunities in order to allocate their resources to their microenterprises. In other voluntary specialist households microenterprise earnings are sufficient to support non-working family members, thereby removing the necessity for additional income sources: a single high-earning microenterprise operated by the household head can support elderly relatives, a wife who does not engage directly in economic activity (a reflection of high social status and a preferred domestic arrangement in most Sri Lankan households) and adult children who are studying or "waiting for a job" in the public sector. While such households could increase their earnings by accessing additional income sources, they choose to give priority to social status and other non-economic considerations, and longer-term human capital development, over short-term economic gain.

Poor and near-poor households are the least likely to specialise in their microenterprises. With the exceptions of overseas or military employment the income sources available to them tend to be fixed at low limits. As they lack access to income sources which are sufficient by themselves to sustain them above the poverty line, they spread their resources among multiple low-income activities: they are compelled by poverty to diversify and when they are not constrained by a shortage of able-bodied adults they seek additional sources of income. Among extreme-poor households however there is evidence of involuntary specialisation (Table 5.5), imposed by household labour shortages, human capital deficiencies and scarce opportunity.

Tables 5.7 and 5.8 show that poor, extreme-poor and rural households which specialise in their loan-assisted microenterprises earn lower incomes than those which have more diverse income sources, while urban, semi-urban and non-poor 2 households earn substantially higher incomes when they specialise, providing further evidence that high household income and favourable location are associated with voluntary specialisation, but that among poor and arid rural households specialisation is usually involuntary.

**Table 5.7: Median household income of specialist and non-specialist households by income group**

Household income category	Median household income (specialist households)	Median household income (non-specialist households)	Median household income
Extreme-poor	2,050	2,550	2,400
Poor	3,500	4,075	4,000
Near-poor	6,250	6,250	6,250
Non-poor 1	8,950	8,350	8,750
Non-poor 2	13,750	12,900	13,000
Total	8,000	6,000	6,250

**Table 5.8: Median household income of specialist and non-specialist households by location**

Location	Median household income (specialist households)	Median household income (non-specialist households)	Median household income
Urban	10,125	8,175	8,875
Semi-urban	7,500	6,612	6,850
Rural (semi-irrigated)	4,000	4,600	4,550
Rural (Uda Walawe)	8,000	8,500	8,200
Total	8,000	6,000	6,250

#### 5.4.2 Local regular wage employment

Regular wage employment opportunities exist only in the non-farm sector and are confined almost exclusively to the larger towns, where most public sector jobs are located, and to non-farm industries and trading activities along the coastal road. The rural non-farm sector offers few wage employment opportunities, as it consists largely of marginal part-time microenterprises which employ unpaid family labour. Among the sample, 67 workers in 54 households - just over a fifth of the sample households - derived income from regular wage employment. The organised sector of the labour market, which consists of secure full-time jobs in government agencies and somewhat less secure jobs in garment factories, accounted for just over a third of regular jobs, and the remaining two-thirds of jobs were in the unorganised private sector. Organised sector jobs are restricted to non-poor 1 and non-poor 2 households, and jobs in the unorganised sector were most likely to be held by non-poor 1 and near-poor households.

Public sector jobs are a particularly scarce and highly-valued resource which is highly sought-after because, as discussed in chapter 3, in addition to relatively high wages they offer security of tenure, pension entitlements and high social status. Low educational status is a barrier to accessing administrative public sector jobs, for which completion of high school is usually a mandatory requirement. Among the sample borrowers fewer than 5 per cent of the poor had completed secondary school, in comparison with nearly a quarter of non-poor 2 borrowers. The other main barrier to entry to public sector employment facing the poor is their lack of political influence. As the allocation of lower-level public sector jobs is among the patronage resources available to local politicians, most are held by members of households which have actively supported the government in recent election campaigns<sup>1</sup>. With a shift in the last two decades in village level political processes away from prominent local families who traditionally were the main local political activists, to lower-status young men, the rewards of patronage are distributed to a wider and poorer section of the population. While influence with local politicians is no longer confined to village elites, local public sector jobs, available to rural households as rewards for political support, do not go to the poorest. The low social and educational status of the poorest households, and their often remote physical location away from the village centres are barriers to their political activity. Furthermore, politicians are more concerned with appeasing the political powder-keg of young high school graduates rather than the less-educated poor, whose labour market aspirations are lower.

Outside the Western Province garment factories established under the THGFP are virtually the only source of organised private sector jobs. The local garment factories are heavily subsidised by the government as part of a program aimed at extending manufacturing employment into rural areas, and like the public sector, access to garment factory jobs is governed by political patronage. Among the sample all garment factory workers were young women from non-poor families which had been able to obtain the "letter from a politician" necessary to secure employment in them. Despite low wages of Rs.2,000 - Rs.2,500, garment factory jobs are highly

sought-after because they constitute virtually the only locally-available employment opportunities for young women.

Regular employment opportunities in the unorganised sector are generally of lower quality than those available in the organised sector, but are highly valued because they offer a scarce opportunity for a local regular income. Wages are substantially lower than those available to emigrant workers in the defence forces or overseas, but do not involve the very high personal and social costs associated with these occupations. SMEs employing up to 25 workers, rather than microenterprises, are the main sources of unorganised sector wage employment, with most jobs being located in small manufacturing workshops and retail stores. The quality of unorganised sector employment varies considerably. At the top end of the informal labour market skilled workers such as mechanics, drivers, stone-masons, carpenters and barbers can earn in excess of Rs.5,000 per month (see case study 6). Most informal sector employees however are unskilled part-time production workers and shop assistants who receive very low wages averaging about Rs.1,500 and are subject to lay-offs during off-seasons.

There are marked gender differentials in access to and remuneration from regular employment. Nearly 80 per cent of regular jobs were occupied by men, who also received far higher wages, averaging Rs.3,500 in comparison to women's Rs.1,400. There is a high degree of occupational segregation. Wage employment in small manufacturing enterprises, shops and restaurants is restricted to men (although it is common to find female family members working as unpaid household workers in these activities). With the exception of two or three women who held high-status jobs as teachers or NGO field organisers, regular employment for women in the sample was limited to the two exclusively female occupational categories of pre-school attendants and garment factory workers. These occupations are restricted to women from better-off households who, as noted above, have the political connections necessary to secure garment factory employment, or live in the urban areas where pre-schools are located. For women in remote areas or from poor households the chances of securing regular local employment are very small.

**Table 5.9: Households receiving income from regular wage employment: median income from regular wage employment by location**

Location	Households with income from regular employment (per cent)	Median income from regular wage employment
Urban	25.0	4,600
Semi-urban	28.8	3,000
Rural (semi-irrigated and rainfed)	13.7	2,000
Rural (Uda Walawe)	24.2	2,000
Total	21.3	2,750

As Table 5.9 shows, households in urban and semi-urban areas are twice as likely as non-Uda Walawe rural households to have a member in regular employment. They also earn higher average incomes from this source, as they are more likely to have more than one household member in regular employment; and with their generally higher education levels, social status and connections, urban and semi-urban workers are more likely to secure work in the formal sector or in the more highly-skilled and better-paid informal sector occupations. In rural areas access to transport is an important factor in a household's chances of securing regular employment. High rates of regular employment in the Uda Walawe settlements are explained by their proximity to local towns and the comparatively good quality of roads and public transport in the Uda Walawe scheme, which makes local towns readily accessible by bus or bicycle (see case study 11). Similarly, in non-irrigated areas most rural households receiving income from regular



employment were located within a kilometre of a main road. Households in the most remote areas were least likely to receive income from regular employment.

**Table 5.10: Households receiving income from regular wage employment: median income from regular wage employment and median percentage contribution of wage employment to household income by household income category**

Household income category	Households with income from regular employment (per cent)	Median income from wage employment	Median percentage contribution of wage employment to household income
Extreme poor	-	-	-
Poor	9.7	1,800	37.5
Near-poor	29.2	3,000	43.5
Non-poor 1	29.5	4,600	55.1
Non-poor 2	26.9	3,650	23.3
Total	21.3	2,750	41.6

As Table 5.10 shows, access to and income from regular employment also rises with household income: the poorest households have the lowest access to regular employment, and are most likely to be found in the most unskilled and poorly-paid jobs, as guards, shop assistants and labourers. The right-hand column in Table 5.10 indicates the relative importance of regular employment as a source of household income. It is significantly more important for near-poor and non-poor 1 households, which are more likely to have members in regular employment and earn the highest incomes from this source, than for other income categories. The wage incomes of near-poor and non-poor 1 households which have members in regular employment are likely to overtake their microenterprises as the principal income source (see case study 8). The relative importance of regular employment is lower among poor households because their wage incomes are low. Non-poor 2 households are less likely than those immediately below them to participate in wage employment, and earn lower incomes from this source, a reflection of their ability to generate very high incomes from their microenterprises and tendency to specialise in entrepreneurial activities. In non-poor 1 households public sector jobs, where available, are generally preferred to microenterprises which offer similar or even somewhat higher monthly earnings, because of security and status considerations. As chapter 7 argues, in general only non-poor 2 households possess the resources necessary for the development of microenterprises which offer the very high returns sufficient to persuade borrowers to forgo public sector jobs in favour of self-employment.

#### 5.4.3 Seasonal work

Among the sample the most widely-available source of local wage employment is intermittent seasonal and casual work, which provides income for close to 40 per cent of the sample. By far the largest employer of seasonal and casual labour is agriculture, which offers employment for 2-4 months annually, during the *maha* planting and harvest months of November and March, and to a lesser extent during the *yala* planting and harvesting months of May and September. Outside the paddy sowing and harvesting seasons the main sources of demand for casual labour are the semi-urban and urban construction and fisheries sectors and the state-owned Lanka Salt Corporation, a major employer of casual labour in the Pallemalala area and a significant source of counter-cyclical income during the dry months between August and November when casual agricultural and fishing work is scarce.

At rates of Rs.150-200 for men and Rs.100 - 150 for women, daily wages for seasonal labourers compare well with the wages of unskilled regular employees, but as employment is intermittent

overall household incomes from seasonal labour are relatively low when averaged over a twelve-month period, as Table 5.11 describes. Low intermittent returns and the low social status of manual labouring work make this type of employment an undesirable option for better-off households and those with access to alternative income sources (Table 5.11). Even among rural households, those below the poverty line were twice as likely as non-poor households to engage in seasonal or casual employment.

**Table 5.11: Percentage of households in seasonal employment and median income from seasonal employment by current household income**

Household income category	Households with income from seasonal employment (per cent)	Median income from seasonal employment	Median percentage contribution of seasonal employment to household income
Extreme-poor	60.0	1500	60.0
Poor	62.5	1600	41.2
Near-poor	38.5	2000	29.6
Non-poor 1	20.5	2000	29.6
Non-poor 2	9.6	2000	19.0
Total	37.9	1950	33.2

As Table 5.12 shows, just over half of the households deriving income from seasonal labour worked exclusively in the farm sector, close to 20 per cent worked exclusively in the non-farm sector and the remaining 30 per cent combined farm and non-farm labour. Incomes from casual labour are lowest among farm workers because of very high rates of underemployment among seasonal farm labourers: the average farm labourer worked for only 60 days in the 12 months prior to the survey. Working hours and incomes are highest among those who combine farm and non-farm labour, but are still part-time at the equivalent of between 4 and 5 months' full-time work annually. For poor rural households seasonal labour is a key income source and rural households are far more likely than others to engage in seasonal work, as Table 5.13 shows. In comparison with rural households, however, semi-urban and Uda Walawe households earn higher incomes from seasonal employment because of their superior ability to access off-season non-farm casual work.

**Table 5.12: Income from seasonal and casual employment by sector of employment and days worked**

Household income category	Number of households	Median number of days worked in last 12 months	Median income from seasonal employment
Agriculture only	51	60	1500
Non-farm only	18	90	2000
Farm and non-farm	28	120	3000
Total	97	60	1950

**Table 5.13: Households receiving income from seasonal employment: income from seasonal employment and contribution of seasonal employment to household income by location**

	Households with income from seasonal employment (per cent)	Median income from seasonal employment	Median percentage contribution of seasonal employment to household income
Urban	7.7	1,600	27.9
Semi-urban	21.1	2,100	53.5
Rural (Uda Walawe)	42.4	2,000	34.3
Rural	62.7	1,500	29.5
Total	37.9	1950	33.2

#### 5.4.4 Other self-employment activities

About one third of households derive income from other self-employment activities in addition to the loan-assisted microenterprise. As the factors which determine incomes from other self-employment activities are essentially those which determine the performance of the loan-assisted microenterprises, discussed at length in chapters 6 and 7, most of the households which earn the highest incomes from their microenterprises also derive the highest incomes from other self-employment activities. As Tables 5.14 and 5.15 show, both the returns from additional self-employment activities and the propensity to engage in them are positively associated with household income and locational advantage: non-poor, urban and irrigated farming households are considerably more likely than others to engage in additional microenterprises.

**Table 5.14: Percentage of households with additional microenterprises and median income from additional microenterprises by household income category**

Household income category	Households with income from additional microenterprises (per cent)	Median income from additional microenterprises
Extreme-poor	15.0	500
Poor	30.6	1,350
Near-poor	30.8	1,600
Non-poor 1	45.5	2,050
Non-poor 2	51.9	4,300
Total	36.4	2,000

**Table 5.15: Percentage of households with other self-employment and median income from other self-employment by location**

Location	Households with income from additional microenterprises (per cent)	Median income from additional microenterprises
Urban	44.2	2,000
Semi-urban	30.3	2,000
Rural (Uda Walawe)	45.5	2,100
Rural (semi-irrigated)	33.3	2,000
Total	36.8	2,000

Some non-poor urban "business" families and Uda Walawe households operate multiple high-value microenterprises, with little difference in size between the nominally loan-assisted enterprise and other family enterprises (see for example case study 11). This phenomenon accounts in part for the high median self-employment incomes of non-poor 2 households in Table 5.14. Most additional microenterprises however are small-scale part-time activities. In non-poor households they are often auxiliary projects operated by a secondary income earner and making a

relatively minor contribution to household income. In rural and poor households additional self-employment activities, though small, often occupy a central role in the household economy. Most rural additional self-employment activities are very low-value semi-subsistence activities. A common combination of income sources in arid rural areas was paddy-farming as the loan-assisted enterprise, combined with seasonal labour, and self-employed fishing when seasonal labour was not available. Aturupane (1999) argues that in general households combining agriculture and non-farm activities are better-off than those depending solely on agriculture. His findings are supported by evidence from the sample, which indicates that rural poverty levels are lowest among households which combine farming with a non-farm enterprise or regular employment. Incomes are lower among households which rely solely on agriculture or on farming supplemented by seasonal labour; and lowest of all among landless households which rely on a combination of seasonal labour and non-farm microenterprises

#### 5.4.5 Remittances

Remittances are a large income source, particularly when they come from women working abroad, and are usually sufficient to lift household incomes above the poverty line while they last, although poor households tend to relapse into poverty soon after the migrant's return. Although close to a third of the sample households had received remittance income in the five years prior to the survey, relatively few the sample households received current income flows from remittances. As Table 5.4 above shows, about 10 per cent of the sample households were in receipt of income from in-country remittances at the time of the survey and only 5 per cent were receiving income from abroad, although, as chapter 3 described, up to 15 of households nationally have a member employed overseas. The under-representation of remittance income among the borrower households is due to a sample bias. As most borrowers are women, usually the senior female household members, who are also the group most likely to work abroad, the borrower population is composed largely of those who have elected not to go overseas or have returned from overseas employment.

There are wide variations in the sizes of remittances from various sources. The highest-paid non-local forms of employment are military service, which at the time of the survey offered a monthly salary of Rs.8,000 to new recruits and ongoing pension benefits to members' families in the event of death or disablement,<sup>3</sup> and domestic service overseas, in which pay rates typically range between Rs.5,000 - 7,000. The other main source of remittances is civilian employment in the Western Province. Most employees in this category are young women working in garment factories in the EPZs, at pay rates of Rs.3,000-3,500; this category also includes a minority of higher-paid skilled and white-collar workers. Women working overseas remit the largest sums, with an average value of Rs.5,000. Remittances from in-country sources were for the most part considerably smaller, with an average value of about Rs.1,500, despite the high value of some in-country sources of employment. The generally lower value of in-country remittances results from a combination of factors which include high accommodation costs, the low wages of female factory workers and gender-based differences in workers' allocation of funds between personal and household priorities.

Most non-local income sources, including relatively well-paid overseas and military employment, are equally available to all income and location groups except the extreme-poor. The obstacles imposed by illiteracy, low social status and poor health which restrict the access of the extreme-poor to local wage employment also limit their access to non-local economic opportunities. They usually fail to meet the basic educational and health qualifications for military and factory employment, and their inability to raise the initial funds for passports and airfares, amounting to about Rs.30,000, which most emigrants finance through informal borrowings, imposes an additional restriction on their access to overseas employment (see chapter 3). Women from

extreme-poor households may also experience greater difficulties in making suitable arrangements for their children (see case study 2). Among the sample, poor, near-poor and to a lesser extent non-poor 1 households were the main recipients of remittances from overseas, military and industrial employment.

**Table 5.16: Households receiving remittance income: median income from remittances and contribution of remittances to household income by household income category**

Household income category	Households receiving remittance income (per cent)	Median income from remittances	Median percentage contribution of remittances to household income
Extreme-poor	-	-	-
Poor	13.9	1,000	23.0
Near-poor	15.2	2,000	32.8
Non-poor 1	11.3	5,000	41.3
Non-poor 2	9.6	6,000	34.1
Total	12.3	2,000	30.1

**Table 5.17: Percentage of households with remittance income and median income from remittances by location**

Location	Households receiving remittance income (per cent)	Median income from remittances
Urban	7.7	5,000
Semi-urban	13.6	3,000
Rural (Uda Walawe)	6.0	1,050
Rural (semi-irrigated)	15.7	1,750
Total	12.3	2,000

About 30 per cent of the sample households had a member overseas at some time in the previous five years. As discussed in chapter 3, overseas employment does not guarantee a high return: nearly a third of the sample returnees reported that they had received little or no net benefit. Among this group, some had returned early for family reasons, or because of problems with their employers; others reported that their employers had withheld part or all of their pay, and that little was left after repaying their debts. About half of returnees had remitted the bulk of their wages during the term of their employment. In most cases income from overseas employment was used to finance day-to-day consumption, consumer durables such as television sets, and housing improvements rather than for investment. While the overseas earnings of this group tended to have little effect on post-return income flows, they often resulted in considerable long-term improvements in living standards; and there were observable differences in housing quality and household asset ownership between returnee households and others of similar income levels.

The ability of households to convert remittance income into profitable investments is related to location and economic status. About 20 per cent of overseas workers returned with savings ranging from Rs.17,000 to over Rs.500,000. This group was the most likely among all returnees to invest their savings in microenterprise development (see case study 12). As discussed in chapter 7, the capital bases of some HVEs were financed via savings from overseas employment. The ability to accumulate savings from overseas employment is related to initial income and the savers tended to come from non-poor households and were under less pressure to remit income flows. Urban and semi-urban non-poor households appear far more likely than rural households to invest Gulf savings in microenterprises, whereas rural returnees tend to use their savings for

housing improvements, children's education and other consumption: a reflection of the scarcity of investment opportunities in rural areas.

#### 5.4.6 Government transfers

Nearly two-thirds of households receive government transfers, most commonly from the Samurdhi and Janasaviya welfare programs. Because of the very low value of most welfare transfers they have little impact on living standards except among the poorest households, where they constitute a significant income source (Table 5.18). Other government transfers include a small number of relatively generous pensions paid to retired public sector workers and restricted to non-poor households. The Janasaviya Program was instigated by the UNP government in 1989, and the current government has continued paying the benefits at a reduced rate of Rs.250 per month. Households which were in the Janasaviya Program when the current government came to power in 1994 receive benefits at half the rate of Samurdhi beneficiaries, regardless of actual household income. Larger benefits are paid under the government's own Samurdhi Program, at an average monthly rate of Rs.500. As neither program has an exit strategy for households whose incomes have risen since joining the program, and the patronage-based allocation of benefits is widespread, particularly under Samurdhi, mistargeting is endemic and as Table 5.18 indicates, most households receiving the benefit are well above the programs' formal income-based eligibility ceiling of Rs.2,000, while more than a quarter of the poorest households receive nothing.

**Table 5.18: Households receiving state transfers: median income from transfers and percentage contribution of transfers to household income by household income category**

Household income category	Households receiving state transfers (per cent)	Median income from state transfers	Median percentage contribution of state transfers to household income
Ultra-poor	70.6	500	18.5
Poor	70.9	250	8.1
Near-poor	73.3	250	4.5
Non-poor 1	62.8	500	5.3
Non-poor 2	42.6	250	2.3
Total	64.8	250	6.0

#### 5.5 Conclusion

This chapter has shown how access to wage employment and other income-generating opportunities, and consequently household income, is contingent on the location and socioeconomic status of the sample households. The largest and most stable income sources tend to be restricted to urban and semi-urban non-poor households which possess the physical, social and educational resources required to secure regular wage employment or operate profitable self-employment activities, while poor and remote rural households, lacking a single reliable income source, spread their resources across a number of small and intermittent activities such as seasonal agricultural labour and marginal self-employment projects. The most remunerative income sources available to poor and near-poor households are often employment overseas, in a Western Province garment factory or in the military, all of which are associated with significant personal risk and costs. Among households which have received remittance income, the non-poor are more likely than poorer households to invest it productively. The extreme-poor, who are often unable to meet the basic health, educational and financial conditions for non-local employment, and are constrained by household labour shortages from diversifying their activities, have the smallest and fewest income sources.

There is a consistent positive relationship between microenterprise income and household income, and a similar relationship between microenterprise income and location: the strongest microenterprises tend to be found in urban and non-poor households. In terms of its contribution to household income, the microenterprise tends to be least important among poor and near-poor households, which are more inclined to diversify their income sources, and to occupy a greater share of the incomes households at each end of the income spectrum, for different reasons. Extreme-poor households are more likely to be involuntary microenterprise specialists: although their microenterprises fail to generate poverty-clearing incomes, resource and opportunity constraints limit their access to additional income sources. The relatively prosperous owners of high-earning microenterprises are voluntary specialists, seeking to maximise their incomes by concentrating on the most profitable activity available to them.

## Chapter 6

### Determinants of microenterprise incomes and the impact of loans on microenterprise performance

M

#### 6.1 Introduction

Some microfinance enthusiasts suggest that a lack of credit is the only binding constraint on sustained improvements in microenterprise incomes. Mohammed Yunus, the founder of the Grameen Bank, argues for example that microcredit generates a virtuous circle in which loans enable investment which in turn raises incomes, thereby enabling borrowers to take larger loans for further investment which generates still higher incomes, and so on (Hulme and Mosley 1996:108). Such arguments underestimate factors in the external environment which limit the impact of financial inputs on earnings. A more accurate description of the role of microcredit in microenterprise development is that it facilitates enterprise growth within the limits imposed by external non-credit constraints, but is rarely able to shift growth ceilings upwards. Research findings indicate that the Yunus virtuous circle exaggerates the benefits of microenterprise credit programs, as most loan-assisted microenterprises do not experience sustained growth but quickly reach a low plateau and thereafter stop growing (Hulme and Mosley 1996, Sebstad and Chen 1996), and many borrowers find that credit-generated improvements in their microenterprise incomes are too small to enable poverty exit.

Evidence from the sample indicates that with ready access to vigorous markets, raw materials and productivity-enhancing infrastructure, and in occupations in which a favourable competitive environment exists, microenterprises are capable of earning incomes which support their owners well above the poverty line. As the main constraint to growth for these enterprises is often a shortage of capital, they are highly responsive to inputs of microcredit. Most microenterprises, however, face formidable constraints which are not amenable to credit-based solutions. Microcredit has little influence on such key determinants of enterprise incomes as local population densities, agricultural commodity prices and input costs, the condition of roads and irrigation facilities and the activities of non-micro competitors. For enterprises which are subject to severe non-financial demand and production constraints microcredit offers little prospect for poverty-clearing income growth.

This chapter examines the impact of credit on the sample enterprises and discusses the key physical and economic determinants of enterprise performance and growth potential. Section 6.2 argues that the sample enterprises fall into two categories on the basis of the median incomes of their occupations. High-value enterprises (HVEs), defined as enterprises in occupations with median incomes of Rs.4,000 or more, are sufficient to enable a household to clear the poverty line, and many offer potential for further expansion. Low-value enterprises (LVEs) are found in occupations where median incomes are below Rs.4,000, and are more likely than HVEs to have reached growth plateaus. Despite inputs of credit, most LVEs have failed to cross the poverty line and their low growth potential suggests that their prospects of doing so in the future are limited. Section 6.3 examines the determinants of enterprise performance. It argues that the main causes of income and growth disparities between LVEs and HVEs are constraints on demand and production which limit enterprise earnings and growth potential in rural areas and in some semi-urban and urban occupations.

Section 6.4 examines post-credit changes in microenterprise incomes. Microcredit produces the largest and most sustained earnings growth among urban HVEs which operate in growing markets and in conditions which support and reward technological improvements. As LVEs face structural constraints which limit their scope for expansion, the responsiveness of enterprise



earnings to continued inputs of credit is limited, and earnings growth quickly reaches a plateau. Many owners of LVEs nevertheless report credit-generated improvements in their microenterprise incomes, because although the scope for investments in expansion or productivity improvements is limited, microcredit increases their net profits by reducing the costs of borrowing, as the interest rates on microcredit loans are substantially lower than those offered by moneylenders and other alternative sources of finance. For about half of LVEs, however, and about a third of the total sample, the impacts of microcredit on enterprise earnings are neutral or negative. While some borrowers in this category had experienced personal misfortunes such as illness or loss of assets through fire or theft, most enterprises which reported zero or negative effects are in occupations facing particularly severe and deteriorating demand and production conditions which exert downward pressures on enterprise incomes and offset the beneficial impact of lower interest rates.

## 6.2 LVEs and HVEs

As Table 6.1 shows, the incomes of the sample loan-assisted microenterprises vary over a wide range but are heavily concentrated at the lower end of the distribution. Only a third of projects earn net incomes above Rs.4,000, the minimum level of monthly earnings - equivalent to 80 per cent of the poverty line for a family of five - which could reasonably be considered sufficient to enable a microenterprise-led exit from poverty. At the bottom end of the distribution another third are very marginal activities yielding monthly incomes below Rs.2,000 or failed projects which earn no income at all. The income from low-earning enterprises makes important contributions to well-being and may enable borrowers who are near the poverty line to cross it, but by themselves they are generally too small to facilitate an enterprise-led exit from poverty.

**Table 6.1: Distribution of loan-assisted microenterprises by microenterprise net income**

Microenterprise net income	Frequency	Per cent
No income	15	5.9
Rs. 1 - 2,000	80	31.6
Rs.2,001 - 4,000	71	28.1
Rs.4,001 - 8,000	56	22.1
More than Rs.8,000	31	12.3
Total	253	100.0

The poverty-clearing capacity of a microenterprise depends on its earning potential, which is not always reflected in its actual earnings, particularly early in its life. For a range of reasons to do with the age of the enterprise and the skills and motivations of the owner, not all of the sample microenterprises have reached their growth ceilings. The upper limits to which these enterprises can aspire can however be predicted with reasonable certainty, particularly in the lower-earning occupational categories. As a recent cross-country study concluded, "the eventual size that an enterprise is likely to assume is . . . a function of the inherent nature of the activity it seeks to carry out. An enterprise grows to settle within a fairly standard size-range for that activity, given average entrepreneurial abilities" (Asian Development Bank 1997:31). Given the resource and market limitations facing a seasonal semi-subsistence activity such as lagoon-fishing, for example, such a project is unlikely ever to earn more than about Rs.2,000 per month. While the upper limits to the potential earnings of enterprises in higher-value occupations are less easily defined it can be confidently assumed, given their median occupation incomes of Rs.4,000 or more, that such enterprises stand a good chance of growing to poverty-clearing income levels. Consequently the enterprises are classified as low-value or high-value projects on the basis of their potential rather than actual earnings, given their occupations. The key indicator of HVE or LVE status is the median occupation income: enterprises in occupations with median incomes of

Rs.4,000 or more are HVEs; those in occupations with median incomes below Rs.4,000 are LVEs (see Table 5.2).

As Table 6.2 shows, occupation is a powerful predictor of enterprise earnings. Over two thirds of HVEs, but only 13 per cent of LVEs, earn more than Rs.4,000, indicating the existence of formidable obstacles to growth facing enterprises in low-value occupations.

**Table 6.2: Occupational categories: some key indicators**

Enterprise occupation	Number of projects	Projects earning Rs.4,000 or more	Median project income
<b>LVEs</b>	<b>135</b>	<b>17</b>	<b>2000</b>
Single season cultivation	48	7	2700
Low-value manual occupations*	38	8	2000
Fishing and small-scale livestock	23	-	1500
<i>Kades</i> and house-to-house mobile trade**	26	2	1500
<b>HVEs</b>	<b>118</b>	<b>81</b>	<b>6000</b>
Mobile <i>pola</i> trade***	21	11	4000
Specialised retail trade, tea-shops, vegetable wholesale trade	21	15	6000
Two-season cultivation	25	19	4300
High-value manual occupations****	37	25	5500
Services and high value n.e.s*****	14	11	7250
<b>Total</b>	<b>253</b>	<b>98</b>	<b>3000</b>

\* Garment-making, brick-making, coir-rope making, stone-crushing, lime extraction from crushed sea-shells.

\*\* A *kade* is a petty retail outlet, usually located in a cadjan roadside hut or in the owner's house, selling staple foods such as rice, lentils and dried fish, soft drinks and basic consumer goods.

\*\*\* A relatively profitable form of petty retail trade in which the trader travels between local towns, selling goods at their weekly *polas* or market days.

\*\*\*\* The main occupations in this category are carpentry, motor mechanics and food processing. Less common occupations such as jewellery-making, joss stick production and electrical equipment repairs are included.

\*\*\*\*\* The main occupations in this category are tractor-hire, larger-scale livestock businesses and rice milling. Less common occupations such as hair-dressing and telecommunications services are included.

To determine whether enterprises had levelled out or were still growing, borrowers were asked if they had made improvements to their enterprises in the 12 months prior to the survey by increasing output or sales, improving product quality, diversifying into new or additional products or services, acquiring new enterprise assets (replacement of existing assets was excluded) or moving into new markets. The enterprises of borrowers who had made no improvements in the previous 12 months were judged to have stopped growing. Among those who reported making improvements, most improvements took the form of minor increases in output and small capital-widening additions to existing assets such as an increase in working hours, or the purchase of additional chairs for customers in a tea-shop. A smaller number of borrowers made major improvements in the form of capital-deepening asset acquisitions, such as the replacement of non-electric with electric equipment; the purchase of assets which were formerly hired - for instance, the construction of a kiln in a brick-making enterprise whose owner previously rented a neighbour's facility - or investments which added substantially to the protection of existing assets and stock - for example, the purchase of a refrigerator or construction of fencing or sheds for livestock. Most improvements took the form of increases in output through increased contributions of labour, diversification of production and new asset purchases. Some growing enterprises reported increasing their sales in existing markets, but hardly any reported expanding

their geographic customer base - an indication of location-related constraints on market expansion, discussed below.

**Table 6.3: Microenterprises aged 12 months or more: enterprise growth by occupational category\***

Enterprise occupation	Owners reporting recent improvements to enterprise (per cent)
<b>LVEs</b>	<b>19.5</b>
Single season cultivation	6.3
Low-value manual occupations	20.6
Fishing and small-scale livestock	25.0
Kades and house-to-house mobile trade	45.0
<b>HVEs</b>	<b>37.7</b>
Mobile <i>pola</i> trade	37.5
Specialised retail trade, tea-shops, vegetable wholesale trade	42.9
Two-season cultivation	24.0
High-value manual occupations	48.4
Services and high value n.e.s	45.5
<b>Total</b>	<b>29.1</b>

\* As nearly all new enterprises undergo an initial period of expansion, growth during the first few months is not a reliable indicator of longer-term growth potential. To control for the impact of newness on growth, enterprises under 12 months old are omitted.

As Table 6.3 shows, the research findings lend little support to claims that microcredit generates sustained enterprise growth. Among enterprises which were over 12 months old, around 70 per cent are non-growing, having made no improvements in the twelve months prior to the survey. The higher growth potential of HVEs is indicated by the fact that they are on average nearly twice as likely to be growing as LVEs. There are significant differences between farm and non-farm enterprises: due to particular constraints facing the farm sector, discussed below, farm enterprises are far less likely to be growing than those in the non-farm sector. Irrigated farms in the Uda Walawe settlements, which are HVEs due to their ability to grow two annual crops, are far more likely to be growing, however, than single-season farms which are LVEs. In the non-farm sector a similar pattern exists, with HVEs displaying a far higher propensity for growth.

The key aim of microcredit is to raise and thereafter maintain microenterprise earnings at stable above-poverty-line levels. Most loan-assisted HVEs have either stabilised at above-poverty-line earnings or are continuing to grow, suggesting that microcredit has had considerable success in achieving its objective with regard to HVEs. Even among HVEs which earn less than Rs.4,000, a quarter of owners report having made recent improvements, suggesting that their enterprises will cross the poverty line in the future. Among LVEs, however, where both incomes and growth prospects are lowest, the ability of microcredit to generate poverty-clearing enterprise incomes is in doubt. Credit has failed for the most part to lift enterprise incomes to above-poverty-line levels and given the low growth prospects of most LVEs, is unlikely to do so in the future.

### 6.3 Constraints on microenterprise development

This section discusses the impact of market and production conditions, the key determinants of microenterprise performance. Market constraints exist where turnover is limited by small, weak markets, or where unequal bargaining relationships or intense competition force prices down. Production constraints are supply-side restrictions on productivity and output which include inadequate electrical, irrigation and transport infrastructure, restrictions on access to inputs imposed by scarcity or high costs, and financial and scale barriers which limit the availability and

utility of improved technologies to micro-level producers. Among HVE occupations market and production constraints are relatively muted: most HVEs operate in growing or strong markets without excessive pressure from competitors, the technology accessible to micro-level operators enables them to be competitive, and inputs are available and affordable. LVEs by contrast operate in weak or overcrowded markets in which profit margins are reduced by low demand and intense competition with other micro-level producers or larger firms, the productivity-enhancing technology used by larger competitors is either unaffordable or uneconomic for micro-level producers, and key inputs may be expensive, scarce or available only on a seasonal basis.

The severity of production and demand constraints varies between locations and occupations. While location-related variables are the principal determinant of performance, occupation-specific constraints are also significant: even in semi-urban and urban locations where physical and economic conditions are favourable some enterprises earn low incomes and have limited growth prospects because they are in occupations which face particular problems of intense competition and barriers to technological innovation. This section is divided into three parts. The first discusses the impact of location-related variables on the performance of non-farm enterprises, the second discusses occupation-specific constraints on non-farm enterprises and the third discusses the particular constraints facing the farm sector.

### 6.3.1 Location-related constraints on non-farm enterprises

The uneven distribution of infrastructure, population densities, average incomes and access to non-local markets between urban, semi-urban and rural areas; and within rural areas, between the irrigated Uda Walawe settlements and arid regions; creates significant regional disparities in enterprise performance and the range of viable occupations available to borrowers. As Table 6.4 shows, there are significant differences in microenterprise occupational composition and incomes between locations: 76 per cent of rural non-farm enterprises are LVEs, in comparison with 47 per cent of semi-urban and only 23 per cent of urban enterprises. To be competitive, most high-value non-farm occupations require favourable demand and production conditions in the form of electricity, ready access to supplies and most importantly a substantial customer base. Most urban, semi-urban and irrigated areas are well-equipped with such resources but in remote rural areas poor infrastructure and market conditions rule out possibilities for the development of most non-farm HVEs, and constitute a major obstacle to growth for other non-farm activities; and irrigation constraints rule out the development of higher-value farming activities, limiting borrowers by default to single-season agriculture or marginal non-farm occupations.

**Table 6.4: Non-farm enterprises: distribution by location**

Location type	Principal microenterprise occupations	LVEs	HVEs	Total
Urban	Mostly high-value retail trade and production, some low-value production	12	40	52
Semi-urban	Low-value trade, mix of high-value and low-value production	31	35	66
Rural (Uda Walawe)	High-value wholesale trade, livestock	3	5	8
Other rural	Low-value trade, fishing, small-scale livestock; non-farm HVEs include tractor-hire, rice milling	41	13	54
Total		87	93	180

As Table 6.5 indicates there are wide location-based inequalities in access to electricity. Nearly all urban areas are serviced with mains electricity, although a minority of urban households lack electricity, usually because they cannot afford the fee of Rs.6,000-10,000 required to connect their houses to the mains supply. Nearly half of the semi-urban households lacked mains electricity, in most cases because, like the poorer urban households, they have not connected to the mains supply although access is available; but also because some of the more remote semi-urban areas lack electricity. In rural areas mains electricity is confined to the centres of large villages and the access routes linking them with main roads, and was present in only a fifth of the sample households. Access to electricity is of key importance for non-farm microenterprises, expanding the range of accessible technologies, offering scope for diversification of production and enhancement of productivity and quality, increasing available working hours via the impact of lighting and electric household goods on domestic labour productivity, and increasing the range of activities that can be undertaken after dark. Lack of electricity limits the range of possible occupations, ruling out most high-value production activities such as carpentry and mechanical workshops. The more sophisticated technologies employed in food processing and packeting, coir rope production and garment-making also require electricity and the few enterprises in these occupations without electrical power are uncompetitive. The ability to refrigerate perishable foods and provide cold drinks adds considerable value to tea-shops and *kades* and non-electrified enterprises in these occupations are at a disadvantage especially when their nearby competitors have electricity.

**Table 6.5: Access to mains electricity by location**

Location	Households connected to mains electricity supply (per cent)
Urban	71.1
Semi-urban	54.5
Rural	19.3
Total	39.1

Market linkages connecting Hambantota producers with the export sector and the country's urban markets are underdeveloped. As discussed in chapter 3, transport costs associated with remoteness from the country's ports and main population centres, and the relatively poor quality of communications and electrical infrastructure in remote provinces create a significant disadvantage for producers in outer provinces relative to their competitors in the south-western regions of the country, and are a major factor in the disappointing performance of the THGFP and the concentration of industry and commercial activity in the Western Province. The geographic constraints which reduce the competitiveness of larger manufacturing firms in remote provinces also affect micro-level producers in Hambantota district. Moreover, few micro-level producers have the necessary entrepreneurial skills and contacts, or are prepared to bear the risks and costs of targeting distant markets. Consequently, with the exception of a small number of vegetable traders who sell their products in the Colombo wholesale markets, nearly all of the sample non-farm enterprises trade within the district, the vast majority confining themselves to customers within a one-kilometre radius of their dwellings.

Within the general constraint imposed by distance from the country's main population centres, local differences in population densities and income levels, and in the quality of transport infrastructure, create considerable location-based disparities in access to markets. The most varied, vigorous and prosperous markets are found in urban areas. Firstly, with populations of 10,000 or more in each of the regional towns, urban enterprises have access to a densely populated and relatively prosperous customer base of local households. Secondly, the towns are commercial hubs for outlying settlements, supplying consumer goods, inputs and services which

are unavailable in villages, and each town has weekly *polas* or market days which draw buyers from outlying villages and mobile traders from throughout the district. The inland town of Suriyawewa derives its main economic importance from its role as the commercial and administrative centre for the relatively prosperous local farming community in the eastern branch of the Uda Walawe irrigation scheme. Thirdly, the busy coastal road on which the towns of Ambalantota and Hambantota are located is the main arterial route connecting the district with Colombo and the south-west, and is the main route for pilgrims travelling from Colombo to the temples of Kataragama to the east, and for foreign tourists travelling to Yala national park. Enterprises in the coastal towns and along the main road are well-positioned to attract passing non-local traffic in the form of trucks, private vehicles and weekend bus-loads of pilgrims are key markets for enterprises located in the town centres and along the main road.

As access to passing vehicle traffic and to customers from outlying areas diminishes considerably for semi-urban enterprises located even a short distance from a town centre or the coastal road, these markets are virtually confined to urban enterprises. Semi-urban and rural enterprises rely principally on customers from their own neighbourhoods and on visiting traders. In addition some semi-urban and Uda Walawe borrowers make use of their access to public transport to engage in mobile trade, following the weekly *pola* circuit. Due to transport limitations, few rural producers are in a position to convey their goods regularly to a main road or town. Among the 21 small-scale mobile trading enterprises sampled, only four were operated by rural households, and three of the latter were located close to reliable main road bus routes. Only one rural borrower, who hired a tractor to travel the 5-kilometre distance between her house and Hambantota town three times a week to sell vegetables from a roadside stall, found it economic to hire transport.

The scarcity of commercial urban properties creates additional difficulties for semi-urban and rural borrowers seeking to access urban markets, even when they are favourably located with respect to transport. Buildings along the Galle Road and in town centres are tightly-held by their owners and in high demand, rental costs are high and landlords typically require between one and two years' rent in advance. Access to secure urban or roadside business premises is essential for the relatively immobile higher-value activities such as carpentry, mechanical repairs or the retailing of prepared food (see case study 6) and the shortage of secure urban premises where stock and equipment can be stored limits the potential for development of urban enterprises operated by commuting rural borrowers.

Market access is weakest among rural enterprises. Deficiencies in the quality of access roads and bus services, described in chapter 5, are a serious impediment to both microenterprise development in remote rural areas, restricting producers' access to non-local markets, raw materials and supplies; and restricting local economic development and opportunities for wage employment, thereby depressing local household incomes and dampening demand. Lacking access to non-local markets, many rural non-farm enterprises rely entirely on local customer bases in regions where average population densities rarely exceed 100 persons per square kilometre<sup>1</sup> (DCS 1998b). In the arid rural areas of the sample, households were located a variety of settings: some were in relatively large villages of up to 200 families; others were in hamlets of 20 to 30 families; others were ranged along thinly-populated unsealed roads. Although somewhat stronger markets existed in the larger villages, their advantages tended to be offset by higher levels of competition.

A recent study of Dry Zone non-farm microenterprises makes the point that "as most sales by (rural) microenterprises are for household consumption, the level and character of market demand for their products and services is most influenced by real per capita incomes in the areas,

particularly farm incomes" (Dunham and Edwards 1997:10). Low average household incomes in rural areas reduce demand and the range of viable business opportunities. In households below the poverty line demand for goods which are traded in the cash economy is virtually confined to food needs which cannot be met from home production. As a result, the occupations of rural non-farm enterprises which trade in local markets are limited to petty retail trade and to fishing and livestock-rearing activities which combine subsistence production with trade in staple foodstuffs. Even in Uda Walawe villages, where higher household incomes and superior transport and electrical infrastructure expand the range of viable activities, local markets tend to be too weak to support most non-farm activities.

In the low-income manual occupations of brick-making, stone-cutting, lime production and coir-rope production - which are found in both semi-urban and rural areas and account for about a quarter of non-farm LVEs - producers deal with visiting traders who purchase the finished products and in some cases supply their raw materials as well. Barriers to entry in these occupations are very low, leading to overcrowding, and producers operate in buyers' markets. Rural manual enterprises are disadvantaged relative to their semi-urban competitors: as their remoteness increases the cost and difficulty of reaching them, fewer traders visit rural enterprises, and restrict their visits to the most remote areas to dry seasons when road access is possible, thereby restricting both turnover and producers' bargaining power. Rural producers claimed that traders passed on the costs of travel to remote areas in the form of lower prices, a problem which was also widely reported among remote-area paddy-farmers.

Given the importance of agriculture in the district economy, most non-farm enterprises experience crop-cycle-related fluctuations in demand. The impacts of agricultural seasonality on demand were strongest among enterprises in arid rural areas, as their markets are composed principally of local farmers and agricultural labourers, and as these areas are dominated by single-season agriculture they experience a single annual peak in demand following the *maha* harvest. Urban and semi-urban enterprises, particularly those in Suriyawewa, whose customers are drawn from the surrounding Uda Walawe villages, reported surges in activity during post-harvest periods, but the effects of seasonality were mitigated by their greater access to non-farm customers, the smoothing of fluctuations due to their location in irrigated areas which produced two annual crops rather than one, and the higher incomes of their customers, which maintained a certain level of demand even during lean seasons. Those least affected were the trade and production activities in the coastal towns and along the Galle Road, which draw their customers primarily from the local non-farm population and from passing non-local traffic.

As Table 6.4 indicates, close to 30 per cent of rural non-farm enterprises are HVEs, but most are confined to the Uda Walawe settlements. The largest group of rural non-farm HVEs consists of vegetable wholesaling and mobile trade enterprises based in Uda Walawe villages. A small number of HVEs in the arid rural areas, such as rice-milling and tractor-hiring, earn high incomes as they protected from competition by high initial capital costs. Tractors are widely used for both cultivation and transport but as they cost between Rs130,000 and Rs.500,000, most households cannot afford to buy one and hire them when required. The barrier to entry constituted by high capital costs restricts competition in this highly profitable occupation. (The role of capital costs in restricting poor borrowers' access to HVEs is discussed further in chapter 7.) Only five HVEs in the manual production trades were found in rural areas, and only two earned incomes above Rs.4,000. Both operated in exceptionally favourable conditions, with access to electricity, and being favourably located with respect to the small population of non-poor rural households which constituted their customer base. One was a carpentry workshop with a relatively prosperous customer base in one of the larger Uda Walawe villages; the other was a mechanical workshop which had developed a niche market specialising in tractor repairs.



In terms of their potential to reduce poverty, skilled production enterprises such as mechanical repairs, food manufacturing and carpentry are among the most promising microenterprise activities. They rely on human capital and, in the case of production enterprises, on incremental additions of technology rather than the large initial capital investments required by some other high-value microenterprises, so they are financially accessible to poor borrowers and responsive to the training and microcredit services which NGOs can provide. Moreover, they have considerable growth potential as they operate in growing markets with little competition from larger producers. However, these highly promising enterprises are virtually absent in rural areas because the key conditions for their survival do not exist there. There is little demand for their products among poor, sparse rural populations and they are limited by remoteness and underdeveloped transport infrastructure from reaching non-local markets.

### **6.3.2 Occupation-specific constraints on non-farm microenterprises**

While arid rural areas have a higher concentration of LVEs than other locations, not all LVEs are rural: as Table 6.4 above shows, a significant minority of urban and semi-urban enterprises are also LVEs. Semi-urban and urban LVEs are affected by occupation-specific constraints: although they are more favourably located than their rural counterparts with respect to markets and infrastructure, and indeed operate in neighbourhoods which also support higher-value enterprises, they earn low incomes and have limited growth prospects because they are in occupations which face particular problems of intense competition, barriers to technological innovation and in some cases restricted access to resources. An important distinction between urban and rural non-farm LVEs relates to the motivations of borrowers in selecting them: whereas the physical environment presents rural borrowers with few options but to select LVEs, many urban and semi-urban borrowers also select LVEs with low incomes and little prospect of improvement, even where local demand and production conditions support the development of higher-value alternatives. They do so because of financial and human-capital-related barriers to entry to HVEs, which are discussed in the next chapter.

Many LVEs experience seasonal fluctuations in productive capacity, due in part to difficulties in accessing supplies and raw materials. The inputs used by HVEs tend to be partly-processed materials such as wood for carpentry projects, retail items for trade, and ingredients for food preparation, which are obtained from local wholesalers. Input costs fluctuate with local demand and supply conditions, but few owners of HVEs reported problems with access to raw materials. LVEs are far more likely to rely on inputs which their owners gather themselves from locally-available natural resources, supplies of which are often affected by seasonal fluctuations, and in some cases by increasing scarcity. As the lagoons are usually dry during the annual dry season, lagoon fishing is confined to seven or eight months during the monsoon and post-monsoon periods. Many brick-makers cease production during the monsoon months due to the difficulty of drying bricks in humid monsoon conditions. Curd production, a higher-value food processing activity, falls during the driest months due to the lack of feed available for cattle. The occupations of lagoon-fishing, lime-production and in some areas, brick-making, are threatened by intense competition for increasingly scarce finite natural resources. Official attempts to ration the supplies of non-renewable resources have proved largely unsuccessful<sup>2</sup>. Remote non-farm microenterprises such as coir-rope production and rock breaking, which rely on non-local supplies of raw materials, which are affected by seasonal climate-related fluctuations in road access, often cease production during the rainy months.

Unlike most LVEs, which are clustered in a narrow range of occupational groups in which large numbers of identical projects compete, HVEs tend to operate in less crowded or growing markets and are more likely to specialise. With the rapid expansion in vehicle ownership in Sri Lanka in



the 1990s, accompanied by increased traffic along the Galle Road, motor vehicle repairs is a strongly-growing sector currently dominated by micro-level enterprises employing fewer than five workers. Similarly, the skilled carpentry and masonry trades, dominated by micro-level producers, are experiencing high levels of demand with a current boom in house construction financed by overseas earnings and concessional government housing loans. HVEs are far more likely than LVEs to operate in specialised occupations and to target niche markets.

Because the demand and production conditions which support diversification and technological improvements do not exist in rural areas, non-farm rural enterprises are clustered in a narrow range of occupations. As non-farm LVEs have minimal skills and capital requirements barriers to entry are low, which combined with the extreme scarcity of alternative income-generating opportunities, creates intense competition and market saturation resulting from an over-supply of micro-level competitors selling identical products in identical markets. In villages which could support perhaps a single *kade* on a modest income it is common to find three or four such enterprises, each with an identical, narrow product range consisting of rice, lentils and soft drinks, and each with earnings well below the poverty line. Overcrowding can lead to unsustainable competition between businesses: a number of *kade* operators complained that although their businesses were being harmed by the extension of credit to non-paying customers, other *kades* in the area offered goods on credit, so each operator was under extreme pressure to continue the practice or lose customers to their competitors. The significant market advantages of semi-urban LVEs relative to their rural counterparts are partly offset by intense competition.

In addition to the intense micro-level competition which exists in all LVEs, inefficient production processes in some manual LVEs expose them to competition from larger, more efficient producers. Among enterprises such as poultry-rearing, coir-rope making, garment-making and rock-breaking, which face competition from more technologically advanced firms, the high costs of the capital improvements required to make them competitive effectively rule out technological expansion as an option even where the required infrastructure is available and impose an effective growth ceiling for poor borrowers. At least larger one rock-breaking firm, which uses motorised equipment rather than the hammers and chisels used by micro-producers, has set up premises in one of the survey locations. The very high capital costs of such technologies are well beyond the reach of micro-level producers who in this occupation are usually very poor. Garment-making microenterprises face intense competition not only at the micro-level, but also from factory-made products. The minor competitive advantage of micro-level garment-makers, in their ability to tailor clothes to order, is outweighed by the lower prices of factory-produced garments. Given the inability of micro-level producers to compete with larger, more highly capitalised firms, it appears that the micro-level industry in many low-value manual occupations faces an uncertain future.

Among coir rope makers, those who used non-electric tools to sort and plait the fibre were uncompetitive with those who used electrically-powered machines. At a cost of about Rs.50,000, an electrical machine is beyond the reach of most producers, but in an interesting development, a local coir mill has leased a number of machines to local producers, some of whom took microenterprise loans to cover the costs of leasing the machines and purchasing raw coir fibre. Equipment-hire arrangements which reduce capital costs and risks for micro-level producers may applied offer considerable potential for income growth, but care must be taken to ensure that technologies are appropriate for local conditions. In the case of the coir machines the arrangement did not appear to be working well, as two workers were required to operate the machines efficiently, and in households without older children or elderly family members the female producers could not secure the full-time cooperation of their husbands. Even with the improved technology incomes from coir production are too low to justify the employment of a

second adult family member, particularly a male who could be more profitably employed elsewhere; and it appeared that status considerations relating to men's participation in "women's work" also had a deterrent effect.

Brick-making is similar in many respects to other low-value rural production activities, being an unskilled, low-technology occupation with many competitors and little product differentiation. Paradoxically, distance and poor transport infrastructure, which are major obstacles to the development of other microenterprises, provide protection for the local brick-making industry. Despite the existence of larger-scale industrialised brick-making firms in the country's Western and North Western provinces brick-making, another low-technology activity, is not currently under threat from more efficient producers as Hambantota brick-makers benefit from significant advantages in terms of demand and location. Local demand is brisk due to the current boom in low-income housing construction in the Southern Province, financed by cheap government loans and overseas remittances; and for local buyers, as well as traders from the regional cities of Galle and Matara to the west, distance and its associated transport costs make the local product a better option, despite its relative inefficiency. Given the strength of demand it seems, however, only a matter of time before non-micro entrepreneurs begin to develop higher-productivity enterprises of the type found in the Negombo area, with devastating consequences for the micro-level industry.

### 6.3.3 Constraints on agricultural microenterprises

#### 6.3.3.1 Irrigation

The quality of irrigation infrastructure is a key determinant of crop composition and farm incomes among the sample farmers, who can be classified into three groups on the basis of their access to irrigation, as per Table 6.6.

**Table 6.6: Agricultural enterprises: key characteristics**

Type of irrigation	Number of projects	Number of annual crops	Crops grown	Income status of enterprise
Year-round water supply from Uda Walawe scheme	25	Two	OFCs, paddy	HVE
Village tanks, peripheries of major schemes	38	Usually one	Paddy, chena	LVE
Rainfed	10	One	Chena	LVE

The first group consists of farmers in the Uda Walawe scheme and a handful near the headwaters of smaller government irrigation schemes, who have access to a reliable continuous water supply which, as described in chapter 3, enables the cultivation of two and sometimes three annual crops of paddy rather than one; and facilitates diversification into higher-value OFCs. Despite an ongoing decline in the profitability of paddy, discussed in chapter 3, two annual paddy crops on a standard irrigated plot of one hectare still produce returns sufficient to sustain a household just above the poverty line. Many Uda Walawe farmers earn higher incomes than they could from paddy alone by combining paddy production with the commercial cultivation of bananas and seasonal vegetables, or specialising entirely in OFCs. Most are experienced producers, who possess the skills and information to anticipate market conditions and plan crops accordingly, and the financial stability to accommodate risk, both found by a recent study to be key success factors among commercial vegetable cultivators (Menegay et al 1996). The Uda Walawe producers have good access to market information through their close links with the Colombo wholesale markets, some combining OFC production with their own wholesale vegetable trade enterprises. Most have managed to weather recent fluctuations in the OFC sector, in part because the primary Uda Walawe OFC is bananas, which have experienced continuing strong domestic demand and minimal competition from imports. Bananas are not entirely immune from the instability

affecting other OFCs, however, and in 1998 an increase in domestic supply, resulting largely from intensive cultivation in the Uda Walawe scheme, caused a slight decline in the banana producer price (Central Bank 1998a).

The second and largest group in the sample are single-season farmers in semi-irrigated areas: "tail-enders" on the peripheries of major irrigation schemes, and those who receive their water supply from canals connecting their fields to communally-maintained village reservoirs, known as tanks. Tank irrigation, the most common form of irrigation among dry-zone farmers, supports a single paddy crop during *maha*, but as most village tanks are dry for part of the year farmers rarely have access to the stored water necessary for a second crop. Some smaller major irrigation schemes, such as the Bandagiriya and Lunugumvehera reservoirs in the survey locations, were designed to provide year-round irrigation, but in practice a continuous water supply is restricted to farms located near their headwaters. Due to poor maintenance, water theft and downstream problems of siltage, tail-ender farmers in these schemes, like those who rely on village tanks, receive inadequate water supplies during most *yala* seasons. As the irrigation constraint rules out dual season cultivation and diversification into off-season OFCs, the farm incomes of this group are considerably lower than those of the Uda Walawe farmers and in most cases are well below the poverty line. All farmers in semi-irrigated areas grow paddy, and about one fifth combine paddy with subsistence-oriented chena cultivation or small-scale home-garden vegetable production. The vegetables and chena crops are primarily for home consumption, although some households earn a small income from the sale of surplus produce. Paddy is produced for both home consumption and the market, and most paddy-farmers grow enough to meet household requirements.

As paddy cannot be grown in the Dry Zone without access to stored water, farmers in areas lacking irrigation infrastructure, who constitute the third and poorest group, grow rainfed *chena* crops, which typically consist of low-value drought-resistant OFCs such as cassava, sweet potato and mung beans which are cheap sources of calories. Because of their low market value and because a large proportion of *chena* crops are consumed rather than marketed, cash incomes from chena production are typically very low, averaging less than Rs.1,000 per month.

As noted in chapter 3, land fragmentation is a significant problem in the Mahaweli schemes in the North Central Province, but was largely absent in the Uda Walawe survey locations. While the reasons for this are not entirely clear it is possible that the high farm incomes of Uda Walawe households and their access to non-farm economic opportunities provide a springboard for launching farmers' children into non-farm activities, thereby reducing pressure on limited land resources. Outside the Uda Walawe scheme, however, farm incomes are threatened by increasing population pressure from the landless descendants of local farmers and in-migration from the overpopulated Wet Zone agricultural regions in Matara and Ratnapura districts, which has led to some fragmentation of existing semi-irrigated paddy land, as well as the expansion of cultivation into increasingly remote and marginal areas<sup>3</sup>.

#### 6.3.3.2 Land size and land tenure

In the Uda Walawe scheme and other major irrigation schemes farmers occupy government-allocated plots, usually of one hectare, with an additional 0.25 hectare homestead plot and home garden. Farmers hold their land effectively rent-free under long-term government leases. Outside the major irrigation schemes dry zone landholdings are on average somewhat smaller, typically ranging between 0.4 - 0.8 hectares. The rental market for irrigated land in the Uda Walawe scheme is minimal. Unlike other Mahaweli settlements, where fragmentation and leasing-out of land parcels is the norm, the sample Uda Walawe farmers retained their own holdings, and some complained that lack of access to additional acreage restricted the expansion of their enterprises.

Farm HVEs are thus restricted to households with existing long-term leases on irrigated landholdings.

There is no shortage of single-season paddy-land available for leasing. Land in Hambantota district is held under a variety of tenure systems: about half of the paddy-land outside the major schemes is held rent-free under various communal and family-based customary arrangements. A small minority hold formal freehold title to their land. About 40 per cent of paddy smallholdings are leased, usually on a short-term season-by-season basis. While most tenant farmers are poor families who have rented their land, often for several generations, from absentee landowners under the semi-feudal *ande* system, a significant minority are better-off households which supplement their existing holdings by renting additional land from neighbours who through illness, poverty or the absence of male adults are temporarily unable to cultivate (DCS 1998b). Rentals, traditionally paid in kind but now more commonly in cash, typically range between Rs.4,000-5,000 per acre, about a fifth of gross paddy incomes, and hence have a significant impact on the production costs of tenant farmers.

#### 6.3.3.3 Marketing

Farm incomes are affected by marketing arrangements which vary with distance and access to transport infrastructure, and with farmers' ability to control the timing of crop sales. While paddy-farmers who live close to major towns usually take their crops to town for sale, the most common marketing arrangement is for farmers to sell their harvest to visiting traders at village depots, or - in more remote areas - literally at the farm gate. The market power wielded by buyers of farm produce, a well-recognised factor in rural poverty, is particularly acute in isolated areas with poor road access and weak transportation arrangements (Aturupane 1999, Menegay et al 1996). Producer prices are discounted for transport costs, resulting in a significant disadvantage for farmers located away from towns and intensive cultivation areas which have good transport infrastructure: farmers who transported their 1998-99 *maha* crops to Ambalantota for sale reported receiving Rs.14 per kilogram while those from more remote areas who sold their crops at the farmgate to traders reported receiving Rs.11 per kilogram.

As paddy producer prices vary with the timing of crop sales farmers who can store their crops for two or three weeks after the harvest receive higher prices than those who sell at harvest-time. There are a number of pressures on the poorer farmers to sell their crops early rather than wait for higher post-harvest prices. As farmers commonly go into debt to finance input costs and household consumption during the growing season, they are often under intense pressure from creditors to sell their crops at the earliest opportunity. Farmers with limited savings supplement their NGO loans by pledging their crops to traders and borrowing against the value of the forthcoming harvest. As traders customarily set the value of the mortgaged crop at the harvest-time market price, farmers lose the advantage of post-harvest prices. Farmers in remote areas are subject to additional hazards not experienced by those in the more densely populated irrigated regions. Some arid areas north-east of Hambantota town border on the jungles of the Yala National Park to the east, and farmers in the north east suffer losses from crop damage caused by wild elephants who encroach on cultivated land in search of food during dry periods. With limited access to crop storage facilities, remote-area farmers prefer to sell as early as possible to reduce the risk of crop losses.

#### 6.4 Impact of microcredit on enterprise incomes

The previous section described the demand and production conditions facing the sample enterprises, arguing that the favourable external environment in which HVEs operate allows them to grow at least to poverty-clearing levels, and sometimes well above them; but that the earnings and growth prospects of LVEs are limited by adverse location-related and occupation-specific

conditions. In occupations where favourable market and production conditions support high earnings microcredit may assist enterprises to grow to levels well above the poverty line, and thereafter maintain them at stable income levels; but among LVEs which are limited by external constraints to low growth ceilings, the stimulus provided by microcredit is rarely sufficient to enable them to clear the poverty line.

For most borrowers microfinance makes loans cheaper and more accessible. With the exception of a small group of prosperous households- about 10 per cent of the sample - which have access to bank loans, the informal financial sector is the only alternative source of finance available to most borrowers. Nearly all borrowers whose enterprises pre-existed the first microcredit loan previously financed their enterprises with borrowings from moneylenders, traders and other informal sector sources. Microcredit has two major advantages over the informal sector. First, it dramatically reduces borrowing costs, thereby enabling enterprises to retain earnings that would otherwise be paid as interest to moneylenders. At annual interest rates of 24 per cent for SEEDS non-farm loans, and 36 per cent for WDF loans and SEEDS single-season cultivation loans, microcredit is more expensive than bank loans which range between 20 and 22 per cent annually, but vastly cheaper than loans from moneylenders, traders and other informal sector sources who charge between 10 and 20 per cent per month<sup>4</sup>. Some studies have reported effective annual interest rates as high as 300 per cent on informal sector cultivation loans (Abeygunawardena and Kudaligama 1989). Second, it provides non-farm borrowers with access to larger loans. While farmers have traditionally used informal sources to finance production costs, usually by mortgaging part of their forthcoming harvests to traders, in the non-farm sector moneylenders tend to lend for short-term consumption purposes rather than business activities (Sanderatne 1992), and are reluctant to extend large collateral-free loans for non-farm purposes, and informal sector loans of more than Rs.10,000 for non-farm projects are difficult to obtain. The NGOs by contrast offer group-based collateral-free loans with no minimum size and up a ceiling of Rs.30,000 (WDF) and Rs.50,000 (SEEDS).

Borrowers were asked to report the cash value of their microenterprise incomes immediately before their first loan, or in June 1994, whichever was the most recent. Reported pre-loan enterprise incomes are adjusted for inflation. Table 6.7 summarises the post-credit earnings growth of LVEs and HVEs and Table 6.8 summarises post-credit earnings growth according to enterprise income. Most borrowers reported an increase in their microenterprise incomes during the period of program participation: about one third of borrowers report substantial post-credit earnings growth of more than Rs.1,000, another third report moderate growth of less than Rs.1,000, and the remaining third experienced a neutral or negative effect on their incomes. Non-farm HVEs were the greatest beneficiaries of microcredit: they were the most likely to report post-credit earnings growth, and their earnings increased on average by greater margins. Non-farm LVEs were considerably less likely to report post-credit earnings growth, and those which did were more likely to report moderate increases of less than Rs.1,000. Microcredit was least beneficial among farm LVEs, 63 per cent of which reported a stagnation or decline in their incomes, in comparison with 35 per cent of non-farm LVEs and only 15 per cent of non-farm HVEs.

Most enterprises reporting increases of more than Rs.1,000 were growing HVEs; a smaller number were newly-established LVEs which experienced strong initial earnings growth, having started from a zero base, but are unlikely to achieve poverty-clearing earnings levels. Most enterprises reporting increases of less than Rs.1,000 were either non-growing enterprises - both LVEs and HVEs - which experienced an improvement in their net incomes resulting from reduced borrowing costs, or LVEs which had invested in expansion but whose earnings growth

was limited by structural constraints. Most enterprises reporting no improvement or a decline in income were non-growing enterprises, predominantly in the farm sector, in which the beneficial effects of microcredit were cancelled out either by personal misfortune or, more commonly, by deteriorating demand or production conditions. This group included fifteen failed projects.

**Table 6.7: Post-credit microenterprise earnings growth by occupation type (per cent)**

Post-credit improvement in monthly enterprise income	Non-farm HVEs N=93	Non-farm LVEs N=86	Farm HVEs N=26	Farm LVEs N=48	All N=253
More than Rs.1,000	55.9	29.1	30.7	15.3	36.8
Up to Rs.1,000	29.0	36.0	46.2	21.7	31.6
No improvement/decline	15.1	34.9	23.1	63.0	31.6
Total	100.0	100.0	100.0	100.0	100.0

**Table 6.8: Post-credit microenterprise earnings growth by enterprise income (per cent)**

Post-credit improvement in monthly enterprise income	Enterprise income category				Total
	0-2,000	2,001 - 4,000	4,001 - 8,000	More than 8,000	
More than Rs.1,000	15.8	23.9	66.1	77.4	36.8
Up to Rs.1,000	30.5	45.1	26.8	12.9	31.6
No improvement/decline	53.7	31.0	7.1	9.7	31.6
Total	100.0	100.0	100.0	100.0	100.0

As Table 6.3 above shows, about 30 per cent of microenterprises more than 12 months old were considered to be growing at the time of the survey, their owners having recently invested in enterprise improvements, and HVEs are far more likely than LVEs to be growing. Microcredit produces the highest earnings growth when it is used to finance productivity improvements or expansions in output in enterprises which have substantial capacity for further growth. As the preceding sections have shown, HVEs tend to have greater scope for expansion because they operate in growing markets and in conditions which support technological improvements. Prior to their first microcredit loan growth in many pre-existing enterprises were restricted by the high costs and limited availability of finance. Several whose pre-microcredit earnings had stabilised at low levels reported an upturn in enterprise growth following the first microcredit loan, as reduced borrowing costs and access to larger loans provided funds for reinvestment in improvements which they had previously been unable to afford. Post-credit improvement in enterprise incomes most commonly took the form of an initial period of income growth followed by stabilisation at a higher income level.

Among LVEs whose owners have used microcredit to make improvements, the initial post-credit growth period tends to be short, and the improvement in incomes relatively small. As most low-value occupations face structural constraints which limit the scope for technological expansion, the owners of LVEs tend to confine their enterprise asset purchases to initial loans, and use subsequent loans for working capital and to repair existing assets (see case studies 4 and 5). HVEs tend to experience greater earnings growth over longer periods. The owners of HVEs tend to invest larger sums in improvements over a sustained period (see case studies 9 and 10), some taking several years to level out, with incremental expansions taking place over the course of several loans. While the greatest post-credit earnings growth occurs among high-earning enterprises, not all HVEs owe their improved incomes entirely to microcredit. Many very high-value enterprises which earn more than Rs.8,000 (VHVEs) owe relatively little of their success to microcredit as they were successful businesses prior to the first microcredit loan, and microcredit tends to be one of many sources of investment capital used by their non-poor owners (see case



studies 11 and 13). The role of additional finance in high-earning enterprises is discussed further in chapter 7.

While most of the sample enterprises pre-existed the first microcredit loan, about one quarter were new activities which commenced with microcredit. Most newly-established enterprises are LVEs which experience initial rapid post-credit earnings growth followed by stabilisation at earnings levels well below the poverty line (see case study 2). Close to two-thirds of new enterprises are marginally viable activities in very low-value occupations such as unskilled production, rural petty trade and backyard livestock-rearing. As they are among the weakest of competitors in overcrowded sectors their earnings are generally meagre and their failure rates high: nine of the fifteen failed projects in the sample were newly-established enterprises. High failure rates among new microenterprises are consistent with the findings of other studies which indicate that most closures occur in the early years of the firm's existence (Liedholm and Mead 1999). A number of new microcredit-supported LVEs have emerged as a result of SEEDS' participation in the CIDA program, described in chapter 4, which targeted extreme-poor households. Given the low capabilities of the extreme-poor and the severity of the external constraints facing new LVEs, and consequent high rates of project failure, the provision of microcredit for such activities carries a risk of deepening rather than reducing poverty by creating debt among those who can least afford it. The establishment of a large number of new low-value enterprises as a result of access to microcredit may also contribute to problems of over-supply, with an adverse effect on the incomes of existing projects.

Among the 70 per cent of enterprises which are non-growing microcredit may boost net incomes by reducing borrowing costs, although the impact on earnings is usually smaller than that produced by investments in improvements in growing enterprises. As non-growing enterprises use loans principally to maintain output at plateau levels, with working capital purchases and replacing equipment where necessary, rather than investing in enterprise improvements, credit-stimulated earnings growth is lower among mature enterprises which had reached their growth ceilings at the time of the first microcredit loan. When external demand and production conditions are stable, reduced borrowing costs produce a modest but sustainable improvement in the net profits of non-growing enterprises. Many of the enterprises reporting post-credit increases of less than Rs.1,000 are non-growing enterprises in relatively stable productive and competitive environments.

Where external demand and production conditions are stable or improving, then, the general effect of microcredit is to raise enterprise incomes: it may facilitate enterprise growth but even when it does not, at the very least, it boosts the net earnings of non-growing enterprises. Where external conditions are deteriorating, however, as in the paddy sector and among some LVEs facing intense competition and depletion of natural resources, credit is unable to reverse the decline. The reduction in costs provided by lower interest rates is offset by other downward pressures on enterprise incomes, with little or no net improvement in incomes. While reduced borrowing costs may help to offset declining profit margins in the short term, in the longer term many enterprises in this position are unlikely to survive. The enterprises most likely to report stagnating or declining incomes were those which faced unfavourable and deteriorating demand and production conditions: paddy farmers, garment-makers, rural petty traders, small-scale livestock breeders and some unskilled production activities. A significant minority of borrowers reported a stagnation or decline in their microenterprise incomes during the period of program participation. While some had been the victims of fire, illness or theft of assets; most borrowers reporting a stagnation or decline in enterprise earnings were owners of LVEs facing deteriorating structural conditions which cancelled out the beneficial effects of microcredit.

Paddy-farmers are less likely than others to report post-microcredit income improvements, partly because their reduced borrowing costs are offset by deteriorating profitability, and also because of their continued reliance on high-cost informal finance. As noted in chapter 4, paddy cultivation is unlike other low-value projects in that it involves high working capital requirements: at about Rs.37,000 per hectare, the gross production costs of a paddy crop are three or four times higher than those of non-farm enterprises with comparable earnings. Due to the NGOs' policy of capping cultivation loans at Rs.20,000 paddy production costs are not fully met by microcredit loans which finance, on average, about 75 per cent of the capital requirements of single-season paddy cultivators. Non-poor farmers supplement their NGO loans with a mixture of household savings and informal sector borrowings while poor farmers make up the deficit entirely with borrowings from traders or moneylenders.

For single-season cultivators microcredit reduces the costs of borrowing by reducing (while not eliminating) indebtedness to moneylenders, but the resulting advantages are offset by rising costs and falling prices and for many, by deteriorating environmental conditions (see case studies 3 and 7). On most farms there is little scope for capital improvements<sup>5</sup>, and the role of credit is limited to supporting subsistence and attempting to maintain farm incomes which are well below the poverty line and likely to deteriorate further. There is however some scope for reducing production costs and improving farmer's market bargaining power through non-financial technical assistance services which can be delivered by NGOs, discussed further in the concluding chapter. While such improvements will not transform paddy-farms into HVEs they may marginally improve the profitability of single-season agriculture and some innovations such as the promotion of organic pest management practices may add considerably to non-economic well-being via their positive environmental and health impacts.

## 6.5 Conclusion

As this chapter has shown, there are considerable disparities between the sample microenterprises in earnings and growth potential. Only a third earn more than the minimum of Rs.4,000 required for an enterprise-led exit from poverty. Among the two-thirds which earn less than Rs.4,000, most face adverse market and production conditions which in all probability will bar them from ever crossing the poverty line. As credit is unable to shift the growth ceilings imposed by external constraints the lowest-earning enterprises experience the smallest credit-led improvements in income. By itself such a finding is not sufficient to establish that an income-related impact gap exists; it needs to be shown that microenterprise performance is linked to borrowers' pre-loan economic status. Chapter 7 develops the second step in the central argument of this study, showing why initially-poor borrowers tend to select LVEs and the non-poor, HVEs.



## Chapter 7

### Impact of socioeconomic variables on microenterprise selection and performance

#### 7.1 Introduction

This chapter examines the factors which predispose initially-poor borrowers to select LVEs, and limit their enterprise earnings within the occupations they select. Section 7.2 reviews the statistical evidence for the existence of an income-related microcredit impact gap. Sections 7.3 and 7.4 examine the key factors which discourage poor borrowers from selecting HVEs and limit their enterprise earnings. Poverty-linked barriers to entry to HVEs fall into three categories: physical, financial and human-capital related. Physical obstacles to enterprise development were discussed at length in chapter 6. As the poor are over-represented among the populations of underdeveloped resource-poor regions they are disproportionately affected by location-related obstacles to enterprise development. For poor and near-poor urban and semi-urban borrowers, who do not face binding location-related constraints, barriers to entry imposed by the financial and human capital requirements of HVEs assume greater importance as determinants of project selection. Section 7.3 examines financial factors, and section 7.4 examines the impact of human capital and sociocultural factors on enterprise selection and performance.

While most LVEs are found in poor households, it is not always the case that low enterprise earnings are linked to poverty. Some non-poor borrowers select LVEs, or operate HVEs at levels well below their capacity. Section 7.5 examines the impact of gender, and of borrowers' decisions regarding the role of the enterprise in the household economy, on enterprise earnings: regardless of household income status women's enterprises usually earn less than men's, and some households elect to allocate the bulk of their resources to non-enterprise activities, operating low-earning enterprises as auxiliary income sources. The chapter concludes with an analysis of the impact of microcredit on household incomes and poverty exit.

#### 7.2. Pre-loan poverty status and enterprise selection and earnings

Tables 7.1 and 7.2 provide compelling evidence for an income-related impact gap, showing that initially-poor borrowers earn less from their microenterprises, and experience smaller absolute post-credit increases in enterprise earnings. Table 7.1 shows a strong positive relationship between enterprise earnings and pre-loan household income, while Table 7.2, which describes post-loan changes in enterprise incomes, shows a similar relationship between initial income status and the impact of loans on microenterprise earnings. Credit-related improvements in enterprise incomes are less likely to occur among initially-poorer borrowers, and when they do occur they are smaller. Although one in two initially below-poverty-line borrowers experienced some post-credit improvement in their enterprise incomes, the magnitude of the increases was rarely sufficient to raise earnings above the Rs.4,000 threshold: fewer than 20 per cent of initially-poor borrowers, and not a single extreme-poor borrower, operated Rs.4,000-plus microenterprises.

**Table 7.1: Enterprise earnings by pre-loan income (per cent)**

Enterprise earnings	Pre-loan income status					Total
	Extreme-poor	Poor	Near-poor	Non-poor 1	Non-poor 2	
Less than Rs.2,001	89.3	50.6	23.9	22.0	6.6	37.5
Rs.2001-4000	10.7	31.3	38.1	24.4	16.7	28.1
Rs.4001-8,000	-	14.5	31.0	34.1	26.7	22.1
More than Rs.8,000	-	3.6	7.0	19.5	50.0	12.3
Total	100.0	100.0	100.0	100.0	100.0	100.0

**Table 7.2: Post-credit enterprise income growth by pre-loan poverty status**

Post-credit growth in enterprise income	Pre-loan income status					Total
	Extreme-poor	Poor	Near-poor	Non-poor 1	Non-poor 2	
More than Rs.1,000	14.3	21.7	39.4	58.5	63.3	36.8
Up to Rs.1,000	28.6	31.3	40.8	26.8	20.0	31.6
No earnings growth	57.1	47.0	19.7	14.6	16.7	31.6
Total	100.0	100.0	100.0	100.0	100.0	100.0

The earnings differential owes its existence principally to occupational segregation between poor and less-poor borrowers. Given substantial variations in median earnings and post-credit improvements in earnings between LVEs and HVEs, occupation selection is a key determinant of microcredit impact. As Table 7.3 shows, there is a strong association between initial poverty status and selection of occupation. The initially extreme-poor and poor are far more likely to select LVEs (at 86 and 69 per cent respectively), than near-poor (55 per cent), non-poor 1 (24 per cent) or non-poor 2 borrowers (13 per cent).

**Table 7.3: Enterprise occupation by pre-loan income**

Enterprise occupation	Pre-loan income category					Total
	Extreme-poor	Poor	Near-poor	Non-poor 1	Non-poor 2	
<b>LVEs</b>	<b>24</b>	<b>57</b>	<b>39</b>	<b>10</b>	<b>4</b>	<b>135</b>
Single season cultivation	5	23	17	1	-	48
Low-value manual production	4	17	12	3	2	38
Fishing and small-scale livestock	11	7	3	2	-	23
Kades and house-to-house mobile trade	4	9	7	4	2	26
<b>HVEs</b>	<b>4</b>	<b>25</b>	<b>32</b>	<b>31</b>	<b>26</b>	<b>118</b>
Mobile <i>pola</i> trade	3	7	3	4	4	21
Specialised retail trade, tea-shops, vegetable wholesale trade	-	3	9	4	5	21
Two-season cultivation	-	6	9	4	6	25
Skilled manual occupations	1	7	8	15	6	37
Services and high value occupations n.e.s.	-	2	3	4	5	14
<b>Total</b>	<b>28</b>	<b>83</b>	<b>71</b>	<b>41</b>	<b>30</b>	<b>253</b>

Not only do the poor tend to select lower-value occupations; within occupational categories their earnings tend to be lower than those of their less-poor counterparts. Table 7.4, which describes differences in enterprise earnings between pre-loan income groups within occupations, shows that in all occupations the initially near-poor and non-poor earn higher incomes than the initially poor. While earnings differentials within occupations contribute to the earnings gap they are not as important as occupational segregation in explaining it, given that few initially-below-poverty-line

borrowers select HVEs, and the fact that those who do earn comparatively high enterprise incomes which approach the poverty line.

**Table 7.4: Median enterprise income by occupation and pre-loan income category**

Enterprise occupation	Pre-loan income category		
	Extreme-poor and poor	Near-poor and non-poor	All
<b>LVEs</b>	<b>1,500</b>	<b>3,000</b>	<b>2,000</b>
Single season cultivation	1,900	3,000	2,700
Low-value manual production	1,500	2,700	2000
Fishing and small-scale livestock	1,250	-	1500
Kades and house-to-house mobile trade	1,500	1,600	1500
<b>HVEs</b>	<b>3,500</b>	<b>6,000</b>	<b>6000</b>
Mobile <i>pola</i> trade	3,250	5,000	4,000
Specialised retail trade, tea-shops, vegetable wholesale trade	-	6,500	6,000
Two-season cultivation	3,900	5,600	4,300
Skilled manual occupations	4,100	5,900	5,500
Services and high value occupations n.e.s.	-	7,250	7,250
<b>Total</b>	<b>2,000</b>	<b>4,250</b>	<b>3,000</b>

As Table 7.5 indicates, LVE selection is closely associated with initial income in all locations. As chapter 6 showed, in remote rural regions geographical constraints impose a near-absolute barrier to the development of higher-value alternatives; as a result the proportion of LVEs among rural enterprises is very high at 67 per cent (rising to 87 per cent outside the Uda Walawe scheme). In urban and semi-urban areas, where more favourable demand and infrastructure conditions offer scope for the development of a range of enterprises, some with considerable earnings potential, the proportion of LVEs is considerably lower. Nevertheless one in three urban and semi-urban borrowers select LVEs, a proportion which rises to close to two thirds below the poverty line, despite the availability of higher-value alternatives, indicating the influence of non-location poverty-linked factors on occupation selection.

**Table 7.5: LVE selection by pre-loan income group and location (per cent selecting LVEs)**

Pre-loan income group	Location		
	Urban and semi-urban	Rural	All
Extreme poor	72.7	94.1	85.7
Poor	58.3	81.1	69.5
Near-poor	41.2	67.6	54.9
Non-poor 1	17.9	38.5	24.3
Non-poor 2	12.5	14.3	13.3
<b>Total</b>	<b>36.4</b>	<b>67.4</b>	<b>53.4</b>

### 7.3 Impact of financial factors on enterprise selection and earnings

In poor households weaker asset bases and smaller income flows discourage investment in high-risk, high-return activities by limiting access to the larger investment funds required for HVEs and reducing their ability to cope with debt.

#### 7.3.1 Enterprise capital requirements

Even with access to microcredit, poor households are unable to finance the high capital requirements of VHVEs and most rural HVEs, which are beyond the NGO's group-based lending limits and are therefore restricted to non-poor borrowers who have access to additional investment funds in the form of alternative lending sources, income streams or savings. Table

7.6. which describes the capitalisation of the sample microenterprises, shows significant variations between occupations in the value of enterprise assets and recurrent expenses. The asset bases and ongoing capital requirements of LVEs are considerably lower than those of HVEs, although there are variations within LVE occupations, with significantly higher average capital requirements among petty traders than among small-scale fishing, farming and manual occupations. Among HVEs there is a clear distinction between enterprises which earn less than Rs.8,000 per month, and highly capitalised very high-earning enterprises (VHVEs), which earn net monthly profits in excess of Rs.8,000.

**Table 7.6 Mean expenditure on fixed assets and working capital by occupation**

Enterprise occupation	Frequency	Mean monthly working capital and enterprise assets** recurrent expenses*	Mean value of
<b>LVEs</b>	<b>135</b>	<b>6,700</b>	<b>7,000</b>
Single season cultivation	48	9,000	7,500
Low-value manual production	38	4,100	3,800
Fishing and small-scale livestock	23	1,300	1,100
Kades and house-to-house mobile trade	26	12,500	15,400
<b>HVEs (monthly earnings &lt;Rs.8,000)</b>	<b>86</b>	<b>14,000</b>	<b>30,000</b>
Mobile <i>pola</i> trade	16	14,600	21,900
Specialised retail trade, tea-shops, vegetable wholesale trade	14	20,400	35,800
Two-season cultivation	25	10,000	36,000
Skilled manual occupations	24	10,200	18,900
Services and high value occupations n.e.s.	7	14,700	37,500
<b>VHVES (monthly earnings ≥Rs.8,000)</b>	<b>32</b>	<b>57,700</b>	<b>94,600</b>
Mobile <i>pola</i> trade	5	67,900	48,000
Specialised retail trade, tea-shops, vegetable wholesale trade	7	63,700	121,900
Skilled manual occupations	13	69,500	88,400
Services and high value occupations n.e.s.	7	22,600	120,100
<b>Total</b>	<b>180</b>	<b>15,600</b>	<b>37,900</b>

\* Includes loan repayments, raw materials and supplies, wages, rent, transport, fuel and power.

\*\*Includes tools, plant, vehicles, livestock. Excludes land and pre-existing buildings but includes building construction and improvements undertaken since start of project. Details of enterprise asset ownership were taken from a representative sub-sample of 87 borrowers. Building improvements were assigned a value on the basis of the respondent's recollection of expenditure. Values of other assets were derived by taking inventories of enterprise assets and assigning each item a value on the basis of 1999 retail prices, and do not take depreciation into account.

VHVEs, which are most common in urban retail trade and service occupations, large-scale cattle and poultry production, vegetable wholesaling in the Uda Walawe scheme and some skilled manual occupations, account for about a third of non-farm HVEs. They are distinguished from the other sample enterprises by the fact that most were well-established high-earning businesses prior to the first microcredit loan, by their vastly higher capitalisation and the relative insignificance of microcredit as a source of funds. They are relative newcomers to the NGOs, their median length of membership being 3.5 years, in comparison to the sample-wide median of 6 years. Their initially non-poor owners thus owe relatively little of their success to microcredit, which for most VHVEs is a useful rather than essential input (see case studies 12 and 13). They tend to finance their more expensive fixed assets with their own savings or with bank loans and use microcredit for relatively small working capital loans. Although the interest rates on NGO loans are slightly higher than the standard bank lending rates but are not a significant deterrent to

this group of borrowers, who see them as an acceptable trade-off for greater ease and accessibility of funds.

Both the overall scale of VHVEs, and the "lumpiness" of their capital requirements create barriers to entry for poorer borrowers. As Table 7.6 shows, monthly recurrent expenditures in most VHVEs are equivalent to a year's household income at the poverty line: the gulf between the capital requirements of VHVEs and rural HVEs and the financial capacity of low-income households creates an unacceptable lending risk which is magnified by borrowers' inability to offer collateral. Moreover the high unit costs of assets owned by VHVEs and rural HVEs do not fit well with the standard model of microenterprise development, which is based on incremental asset growth through repeated small loans. As Table 7.7 shows, the unit costs of assets commonly employed in VHVEs, such as tractors, vans, and the machinery employed in large manual and livestock enterprises, are usually well in excess of the group-based loan size limits of Rs.30,000 in the WDF and Rs.50,000 in SEEDS. Other VHVEs such as vegetable wholesaling and the largest mobile trade operations are somewhat less reliant on fixed assets, but are high-turnover activities which require regular access to large volumes of cash. Uda Walawe vegetable traders, for instance, who convey truck-loads of vegetables twice a week to the Colombo wholesale markets, typically spend more than Rs.30,000 on each trip. Rural borrowers are particularly adversely affected by the gap between NGO loan size limits and the initial investment requirements of locally-available HVEs. Like VHVEs, rural HVEs such as tractor-hire enterprises and rice mills involve high initial investment requirements which impose a barrier to poorer rural borrowers.

**Table 7.7: Enterprise asset ownership by occupation status**

Occupation status	Enterprise assets typically owned*
LVEs	Bicycle (Rs.3,000), non-electric tools (less than Rs.1,000 per unit), owner-constructed clay or cadjan kiosk, canoe (Rs.3,000), fishing net (Rs.2,500), owner-constructed kiln, sewing machine (up to Rs.15,000), up to 10 goats (Rs.1,800 per breeding female), up to 50 chickens (Rs.200 per laying female)
HVEs	Basic power tools (Rs.3,000 - 15,000 per unit), electricity supply (Rs.6,000), domestic refrigerator (Rs.26,000), semi-urban brick workshop (construction costs Rs.15,000), pumpset irrigation equipment (Rs.26,000 - 36,000)
VHVEs	Tractor (Rs.130,000 - 500,000), van (from Rs.200,000), motorcycle (Rs.50,000), commercial baking oven (Rs.50,000), sophisticated power tools (Rs.20,000 - 50,000 per unit), poultry farms with 1,000-plus chickens, cattle herds (Rs.5,000 - 10,000 per head), shop in town centre, coir mill (Rs.300,000)

\* Purchase prices are based on June 1999 Hambantota retail prices

While caps on their access to microcredit compel paddy-farmers to supplement their NGO loans with informal sector borrowings, non-farm borrowers are less likely to use non-NGO sources of finance, as microcredit is sufficient to cover the capital requirements of most non-farm enterprises. About one third of non-farm borrowers reported using non-NGO funds to purchase enterprise assets. As Table 7.8 shows, both the proportion of borrowers using additional capital and the contribution of additional capital to the value of enterprise assets increase with enterprise value. Among non-farm borrowers who reported using non-microcredit funds, the most important source of additional capital was household savings, used by 70 per cent of borrowers. Other additional capital sources included assistance from relatives, collateral-based NGO loans and bank loans. Only 10 per cent used loans from moneylenders, a reflection of the relatively high

income status of non-farm borrowers using additional capital sources, and their ability to raise funds from their own resources or from cheaper sources of alternative finance.

**Table 7.8: Non-farm enterprises: proportion of microcredit-financed enterprise assets by enterprise type**

Enterprise type	Non-microcredit finance as mean percentage of total investment in enterprise assets	Proportion of borrowers using additional finance
LVEs	12.2	13.4
HVEs	20.3	43.3
VHVEs	43.6	100.0

In their endeavours to attract a well-off urban client base, both NGOs have recently introduced collateral-based loans of up to Rs.500,000 at rates comparable with bank lending rates and which are approved by district-level NGO staff rather than by the borrower's peer group. SEEDS offers "equipment loans" of Rs.50,000 - 100,000 and "prosperity loans" of up to Rs.500,000, at a lower interest rate of 22 per cent which is comparable with bank lending rates. The WDF has recently introduced a collateral-based loans scheme offering loans of up to Rs 300,000 at bank interest rates. As eligibility for these loans is based on standard banking criteria rather than peer group guarantees they do little to assist poorer borrowers to overcome the barriers to entry imposed by the capital requirements of the highest-performing projects. At the time of the survey thirteen borrowers had taken collateral-based NGO loans ranging between Rs.30,000 and Rs.100,000, but their popularity is likely to increase as it will encourage the owners of VHVEs to make more intensive use of NGO services in the future.

### 7.3.2 Other financial obstacles

High capital requirements form a barrier to entry to rural HVEs; but in urban and semi-urban areas, where a diverse range of occupational choices includes HVEs whose performance is less dependent on large initial capital outlays and more responsive to incremental capital improvements, loan size limits are a barrier only to very high-earning activities such as those described in case studies 12 and 13. As Table 7.7 shows, the unit costs of electricity installation, refrigerators, power tools and other assets typically used by mid-range HVEs are within the scope of group-based NGO loans. A loan of Rs.20,000 is sufficient to cover the initial capital costs of many HVEs, particularly in food processing and other manual trades. Microcredit thus offers scope for the development of mid-range HVEs through incremental asset growth, as illustrated by case studies 9 and 10. Nevertheless, even where microcredit provides access to sufficient finance for HVEs, poor households are reluctant to make use of it.

As described in chapter 2, NGO lending practices and the attitudes of less-poor members may affect the access of poorer borrowers to loans. If discriminatory practices prevent the poor from obtaining the larger loans required for HVEs, they may account for their tendency to select LVEs and thus to benefit less from microcredit. Among the sample NGOs, restrictions on loan access apply to new borrowers and those whose peer group members are in arrears. While there is no formal stipulation limiting the size of loans to new borrowers, village society officials and members reported that while non-poor new members receive initial loans of Rs.20,000 or more, the peer groups which appraise loan applications tend to exercise caution in lending to poor newcomers, who may be issued one or two small loans, typically below Rs.7,500, and do not receive larger loans until they have convinced other members of their creditworthiness. As discussed on chapter 4, when a peer group member falls into arrears, conditions are imposed on the loan access of other members, or they denied access to group-based loans altogether, depending on the extent of the arrears. As borrowers who are in arrears are nearly all below the

poverty line, and peer groups tend to be socioeconomically homogeneous, poorer borrowers are more likely than others to be adversely affected by group liability requirements.

Although restrictions on loan access bear disproportionately on the poor, they are unlikely to be a major factor in the tendency of poor borrowers to select LVEs. The loan size restrictions imposed on poor newcomers are a temporary impediment which is lifted after one or two years; and those whose peer group members are in arrears are usually rural and very poor (most of the arrears in the sample occurring among the poorer single-season farmers) and therefore unlikely to select HVEs in any case. Significantly, the owners of non-farm LVEs were the least likely of all borrowers to report that limited access to finance had influenced their selection or created problems for their enterprises. Not surprisingly, paddy-farmers were the most likely to report a problem with limited access to credit. Additionally some owners of mid-range HVEs complained that they were unable to purchase large units of equipment as the group-based loans were too small and they were unable to provide collateral for larger loans or raise funds from other sources - suggesting that the capital requirements of VHVEs impose barriers to entry for all but the most prosperous.

The evidence indicates that demand-side factors, rather than restrictions on their access to microcredit, are the main reason why poor borrowers select LVEs. Given their lack of economic resources, the consequences of project failure for household well-being are more severe. Poverty intensifies pressure on borrowers to allocate scarce funds to consumption expenditure rather than investment, and to sacrifice higher-risk fixed capital investments which produce higher delayed returns in favour of low-risk working capital investments which provide immediate cash flows. As a result of these factors, poor borrowers are more risk-averse than the less-poor and use their loans less productively.

The degree of risk involved in an investment depends partly on the borrower's ability, in the event of enterprise failure or prolonged period of negative returns, to finance consumption and loan repayments from non-project resources without compromising living standards or longer-term economic security. Such ability is a function of current economic status: the households which are most able to tolerate risk are those with sound asset bases and income flows, and access to alternative income sources should they become necessary. As chapter 5 showed, less-poor households are more likely to receive steady income flows from regular wage employment, remittances and other household microenterprises, while poorer households rely on fewer, smaller and less regular sources of income, mostly from farming, seasonal wage-labour and government welfare programs. Stable and relatively large income flows and sound asset bases not only provide a last-resort safety net in the event of project failure; they also support loan repayments and consumption through the initial lean periods commonly associated with new HVEs, many of which earn low or negative net incomes during the first six to twelve months of operation while their owners develop skills and markets, and through seasonal fluctuations and shocks which may threaten the viability of microenterprises in more vulnerable households. Because the poor rely on their enterprise incomes to repay their loans they cannot afford to operate enterprises which sustain net losses, even for a short periods, and therefore tend to invest in semi-subsistence activities and projects which generate immediate cash flows, rather than the longer-term investments which are more likely to facilitate poverty exit.

For poor borrowers who have difficulty meeting their basic survival needs the adverse social and material consequences of falling into arrears create an extreme reluctance to incur high levels of debt. The NGOs adopt a humane approach to borrowers who fall into arrears through poverty, often rescheduling loans a number of times, and resorting to legal action only in cases of "wilful default" where borrowers who are deemed capable of repaying their loans seek to avoid their



obligations. They do not engage in the extreme loan recovery measures reported by observers of some Bangladesh credit programs<sup>1</sup> (Montgomery et al 1996). Borrowers who fall into arrears are however subject to considerable social discomfort in the form of close attention by NGO staff and intense pressure from other group members and their families, which creates a powerful incentive to forgo consumption in order to clear their debts as quickly as possible.

In poor households, where there are competing uses for scarce funds, microenterprise loans are more likely to be diverted for non-enterprise purposes. As Table 7.9 shows the propensity to use loans for non-enterprise purposes is inversely associated with income. Among borrowers who diverted microenterprise loans, the near-poor and non-poor were more likely to divert loans to other household microenterprises or non-essential consumption such as housing improvements; while poorer households were more likely to use loans for survival purposes such as food purchases, medical expenses and the repayment of debts to moneylenders. Unlike many microfinance programs which make no distinction between loans for enterprise and consumption purposes, both NGOs operate a variety of separate consumption lending programs, most of which offer short-term loans at lower interest rates than those attached to microenterprise loans (see chapter 4). As the interest differential discourages the use of microenterprise loans for consumption, the borrowers most likely to do so are poorer members who have an urgent need for cash which cannot be raised from other sources, and are unable to access the cheaper NGO consumption loans, usually because they have existing loans outstanding. The very high propensity of the extreme-poor to divert their loans is due in part to their participation in the CIDA program, under which some were issued loans of Rs.10,000 with little regard for the actual capital requirements of their enterprises (see chapter 4). As most CIDA participants were involved in very small-scale fishing and backyard poultry-rearing projects which were unable to absorb large inputs of credit, they were left with excess funds which they used for consumption (see case study 1).

**Table 7.9: Use of most recent loan for non-enterprise purpose by household income**

Current income category	Percentage using part of loan for non-enterprise purposes
Extreme-poor	45.0
Poor	36.1
Near-poor	20.0
Non-poor 1	13.6
Non-poor 2	13.5
<b>Total</b>	<b>24.9</b>

#### **7.4 The impact of human capital and sociocultural factors on enterprise selection and earnings**

The first consideration in a borrower's assessment of risk has to do with the consequences of a loss. The second has to do with the probability that a loss will occur. Poor borrowers avoid HVEs because they believe that given their resource deficiencies such projects run an unacceptably high risk of failure, an assessment which has considerable justification. As we have seen, the market-access and infrastructure requirements of most HVEs, and the capital requirements of rural and very high-earning HVEs, create absolute barriers to entry, and poor borrowers and those who live in underdeveloped areas judge correctly that their chances of developing a successful HVE are minimal. Additional barriers to entry are imposed by the technical and business skills requirements of many HVEs, limitations on mobility and productivity imposed by poor health and the absence of able-bodied adults in extreme-poor households, and anti-entrepreneurial social and psychological traits which are characteristic of



disempowerment: low social status, a cultural environment which discourages upward mobility and competition, illiteracy and poor communication skills and a low sense of personal efficacy.

The possession of technical occupation-related skills appears to be more important than formal school qualifications in enterprise selection. While formal education is associated with higher-value enterprises (see Table 7.10), completion of secondary school is neither a prerequisite for nor guarantee of microenterprise success. The owners of VHVEs are significantly more likely than others to have completed secondary school, but nearly half of the VHVEs and about 60 per cent of other HVEs, particularly the skilled manual trades enterprises and irrigated farms are owned by non-graduates. The weakness of the relationship between formal education and enterprise earnings is further suggested by the fact that nearly a third of LVE owners are secondary school graduates. On the other hand, the fact that not one of the 19 respondents with no schooling had selected an HVE suggests that illiteracy may present a barrier to entering higher-value occupations.

**Table 7.10: Enterprise occupation type by education of borrower (per cent)\***

Borrower education level	LVEs	HVEs (earnings < Rs.8,000)	VHVEs	All
No schooling	12.1	-	-	7.5
Primary schooling	36.4	29.6	29.7	32.8
Some secondary school	20.5	30.9	18.9	23.3
Completed secondary school	31.0	39.5	51.4	36.4
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

\* The survey collected information on the education levels of borrowers but not of enterprise operators. Borrowers and operators are not always identical due to the tendency, discussed below, for women borrowers to transfer project management to their male relatives. As men have marginally more years of education on average than women the use of borrower education levels as a proxy may underestimate operator education status. The differences are small however as gender inequalities in education in Sri Lanka are minimal and education levels within households are generally homogeneous.

Technical skills requirements form a significant barrier to entering some higher-value manual and service occupations which might otherwise be accessible to poorer semi-urban and urban borrowers. The high-level skills required for furniture-making, motor mechanics, jewellery-making, pastry-cooking and indigenous medicine production are developed over time; nearly all borrowers in these occupations had worked for several years as wage employees or in family enterprises prior to starting their own businesses. Furthermore one third of the owners of higher-value manual enterprises had completed vocational training courses of six to twelve months duration offered by the National Youth Services Council, Department of Labour and other government agencies. As they come under the umbrella of Sri Lanka's public education system, the state-sponsored vocational training courses are nominally free of charge. In practice however they are inaccessible by poor households which are unable to meet the costs of accommodation (most courses are conducted outside the district) and participants' foregone wages.

The poor are least likely to possess entrepreneurial aptitudes and aspirations. The owners of LVEs tended to take a passive approach to enterprise selection: they were far more likely than others to cite "copying others" as the primary determinant of their choice, and few had investigated alternatives. The owners of higher-value production and trade activities on the other hand tended to base their selection of projects on previous experience and training, and to seek out market opportunities. The business relationships associated with wage labour and traditional LVEs may be unprofitable and exploitative, but they have the advantage of being well-established, predictable and relatively low-risk. For poor borrowers the relative simplicity and familiar relationships with buyers

and suppliers developed over time in traditional activities may be preferable to the extra risk, responsibility and learning of unfamiliar skills required by more complex non-traditional microenterprises.

In urban communities, where the growth of the cash economy and new forms of economic organisation have broken down traditional patron-client relationships and their associated ties of mutual obligation (although traces of them may still be found in local political processes), borrowers are individualistic and their business decisions tend to be based on commercial considerations rather than non-economic relationships. In rural communities and the more isolated semi-urban villages, however, cultural attitudes which prioritise the communal good over individual interests, and social relations based on kinship ties and mutual obligation between patrons and clients may inhibit entrepreneurial activity among poorer households (Brow 1996). Villages are socially conservative communities with well-established social hierarchies. The prospect of social conflict may deter poorer producers from challenging established economic relationships - for example, by introducing marketing arrangements which compete with or bypass powerful village traders (Menike 1992). Among the sample it was noted that the accumulation of wealth, impossible to conceal in village communities, appears socially acceptable among higher-status families, but is viewed as a mixed blessing by poorer households as it attracts unwelcome attention from envious neighbours and from relatives in search of assistance. Where a large number of identical microenterprises are clustered in a single village, a common arrangement in Sri Lanka where occupations are caste-based or require a particular localised natural resource, there is strong social pressure on individual producers not to engage in price competition. Among the brick-makers in Palugasgodella, who produce an identical product and compete in identical markets, it was acceptable to compete in terms of output, but there was a strong social prohibition on price competition and no individual brick-maker in Palugasgodella was prepared to lower prices.

As they operate in the unorganised sector of the economy most microenterprises have little contact with regulatory authorities, but some urban and higher-value trading enterprises depend on the support of local politicians and officials, creating barriers to entry for the poor and unconnected. Many urban roadside microenterprises breach zoning and building construction regulations: while these technical illegalities are usually ignored by regulatory authorities, they have in some cases given rise to attempts by police and other officials to extract "protection" payments. Connections with politicians and high-level officials protect owners from such harassment which may otherwise constitute a debilitating unofficial tax. In the *pola* trade, which is regulated by a licensing system controlled by town officials, permits to set up stalls are scarce and fiercely contested, and were reported to depend on access to politicians and bureaucrats. Because of the civil conflict in Sri Lanka vehicles using the main roads are regularly stopped and searched, and for vegetable wholesalers transporting goods to Colombo letters of introduction from local police chiefs or politicians are necessary to avoid long delays at police checkpoints.

Most extreme-poor households face particular disadvantages of class and caste which reduce the range of viable microenterprise opportunities open to them. In urban communities caste has little impact on economic and social relations, surfacing only in relation to arranged marriages and some ceremonial occasions<sup>2</sup>. In the sample villages however, where lower-caste communities live in separate areas and have limited social interactions with other villagers, caste appears to have a significant impact on opportunity. In such environments economic transactions between members of lower and higher castes are regulated by custom and are limited to traditional activities such as fish-trading and labour-hire; while low-caste borrowers may be able to develop enterprises which trade in non-local markets, social discrimination places them at a severe disadvantage in operating local retail and service activities.

As discussed above, labour supply is limited in some extreme-poor households (see chapter 5), which are smaller on average than other households. They are more likely to be female-headed, which has a significant impact on enterprise selection and earning capacity, discussed below. Gender, poor health status and household labour shortages limit the mobility and productivity of extreme-poor borrowers. Labour supply constraints rule out most higher-value manual enterprises which require considerable labour inputs from two or three workers, and may limit borrowers to LVEs which are typically staffed by a single operator working part-time. Poor health was a commonly reported problem among poor and extreme-poor borrowers, imposing a significant restriction on enterprise earnings by limiting working hours and the productivity of manual LVEs (see case study 2).

## **7.5 Impact of gender and other household economic activities on microenterprise selection and earnings**

As discussed above, access to geographical, financial and human capital resources are key influences on microenterprise selection and performance. As access to these resources is poverty-linked, poor borrowers earn lower incomes from their microenterprises. Not all determinants of microenterprise incomes are directly poverty-linked, however. The gender of the microenterprise operator, and borrowers' decisions regarding the role of the enterprise in the household economy are also important factors in selection and performance. Although women's microenterprises earn less than those managed by men, most households have a range of income sources which offset the low earnings of women's projects. As a result there was no general relationship between the gender of the enterprise operator and overall household income, except in a small minority of households which are female-headed, where the gender of the operator is a significant poverty factor. Some households with substantial additional income sources allocate the bulk of their resources to non-microenterprise activities: in such cases low microenterprise incomes are inversely associated with the household's total income.

### **7.5.1 Gender**

All WDF borrowers, and two thirds of SEEDS borrowers are female. Although women comprised over three quarters of the sample borrowers only 38 per cent of projects are managed by women as over half of the female borrowers transfer their loans to male relatives. Paddy-farming, fishing and most higher-value manual trades (with the exception of food processing) are almost exclusively male activities and loans for these purposes issued to women are almost always transferred to men. Women are most likely to retain control of loans issued for traditionally female occupations such as livestock-rearing, kades, garment-making and other home-based production activities. While the transfer of loans to men may reduce their effectiveness as a direct means of economic empowerment for women vis-a-vis men, the net economic benefit to women and children is usually greater, given the restricted economic opportunities available to women, if they are allocated to men's microenterprises. There was little evidence of any offsetting effects resulting from a propensity, noted by some researchers and described in chapter 2, for male project managers to retain their earnings rather than contribute them to the household. The gender of the project manager appears to have little effect on the share of project earnings contributed to the household pool: when questioned in all-female focus groups some non-poor respondents reported that male household members retained a portion of their earnings for their own use; but most women, particularly the poor, stated that all household income was pooled in a common fund.

Women's enterprises earn considerably less than men's, for a number of reasons. First, gender-based occupational segregation and limitations on women's mobility restrict their ability to engage in many higher-earning activities. Second, gender discrimination similarly reduces

women's wage labour market access and lowers the opportunity cost of their labour. As a result LVEs are generally operated by female household members rather than men, who can often earn higher incomes in wage employment. Third, when women's enterprises are successful there is a tendency for male household members to assume control of them.

**Table 7.11: Median project earnings by gender of project manager**

Enterprise occupation	Female manager		Male manager	
	Frequency	Median enterprise income	Frequency	Median enterprise income
<b>LVEs</b>				
Single season cultivation	5	1,000	41	2,700
Low-value manual production	25	2,000	12	1,750
Fishing and small-scale livestock	7	500	16	1,500
Kades and house-to-house mobile trade	19	1,500	7	2,000
<b>HVEs</b>				
Mobile <i>pola</i> trade	2	-	19	3,500
Specialised retail trade, tea-shops, vegetable wholesale trade	9	4,000	12	7,500
Two-season cultivation	-	-	28	4,300
Skilled manual occupations	14	2,700	23	7,250
Services and high value occupations n.e.s.	4	2,000	10	10,300
<b>Total</b>	<b>85</b>	<b>2,000</b>	<b>168</b>	<b>3,400</b>

Occupational segregation is most disadvantageous for women in rural areas because paddy-farming, the most profitable and in some cases virtually the sole available activity, is restricted by custom to men, with often devastating consequences for female-headed households. Under some customary land tenure arrangements, when a man dies his land is passed to his brothers or other male relatives, who are under no formal obligation to provide for his widow and children (see case study 2). Female household heads who have secure tenure of their land are in a somewhat better position, but unless they can secure the assistance of male relatives or have sufficient funds to employ a farm manager they are obliged to rent their land to neighbours for very low returns of Rs.4,000 - 5,000 per acre per season. As rural women have few local employment options the incidence and depth of poverty is very high for rural female-headed households, which have an average household income of Rs.2,800. Such households were under-represented in the sample because of the high propensity of rural female household heads to migrate for employment, either to Western Province garment factories or overseas, leaving their children with relatives.

In the semi-urban and urban non-farm sector gender-based occupational segregation is also present and is an important factor in male-female microenterprise income disparities. Men predominate in the most profitable skilled manual occupations and mobile trading enterprises, while women are concentrated in low-value part-time home-based activities such as garment-making and suburban kades. Not all high-value occupations are reserved for men: women are present in significant numbers in some high-value occupations such as food processing, and as the gender boundaries around male-dominated non-farm occupations are less rigid than those associated with agriculture and fishing, they are not completely closed to women. Female household heads had a degree of freedom in project selection and mobility that was not evident among married women. Among the small number of women who enter male-dominated occupations, most are female household heads: one widow, for example, assisted by NGO-sponsored technical training, was making a moderate success of an urban welding workshop inherited from her husband; another widow was operating a mobile vegetable trading business.

Socially imposed restrictions on the mobility of married women appear linked to economic status and social class: a family unit in which a male primary earner supports a wife who does not work outside the home is seen by both men and women as a desirable ideal but in practice it is a luxury which few households can afford. In enterprises which combined home-based production with travel outside the local area there was a clear gender-based division of labour. Men were responsible for dealing with suppliers and selling the finished products at local *polas*, while women took charge of any components of the project which could be carried out at home and, as they were usually the nominal borrowers, for weekly loan repayments and other loan-related duties such as meeting attendance and *shramadana*. In poorer households, where it is common for women to work outside the home as seasonal labourers or to migrate for employment, women engage in home-based LVEs because of a lack of alternative opportunities rather than gender-related social pressures. The success of a small number of urban female-managed microenterprises and the entry of a few female household heads into higher-value male-dominated occupations indicate that in urban areas at least, gender restrictions are not an absolute barrier to the development of women's HVEs, and suggest scope for NGO gender awareness programs promoting women's entry into higher-value non-traditional occupations.

Low-value occupations such as chicken and goat-rearing, garment-making, coir rope-making and the running of rural *kades* are female-dominated partly because they are part-time home-based occupations which can be combined with domestic duties, and also for economic reasons associated with the low opportunity cost of women's labour. For men the incomes from wage labour usually exceed the earnings of non-farm microenterprises, even in rural areas, but as wage employment opportunities for women are both extremely scarce and poorly paid, it is economically rational for women to take charge of low-value home-based enterprises.

Occupational segregation does not wholly explain gender earnings differentials: as Table 7.11 shows, women earn significantly less than men even in occupations which are relatively non-segregated or mainly female. The stronger performance of male-managed microenterprises within particular occupations is explained by a tendency within households for men to assume control of strongly-performing microenterprises, in some cases abandoning their own wage employment or microenterprises to take over the management of successful projects begun by their female relatives, while women retain control of poorly performing activities. There are, however, a number of notable exceptions to this rule, in which women retain the management of their high-value trade, food-processing and livestock projects, or share responsibilities equally with male relatives. It appeared that women were particularly likely to retain control of projects which were financed by their overseas earnings, suggesting a connection between the size of women's economic contributions and their intra-household bargaining power and economic independence.

### 7.5.2 The enterprise in the household economy

In some non-poor households the presence of additional income sources is a disincentive to microenterprise development as it may reduce borrower commitment to the enterprise: a household with one or two members in regular employment, or an established microenterprise, has less motivation to invest substantial resources in a new activity. Some non-poor borrowers select LVEs, even when higher-return microenterprise opportunities are available, or operate HVEs at sub-optimal levels, because they choose to concentrate their resources on wage employment or other self-employment activities (see case study 8), or have reached an economic threshold at which increases in leisure are valued more highly than income increments. In remote rural households, where as noted in the previous section incomes from non-farm LVEs are lower than those from seasonal wage labour, borrowers operate their loan-assisted microenterprises during off-seasons and abandon them when higher-earning activities become

available. In urban and semi-urban households where a member is in regular wage employment, particularly in the public sector, wage income is often comparable with the earnings of HVEs, and is preferred as a more stable, lower-risk and higher status income source.

A number of non-poor households operate low-value enterprises as a secondary occupation: about 40 per cent of low-value urban enterprises are operated by non-poor households as an auxiliary income source. Nearly all of these auxiliary projects are part-time home-based activities such as garment-making, suburban kades and backyard livestock enterprises, operated by women who combine them with housework and childcare. The primary income earners are usually males in wage employment or operating other higher-value microenterprises. Auxiliary microenterprises share most of the characteristics of other LVEs, in particular low levels of investment and capitalisation, low growth potential, low labour input and use of earnings for consumption; but differ in their role in the household economy and the characteristics of their operators. The operators of auxiliary microenterprises typically have two or three larger sources of regular income, while the additional income sources of operators of livelihood enterprises are fewer, smaller and less regular. Even without their microenterprise income, non-poor households operating auxiliary microenterprises would be above the poverty line; while many operators of other LVEs are below the poverty line even with their microenterprise income, and all would fall below the poverty line without it.

#### 7.6 Impact of microcredit on household incomes and poverty

This section examines patterns of income change and the extent to which the loan-assisted microenterprises have contributed to improvements in household income. Table 7.12 compares changes in household income between pre-loan income groups during program participation. A distinct improvement in incomes has occurred in 60 per cent of borrower households: nearly a quarter have experienced substantial income growth of more than Rs.1,000, and over a third have experienced moderate income growth between Rs.500 and Rs.1,000. In another third of households incomes have stagnated or grown marginally by less than Rs.500, and in 8 per cent incomes have fallen. There is a strong and consistent positive relationship between initial household income and the propensity for income growth: initially below-poverty-line households are more than twice as likely as those in the non-poor categories to have experienced stagnating or falling incomes, at 54 and 23 per cent respectively, and three times less likely to have experienced income growth of more than Rs.1,000, at 14 and 45 per cent respectively.

Table 7.12: Post-credit growth in household income by pre-loan income

Table 7.12: Post-credit growth in household income by pre-loan income						
Post-credit growth in household income	Pre-loan income category					Total
	Extreme poor	Poor	Near-poor	Non-poor 1	Non-poor 2	
Frequency						
More than Rs.1,000	2	13	14	17	15	61
Rs.500-1,000	10	26	32	12	11	91
Less than Rs.500	12	41	19	7	3	82
Decline in income	4	3	6	5	1	19
Total	28	83	71	41	30	253
Per cent						
More than Rs.1,000	7.1	15.7	19.7	41.5	50.0	24.1
Rs.500-1,000	35.7	31.3	45.0	29.3	36.7	36.0
Less than Rs.500	42.9	49.3	26.8	17.1	10.0	32.4
Decline in income	14.3	3.7	8.5	12.1	3.3	7.5
Total	100.0	100.0	100.0	100.0	100.0	100.0

As Table 7.13 shows, rates of household income growth vary considerably with location, with non-Uda Walawe rural borrowers being more than twice as likely as urban and semi-urban borrowers to have experienced stagnating or falling incomes, and far less likely to have experienced Rs.1,000-plus income growth.

**Table 7.13 : Household income growth by location (per cent)**

Post-credit growth in household income	Urban (N=52)	Semi-urban (N=66)	Uda Walawe (N=33)	Other Rural (N=102)	Total (N=253)
<b>Frequency</b>					
More than Rs.1,000	25	19	8	9	61
Rs.500-1,000	16	31	12	32	91
Less than Rs.500	10	11	13	48	82
Decline in income	1	5		13	19
<b>Total</b>	<b>52</b>	<b>66</b>	<b>33</b>	<b>102</b>	<b>253</b>
<b>Per cent</b>					
More than Rs.1,000	48.1	28.8	24.2	8.8	24.1
Rs.500-1,000	30.8	47.0	36.4	31.4	36.0
Less than Rs.500	19.2	16.7	39.4	47.1	32.4
Decline in income	1.9	7.6	-	12.7	7.5
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

Table 7.14, which compares the pre- and post-loan income distributions of the sample, shows that program participation has coincided with a marked improvement in the sample's poverty profile, with a substantial reduction in the number of households below the poverty line and an even larger increase in the number of households in the highest income category. While the overall direction of income change has been positive, with 60 per cent of households having experienced some improvement (Table 7.12), the size of the improvement has however been too small in most cases to enable graduation to a higher category, and over half of the sample households have remained in their pre-loan income categories.

**Table 7.14: Household poverty status of sample: current poverty status**

Income category	Pre-loan income status		Post-loan income status	
	Frequency	Per cent	Frequency	Per cent
Extreme poor	28	11.1	20	7.9
Poor	83	32.8	72	28.5
<b>Total below poverty line</b>	<b>111</b>	<b>43.9</b>	<b>92</b>	<b>36.4</b>
Near-poor	71	28.1	65	25.7
Non-poor 1	41	16.2	44	17.4
Non-poor 2	30	11.9	52	20.6
<b>Total above poverty line</b>	<b>142</b>	<b>56.1</b>	<b>161</b>	<b>63.6</b>

Table 7.15 provides a more detailed description of patterns of income change at the household level, with information on source and destination income categories. There has been a degree of churning: 77 borrowers - close to a third of the sample - have graduated to higher categories, while the incomes of 17 have fallen substantially, relegating them to lower categories. Thus while about a quarter of initially below-poverty-line households have crossed the poverty line, nine initially above-poverty-line households have become poor, producing a net poverty exit rate of 17 per cent. Of the 111 households which were initially below the poverty line, 28 have exited poverty. While most of them joined the ranks of the near poor, nine graduated to non-poor status. The bulk of poverty exit occurred among initially-poor households, nearly one third of whom have crossed the poverty line. Only one of the 28 households exiting poverty was initially



extreme-poor, indicating obstacles to poverty exit among the poorest households. However in well over a third of initially extreme-poor households incomes have improved sufficiently to elevate them from extreme-poor to poor status although they remain below the poverty line. Similar rates of income category graduation have occurred among initially near-poor households, nearly a third of whom have become non-poor, and initially non-poor 1 borrowers, a third of whom have entered the non-poor 2 category.

**Table 7.15: Current household income by pre-loan income**

Pre-loan income category	Post-loan income category					Total
	Extreme poor	Poor	Near-poor	Non-poor 1	Non-poor 2	
Extreme poor	16	11	1	-	-	28
Poor	3	53	18	5	4	83
Near-poor	-	6	41	19	5	71
Non-poor 1	1	2	4	20	14	41
Non-poor 2	-	-	1	-	29	30
<b>Total</b>	<b>20</b>	<b>72</b>	<b>65</b>	<b>44</b>	<b>52</b>	<b>253</b>

Location is an important determinant of poor borrowers' chances of exiting poverty, as Table 7.16 shows: initially below-poverty line borrowers in semi-urban and Uda Walawe settlements, and particularly in urban areas, are twice as likely as their rural counterparts to have exited poverty.

**Table 7.16: Initially-poor and extreme-poor borrowers: current income by location**

Location	Current household income category					Total	Per cent exiting poverty
	Extreme-poor	Poor	Near-poor	Non-poor 1	Non-poor 2		
Urban	2	5	2	3	-	12	41.7
Semi-urban	5	14	7	-	2	28	32.1
Uda Walawe	-	5	1	2	-	8	37.5
<b>Sub-total</b>	<b>7</b>	<b>24</b>	<b>10</b>	<b>5</b>	<b>2</b>	<b>48</b>	<b>35.4</b>
<b>Other rural</b>	<b>12</b>	<b>40</b>	<b>9</b>	<b>-</b>	<b>2</b>	<b>63</b>	<b>17.5</b>
<b>Total</b>	<b>19</b>	<b>64</b>	<b>19</b>	<b>5</b>	<b>4</b>	<b>111</b>	<b>25.2</b>

To what extent do the patterns of income change described above owe their existence to the loan-assisted microenterprises? In about two-thirds of households which experienced income growth, the loan-assisted microenterprises were the principal source of growth. Not surprisingly, the contribution of the loan-assisted microenterprise to income growth was highest at the upper end of the initial income spectrum and in locations most favourable for microenterprise development. As Table 7.17 shows, the microenterprise was overwhelmingly the major source of income growth in initially non-poor 2 households. Its contribution to household income growth declines in the lower initial income categories, where it was the major growth factor in about two-thirds of initially non-poor 1 and near-poor households reporting increases in their incomes, and among extreme-poor borrowers, but was considerably less important among initially poor borrowers, where it was the main growth source in just under half of households. The relative insignificance of the loan-assisted enterprise as an income growth factor in initially poor and rural households is a reflection of the low growth potential of the LVEs operated by this group, and their propensity to spread their activities across a range of income sources. Among extreme-poor borrowers the relatively high importance of low-earning microenterprises to income growth indicates the scarcity of alternative economic opportunities available to the poorest households.



Tables 7.17-18 illustrate the considerable contribution of non-microenterprise sources to income growth. Remittances are a key contributor, being the principal growth factor in about one third of poor and rural households which experienced income growth. Similarly, the loss of remittance income was a major explanatory factor among the 19 households whose incomes fell during program participation. The return of a family member from the Middle East explains the relatively large proportion of initially non-poor 1 households which fell to lower income categories (see Table 7.15): overseas remittances are usually sufficient, while they last, to elevate poor households to non-poor 1 status, but the failure of most to invest their income productively means that they quickly revert to state of income poverty or near-poverty following the migrant's return, although as chapter 5 showed, the return is usually associated with welfare-enhancing investments in housing and consumer goods. Increasing participation in non-local labour markets often produces a net increase in household income in the short-term but, as argued in previous chapters, is an unsatisfactory solution to rural poverty because it is usually temporary; moreover most forms of non-local employment - in EPZ garment factories, the military or overseas - are likely to involve high personal costs to the migrant and his or her family.

**Table 7.17: Households experiencing income growth: main source of income growth by pre-loan income**

Main source of income growth	Pre-loan household income category					Total
	Extreme-poor	Poor	Near-poor	Non-poor 1	Non-poor 2	
Microenterprise	8	19	30	19	23	99
Local wage employment	3	7	7	4	1	22
Remittances	1	11	7	5	1	25
Other*	-	2	2	1	1	6
Total	12	39	46	29	26	152

\* Other self-employment activities, pensions and welfare transfers

**Table 7.18: Households experiencing income growth: main source of income growth by location**

Post-credit growth in household income	Urban	Semi-urban	Uda Walawe	Other rural	Total
Microenterprise	31	37	13	18	99
Local wage employment	3	6	6	7	22
Remittances	5	5	1	14	25
Other	2	2	-	2	6
Total	41	50	20	41	152

### Conclusion

HVEs are more likely than LVEs to experience post-credit increases in earnings, and their earnings grow by greater margins. Credit therefore has the most impact on the household incomes of owners of HVEs, who were often initially non-poor, and least on the owners of LVEs, who were often initially poor. The impact of microenterprise credit on poverty is thus limited by the high propensity of initially-poor borrowers to select low-earning enterprises whose incomes are relatively unresponsive to credit inputs. Poor borrowers select LVEs because they face a range of physical, financial and human capital constraints which constitute barriers to entering higher-value occupations. In remote rural areas, where physical limitations on demand and production capacity are so severe as to rule out the possibility of HVE development for all except

a small minority of borrowers who possess large financial resources, there is little prospect that microenterprise development can contribute significantly to poverty reduction. In urban and semi-urban areas, where physical conditions are more favourable for microenterprise development, poorer borrowers are deterred from selecting HVEs by sociological and human capital factors which may be more amenable to training and awareness-raising interventions. More poverty may be reduced by encouraging the urban and semi-urban poor to select HVEs than by continuing to support low-value activities with minimal growth potential. The prospects for the use of non-financial NGO interventions to encourage HVE selection are discussed in the following, concluding chapter.

What conclusions can be drawn about the impact of the loan-assisted microenterprises on poverty? The period of program participation coincided with a considerable improvement in the poverty profile of the sample. About 60 per cent of borrowers, and 46 per cent of those who were initially below the poverty line, experienced some household income growth during program participation. For a quarter of below-poverty-line households these increases were sufficient to enable poverty exit and another 10 per cent graduated from extreme-poor to poor status. Nearly two-thirds of initially near-poor households experienced some household income growth, and one third graduated to non-poor status.

The role of the loan-assisted microenterprises in generating income growth is somewhat less impressive, however. While increases in loan-assisted microenterprise earnings were the most important cause of household income growth, being the principal growth factor in two thirds of households whose incomes had increased, the microenterprise was a less important contributor to income growth in initially below-poverty line households than in the non-poor categories, where it was the main growth factor in 53 and 75 per cent of cases respectively. While improved microenterprise earnings are likely to have contributed to raising the incomes of most of the 25 per cent of initially below-poverty-line borrowers who exited poverty, in nearly half of these households non-microenterprise income sources - in particular, remittances - were the principal factors in income growth. Furthermore, loan-assisted microenterprises were unable to halt falling incomes in 19 households, 11 of which fell below the poverty line or fell from poor to extreme-poor during program participation. Thus given a net poverty exit rate of 17 per cent, perhaps 10 per cent is attributable to improvements in microenterprise earnings and much of the remainder owes its existence to remittances. In remote rural areas the contribution of microenterprise earnings to poverty exit is even lower. The low rate of enterprise-led poverty exit indicates that although microenterprise development may be an important component of a more comprehensive approach it is not sufficient by itself to produce a significant impact on rural poverty.

## Addendum to Part 2

### Case Studies

#### **Case study 1: a semi-urban fishing project in an extreme-poor household**

Geeta's household is located in a very poor and socially-disadvantaged fishing hamlet. Although its residents have good transport access to Hambantota town, being located about 5 kilometres out of town and near a bus route, they are isolated by their low caste and poverty. They lack mains electricity, and 30 households draw their water from a single communal tap. Geeta's and her husband's families have traditionally made a living as "fishing people", using hand-nets to fish in the lagoon and selling the catch to local traders. Geeta has taken only one NGO loan, when she was recruited in 1998 by a local SEEDS official as part of a special program funded by CIDA which targeted the poorest households. She gave the loan of Rs.10,000 to her husband, who spent Rs.2,000 on a new fishing net. She does not know what happened to the rest of the money, but believes that her husband, a heavy drinker, spent it on alcohol. The family is undernourished and in poor health. Geeta has never been to school and her two sons, aged 13 and 14, left school after three years and work in the lagoon with their father. Geeta rarely leaves her hamlet and does not go to the compulsory weekly meetings of SEEDS members which are held about two kilometres from her house; she is several months in arrears with her loan and fears criticism from better-off SEEDS members. In addition she has epileptic seizures and is afraid of becoming ill in an unfamiliar place. During the fishing season, which lasts from December to July, the family lives on the project's earnings of about Rs.3,000. For the rest of the year, when the lagoons are dry, Geeta's husband earns about Rs.3,000 per month as a casual labourer.

#### **Case study 2: a rural non-farm LVE in an extreme-poor household**

Seelawathie is a 33-year old widow who lives with her 7-year old son in a single-room clay hut in a remote region about 5 kilometers from the village of Bandagiriya and 10 kilometers from Hambantota town. The houses in her neighbourhood have no electricity or mains water; the nearest water supply is a public well 500 meters from her house. Due to poor road quality the nearest bus route, 3 kilometers from her house, does not operate during the rainy months between November and February. Single-season paddy-farming and agricultural labour are the principal economic activities among neighbouring households, and were the household's main income sources until the year prior to the survey when, following the death of her husband in a road accident, the family's paddy fields were occupied by Seelawathie's brother-in-law.

In the twelve months prior to the survey Seelawathie has taken two microenterprise loans from the WDF of Rs.2,500 each to purchase trailer-loads of granite chunks to be broken into smaller rocks. Her productivity is limited by poor health and undernutrition which reduce the stamina required for the demanding physical labour of rock-breaking, and a household labour shortage as her son is too young to assist her, and she took two months to complete each load of rocks, a task which most other producers complete in a month. The net profits of Rs.1,500 per trailer-load provide a net monthly income of about Rs.500 after loan repayments are deducted. For two to three months during the rainy season when the rock-breaking business is inoperative due to transport difficulties Seelawathie earns about Rs.700 per month from occasional labouring work. She receives Janasaviya payments of Rs.250 per month and occasional help from her husband's relatives, who are unable to provide much assistance as they are also poor. Her monthly household income averaged over the twelve months prior to the survey is less than Rs.1,000. As Seelawathie has completed six years of schooling and can read and write she possesses the minimum educational qualifications required for work in an EPZ garment factory or overseas as a housemaid, but her prospects of securing non-local employment are remote due to her poor

health, inability to raise the initial outlays for travel abroad, and difficulty in finding suitable accommodation for her son.

**Case study 3: A single-season paddy-farming enterprise in a poor household**

Sirinanda aged 41 is a paddy-farmer who lives with his wife and two young children and farms 0.8 hectares of tank-irrigated paddy-land which he leases from a local landowner near Udamalalla, 15 kilometers from Hambantota town. As his land is located in a remote area adjacent to jungle, his crops are prone to damage from wild elephants and to minimise the risk Sirinanda harvests and sells his crop as quickly as possible, thereby forgoing the opportunity to secure higher post-harvest prices. He supplements his farm income with agricultural labour on irrigated holdings during the *yala* season. Like many other farmers in his area Sirinanda lost his eligibility for SEEDS loans when he fell into arrears following the failure of his crop during the 1996 drought, and was unable to resume borrowing from SEEDS until 1998 after settling his debt. The household income shock which followed the 1996 crop failure necessitated borrowing to finance consumption. Sirinanda's financial difficulties were compounded by his temporary loss of eligibility for SEEDS loans, and the post-1996 capping of loans at Rs.20,000, which covered less than two-thirds of the production costs of his most recent crop. As a result, Sirinanda has become heavily indebted to a moneylender, to whom he owed Rs.48,000 at the time of the survey. The household retains about a third of the crop for home consumption, and earns an annual net profit of about Rs.20,000 from sales. The household's monthly income of just over Rs.5,000 consists of about Rs.2,500 from farming (includes both cash and in-kind income from subsistence production), Rs.2,000 from seasonal labour and welfare payments of Rs.500 under the Samurdhi program.

**Case study 4: A semi-urban LVE in a poor household**

Vijayanthi aged 50 is a widow who lives with an adult son and daughter and two younger children in a partially completed brick dwelling in a fishing village on the outskirts of Ambalantota. For several years she has operated a garment-making business. Before joining the WDF in 1996 her access to finance had been limited to very small working capital loans from moneylenders. After repaying her initial microcredit loan of Rs.7,500 she used her second loan to replace her pedal-operated sewing machine with an electric machine at a cost of Rs.15,000. The new machine added substantially to productivity and improved the quality of the finished products, enabling an increase in output and an initial growth in sales. Due to intense competition however Vijayanthi has had difficulty in further expanding her sales and since 1998 her enterprise earnings have stabilised at about Rs.1,000 per month.

The main source of household income is her son's casual wage employment in agriculture and construction, which yield an average monthly income of about Rs.2,500. The household supplements its income with fishing (carried out by the son), and Vijayanthi earns a small income from occasional agricultural labour. She has two non-resident adult sons, one a Buddhist monk who provides no income and another who has recently joined the army. Vijayanthi was not receiving remittances from military employment at the time of the survey but expected her son to start sending home a share of his wages on completion of his training. Until recently the household was receiving remittances of Rs.1,000 from the adult daughter who worked for three years in a garment factory in Colombo but had left her job and returned home at the time of the survey. The daughter is seeking employment in the Middle East and plans to borrow Rs.30,000 from a moneylender to finance her travel expenses. The short-term poverty status of this household is contingent on remittance income. The termination of remittances from the daughter's garment factory employment pushed the household below the poverty line, but barring mishaps the forthcoming military and overseas remittances should elevate the household's

income to near-poor or non-poor status after an initial period of 6-12 months during which remittances will go to settling the debt.

**Case study 5: a semi-urban LVE in a near-poor household**

Piyaseeli aged 49 lives with her husband and three children in the brick-making village of Palugasgodella, about 3 kilometers from Ambalantota. Since 1997 she has operated a *kade* at front of her house which earns a variable income ranging from about Rs.2,600 following the Maha harvest, to about Rs.1,500 during other months. The family's monthly income of about Rs.6,000 consists of the microenterprise earnings, her husband's wages of Rs.2,500 in regular employment as a shop assistant in Ambalantota, and an additional income of Rs.1,000 from part-time brick-making carried out by the husband and children after school. Since 1997 Piyaseeli has taken four loans for the *kade*. The initial loans were used to construct the building and purchase enterprise assets such as scales and shelves. As the addition of further assets would add little value recent loans have been used mostly for stock purchases.

When she commenced the project hers was one of only two *kades* in the village; but at the time of the survey there were five *kades* servicing a population of 260 households, and excess competition has led to a general fall in profits. The most successful of the *kades*, which is located in a part of the village which has mains electricity, has a refrigerator. Piyaseeli would like to buy a refrigerator and is waiting for an electricity cable to be extended to her section of the village, but is not sure when this will happen. Given the small size of the available market and the intensity of competition, it is unlikely that the returns from a refrigerator, even if the necessary infrastructure were available, would justify the required investment of Rs.30,000.

Piyaseeli is under pressure to supply goods on credit, a standard practice among her competitors. She dislikes the practice because it imposes a business risk and strains her relations with her neighbours, but reluctantly sells about 10 per cent of her goods on credit because she fears she would otherwise lose customers to her competitors. High competition and competitive disadvantage have contributed to a decline in the *kade's* profits over the twelve months prior to the survey. Piyaseeli and her husband plan to switch their self-employment activities to prioritise brick-making, an activity which they believe offers the potential for higher returns due to current brisk levels of demand. She plans to maintain the *kade*, but has reduced opening times from 14 hours a day to 6, and plans to use a forthcoming SEEDS loan of Rs.15,000 to build a kiln.

**Case study 6: a failed rural non-farm HVE operated by a non-poor 1 household**

Tilakaratne aged 44 lives with his wife and four school-attending children in a sparsely-populated arid rural neighbourhood near Paillemalala. Although local conditions are highly unfavourable for non-farm microenterprise development, lacking electricity and with low local demand, he is more mobile than many other rural householders as he lives less than a kilometre from the Tissamaharama Road on which a regular bus service operates. He is a skilled welder who worked as a wage employee for several years before establishing a microenterprise in 1994 making welded furniture and selling it to retail customers. The microenterprise operated from a rented electrified workshop on the Tissamaharama road. Between 1994 and 1997 his wife borrowed a total of Rs.50,000 from the WDF over the course of four loans, and the net earnings of the project grew from an initial Rs.2,000 to a peak of Rs.6,000. In 1997, for reasons unrelated to enterprise performance, Tilakaratne was forced to vacate the workshop. Unable to rent alternative roadside premises, he tried operating the business from his house, but without ready access to passing trade was forced to abandon the project after a few months. As a skilled tradesman he was readily able to obtain alternative employment and at the time of the survey was employed in an Ambalantota workshop 20 kilometres from his house, to which he commuted daily by bus. The household's income of about Rs.6,500 consists of his wage employment

(Rs.5,000), an annual paddy crop on 0.5 hectares (Rs.1,200) and a government transfer of Rs.250 under the Janasaviya Program.

**Case study 7: a single-season paddy farm in a non-poor 1 household**

Heenona aged 50 lives with her husband and two adult sons on the outskirts of a paddy-farming region 10 kilometers from Hambantota town. The family farms a hectare of paddy-land which they hold under a long-term government lease, and an additional 0.5 hectare which they lease from a neighbour. Their land, which was allocated in the 1960s under a government settlement scheme based around the Bandagiriya tank, was formerly able to support two annual crops but since the 1980s a combination of poor tank maintenance and increasing pressure on water resources have reduced reliable year-round irrigation to farms close to the tank's headwaters. As "tail-ender" farmers Heenona and her neighbours only attempt a *yala* crop once every three or four years when tank water levels are unusually high (7.8). In 1998 the farm earned a net profit of Rs.28,000. The family covers its rice consumption requirements by retaining about a fifth of the crop. Averaged over a twelve-month period the household's monthly income from farming, including the imputed income from subsistence production, is about Rs.3,000. Heenona earns a marginal additional income from a small herd of goats, selling between five and ten goats a year at Rs.1,200 per head. The sons have remained underemployed in the family home since completing secondary school several years ago. Although their chances of securing public sector employment are remote both are "waiting" for government jobs. The three male household members work as casual labourers on neighbouring farms and in the Lanka Salt Corporation when work is available, and their seasonal wages averaging about Rs.5,000 are the main contributor to household income which averages about Rs.8,500. The boost to household income resulting from the sons' entry to the workforce was a key factor in the household's decision to expand its cultivation activities.

**Case study 8: A semi-urban LVE in a non-poor 1 household**

Chandrika aged 33 lives with her husband and infant daughter in a suburb of Hambantota, in a partially completed brick house which they are building with the help of her husband's brothers. The primary source of household income is her husband's wage of Rs.5,700 as a clerk in the government postal service. Chandrika earns an additional income of about Rs.1,000 from brick-making, her husband earns about Rs.500 from fishing when not at work and they receive a welfare payment of Rs.500 from the Samurdhi program. The brick-making project is operating at a sub-optimal level; Chandrika works on it for 2-3 hours a day, selling about half of the product and using the rest for the house. She has taken only one loan from SEEDS of Rs.5,000 which she used to transport a trailer-load of clay and to pay for the use of a neighbour's kiln. Although she could easily afford to borrow the Rs.10,000 - 15,000 to construct her own kiln, which together with an increase in the labour input would likely double the project's net profits, neither Chandrika nor her husband are interested in expanding their brick-making business. They are satisfied with their secure and moderately comfortable income of about Rs.8,000 and Chandrika prefers to devote her time to her young daughter and her voluntary work as an infant nutrition counsellor with the WDF.

**Case study 9: an urban HVE in an initially-near-poor household**

Mary aged 62 lives with her husband and disabled son, and operates a sixteen-year old tea-shop on the main coastal road. During its first years she financed the business with working capital loans from moneylenders at 10 per cent per month. Because of the high costs of informal credit and limited demand, the shop earned a marginal income during its early years, and she made few improvements. Since the early 1990s increasing vehicle traffic along the Galle Road has significantly improved demand conditions for roadside businesses. Encouraged by the growth of economic activity along the road and the improving fortunes of neighbouring businesses, Mary

decided that the shop would benefit from an injection of capital and joined SEEDS in 1995. Since joining SEEDS she has taken three loans with a total value of Rs.50,000, and has used them to make substantial improvements, replacing the original cadjan hut with a brick building, installing electricity, buying shop furniture and making down payments on a refrigerator and ceiling fan, the balance of which is being financed by instalments paid out of enterprise profits. The shop has expanded its initial customer base of local people to include truck-drivers and the weekend Kataragama pilgrim trade, and its net earnings have grown from about Rs.3,000 in 1995 to about Rs.6,000 in 1999. This case study illustrates the strong positive impacts that microcredit can produce in enterprises which operate in favourable demand and production conditions but face capital constraints.

**Case study 10: a semi-urban HVE in a non-poor 1 household**

Priyantha aged 25 lives with his wife in a relatively prosperous suburb of Ambalantota, in a house owned by his relatives. He established a carpentry workshop in 1996. Prior to opening the business he had completed a twelve-month carpentry training course with the Department of Labour. The project has been financed with a combination of four SEEDS loans totalling Rs.30,000, the borrower's savings and reinvested profits. Nearly all investment has been in carpentry tools with unit costs of between Rs.2,000 and Rs10,000, to which he has made incremental additions over the years. He plans to purchase a lathe costing Rs.30,000. The main activity of the business is the making of furniture to order for local customers, with some additional construction work. Priyantha reports that demand is strong although there are several micro-level competitors in the area. He plans to develop a niche market, specialising in buying furniture from a Colombo wholesaler, improving it and selling it locally. Current monthly earnings of Rs.5,000 per month are expected to increase.

**Case study 11: an Uda Walawe non-poor 2 household**

Wijesinghe aged 60 has a long-term lease of 1.25 hectares in the Uda Walawe scheme on which he grows bananas and seasonal vegetables. His family has occupied the land since settling there in the 1960s when irrigation was first introduced in the area. He lives with his wife, five sons, three of whom are married, and one daughter. Like many other Uda Walawe farmers this prosperous family engages in a number of non-farm activities which together with farming produce a combined household income of close to Rs.30,000. One son is at school, the others assist with the household's multiple self-employment activities which in addition to farming (average income Rs.5,000), include a tractor-hire business (Rs.6,000) and vegetable trade, in which Wijesinghe hires a truck to transport local farm produce twice a week to the Colombo wholesale markets, for a net profit of about Rs.10,000, a cattle herd (Rs.6,000) and the wages of the daughter who is employed in a local garment factory (Rs.2,000). He joined SEEDS in 1995 and took his first loan of Rs.5,000 in 1997, followed by second and third loans of Rs.20,000 each in 1998 and 1999. The initial loan was used to purchase farm inputs and the second and third loans were used to purchase vegetables for the wholesale trade business. Wijesinghe has no plans to expand the farm business, preferring to concentrate on non-farm activities which he believes hold higher potential for future growth.

**Case study 12: a semi-urban VHVE in a non-poor 2 household**

Indrawathie aged 39 lives with her husband and two children aged 15 and 17 near the coastal road between Hambantota town and Ambalantota. Both Indrawathie and her husband have completed secondary schooling. Their highly successful enterprise is the outcome of several years of planning and was enabled by a combination of strong business and practical skills, exceptionally high motivation and a above-poverty-line base income level which facilitated the accumulation of savings. Between 1988 and 1995 Indrawathie worked as a housemaid in Saudi Arabia, saving most of her wages. During this period the household relied on earnings of about Rs.6,000 (at



1999 values) from the husband's self-employment as a lobster fisherman. On Indrawathie's return in 1995 the household invested Rs.200,000, which consisted of Indawathie's savings and loans from both SEEDS and the WDF, in a poultry-rearing project, in which the experience of the husband, who had previously worked for 8 years on a poultry farm, was a key input. Apart from being used to buy an initial consignment of chicks, the loans were spent primarily on fixed assets in the form of sheds and "scientific" poultry-rearing equipment including an incubator, electric lighting and quarantine quarters. Since 1995 the business has expanded from an initial 360 birds to 1,500, and earns about Rs.12,000 per month. The business is the sole source of household income, the husband having abandoned fishing in order to work full-time with Indrawathie on the poultry project.

**Case study 13: an urban VHVE in a non-poor 2 household**

Kumarasinghe owns a "communications shop" in the Suriyawewa town centre, one of two such businesses in the town providing long-distance telephone, fax and photocopying services. The largest part of his business is the long-distance telephone service, which is in high demand given high levels of labour migration and the extreme scarcity of telephones in the district. He opened the business in 1996 after returning to Suriyawewa from several years' work in Colombo, with personal savings of Rs.80,000 and a Rs.200,000 loan from a local bank, which he used to purchase a cellular telephone and photocopying machine. Since joining SEEDS in 1997 he has taken three microcredit loans with a total value of Rs.70,000, and reinvested a substantial proportion of enterprise profits, and has acquired land telephones, a fax machine and other equipment. He plans to buy a computer and set up an email and internet service. In 1999 he participated in an intensive business management training program in Colombo, a service sponsored by SEEDS and targeting its most promising entrepreneurial members.

The business showed early promise, with gross earnings of about Rs.5,000 per month; but earned a negative net income during its first year of operation as earnings were insufficient to meet repayments on the bank loan. Since 1996 its average net earnings have increased to about Rs.15,000. Kumarasinghe was able to bear the risks associated with high capital costs, and support the business through its initial lean period because he is independently well-off: his family owns the shop premises and four acres of irrigated paddy-land outside the town, and he combines the business with commission-based employment as an insurance agent, for a salary of about Rs.8,000.



## Chapter 8

### Infrastructure development and non-financial microenterprise services: a way forward?

#### 8.1 Introduction

As previous chapters have argued, non-credit factors are key determinants of microenterprise performance. Inadequate infrastructure facilities impose severe constraints on production and market access, particularly among rural microenterprises, and economic and human resource disadvantages impose additional impediments on the microenterprises of poor borrowers. Given the importance of non-credit factors in determining microenterprise performance, strategic non-financial interventions may offer scope for the improvement of microenterprise incomes to levels which offer poor borrowers more realistic prospects of microenterprise-led poverty exit. By way of a conclusion this chapter assesses the current status quo and recent developments in rural infrastructure development in Sri Lanka, and evaluates the non-financial microenterprise assistance services which are provided by the NGOs, particularly SEEDS, as an adjunct to their lending activities, aiming to address skills, information, market and technology constraints. The final section contains some concluding remarks on the role of microenterprise credit in poverty reduction.

#### 8.2 The problem of infrastructure

As previous chapters have shown, deficiencies in power and telecommunications and particularly in transport are particularly severe in non-metropolitan regions and are a serious impediment to non-farm development and a key factor in rural underemployment and poverty. Boosts in infrastructure spending in remote areas may invigorate the microenterprise sector, stimulating local economic activity by increasing the productivity of local firms and encouraging larger investors, broadening their market opportunities and reducing their competitive disadvantages in metropolitan and export markets. Given budgetary constraints and government and donor policies which target the high-growth urban and export sectors as priorities for capital spending, there is little likelihood of a significant reorientation of spending towards poverty-focused rural infrastructure in the foreseeable future. While some microenterprises will benefit from recent investments in rural electrification and the improvement of strategic main highways, these benefits are confined to a small localised minority and do not address the severe infrastructure deficiencies which persist in most areas. In particular the tertiary transport sector, which links remote regions with local towns and arterial roads, and is of critical importance for rural poverty reduction, remains underdeveloped.

As a percentage of GDP the Sri Lankan government's revenue base has fallen during the 1990s, despite considerable inflows from privatisation proceeds, largely because of various tax concessions and import waivers granted to the corporate sector (World Bank 1998a). Despite the weakening of its revenue base and the continuing drain on the budget imposed by the civil war, the government has significantly reduced the budget deficit through tough expenditure containment measures. Sri Lanka's physical infrastructure has deteriorated considerably in the last decade as the brunt of fiscal adjustment has fallen on capital expenditure, which is well below the average for low and lower-middle-income Asian countries<sup>1</sup> (World Bank 1996a), and in the late 1990s reached its lowest level for many years, falling as a proportion of GDP from 12 per cent in 1988 to 5 per cent in 1997 (World Bank 1998a). Low as it is, this level of expenditure overstates public investment in economic infrastructure, given the government's practice of classifying recurrent expenditures as capital items (World Bank 1997c) and that an undisclosed but substantial share of capital expenditures is allocated to defence equipment and other non-economic items. In the late 1990s observers began to issue warnings that reductions in

capital spending were jeopardising the country's economic and human resource base (World Bank 1998a, Institute of Policy Studies 1998). As noted in chapter 3, a number of industry surveys show that the poor quality of infrastructure is a significant deterrent to expansion, particularly outside the Western province, suggesting the doubtful wisdom of policies aimed at stimulating private investment by trading off capital spending for financial incentives to manufacturers. A recent report on the role of infrastructure in the economy concludes that "Better roads and public utilities are necessary, rather than incentives and handouts, if entrepreneurs are to be persuaded to invest in the provinces" (Institute of Policy Studies 1996:49).

In the late 1990s there has been something of a renewal of activity in infrastructure provision, with an increase in government capital expenditures from 4.9 to 5.6 per cent of GDP between 1996-98, the commencement of a number of major donor-supported projects in the power, telecommunications and transport sectors, and increasing private sector involvement. The benefits of recent infrastructure investments are skewed towards medium-to-large firms, exporters and urban consumers rather than to non-metropolitan households and the microenterprise sector, although some will benefit directly from improved services and more will experience indirect economic growth and employment effects. The focus of international donors, led by the multilateral development banks, on national economic growth over direct poverty reduction is likely to increase distributional inequalities by concentrating resources in the country's most rapidly growing sectors and regions where poverty incidence is relatively low. Given the high costs of extending services to remote areas, the limited ability of rural users to pay for them and a policy climate which is generally hostile to the provision of subsidised services, the increasing involvement of the private sector in infrastructure provision, a strategy actively supported by the World Bank and other donors which envisage the widespread privatisation of public utilities, may widen existing disparities.

Investment in the power sector increased sharply, by 58 per cent in 1998, about half of which came from external donors. While most of the funds were dedicated to rehabilitating existing facilities and adding to the capacity of the existing grid, rather than extending supplies to new rural users (Central Bank 1998a), there has been some investment in new small-scale mini-hydro, photovoltaic and wind-power technologies which offer considerable potential for extending power supplies to remote villages. Two major donor-funded rural electrification projects which commenced in the late 1990s are using the new technologies to reach 150,000 rural users, with an emphasis on remote mountainous areas which are least accessible to the national grid, using local NGOs and community groups as implementing agencies<sup>2</sup> (World Bank 1997d). While the prospective beneficiaries of these projects constitute a small proportion of the 2-2.5 million rural households which lack electricity, such strategies may offer scope for replication. For poor households the economic viability of installing and maintaining power supplies is doubtful, as installation costs alone vary between Rs.16,000 and Rs.41,000, depending on local conditions and the type of technology used, and services are provided to consumers on a full cost-recovery basis (World Bank 1997d).

There has been significant recent growth in the telecommunications sector resulting from the introduction of wireless technology and the partial privatisation of the national provider in 1997, with an increase in telephone density from 1.7 to 2.4 lines per 100 persons in 1997-98. As with the power sector, new investments in telecommunications are concentrated in the Western Province, although by the end of 1998 150,000 new telephone lines had been installed in regional towns and rural areas (Central Bank 1998a). Telecommunications services are unlikely to add directly to the capacity of most microenterprises but may generate flow-on benefits in the microenterprise sector as they are a key input for larger businesses which deal extensively with non-local suppliers and customers. The improvement of regional telecommunications is unlikely to have much impact on rural microenterprises as high installation costs tend to limit services to relatively accessible areas of high population density.

As discussed in chapter 3, underinvestment has led to a substantial deterioration in transport infrastructure in the 1990s, with significant problems of congestion, pollution, road accidents and limitations on rural mobility. It is estimated that only 10 per cent of the country's primary and secondary paved road network is in good condition (World Bank 1997c). The condition of the mostly unpaved tertiary roads which link villages with main roads and regional hubs, and account for over half of total road mileage, is generally very poor. Over a third of tertiary roads are accessible by vehicular traffic during dry seasons only, and a smaller proportion are entirely inaccessible to vehicles, being restricted to travel by foot or bicycle (Central Bank 1998b). As previous chapters have argued, road and transport quality is a principal factor in rural poverty because of its importance in enabling household access to social services, information, and labour, product and input markets. As with other public utilities, there has been a resurgence of investment in the transport sector in the late 1990s, with the commencement of several large donor-funded projects, although government allocations have increased only marginally, by 3 per cent in 1997-98 (World Bank 1997c, Central Bank 1998a). New projects have given priority to efficiency improvements in the export sector. A recent World Bank transport strategy paper argues that:

Supporting export-led growth requires a transport infrastructure investment strategy and policy which favours regions or activities that contribute to exports . . . This means more focus on the regions contributing the most to exports and regions whose export products are growing faster, as well as increased attention to maintenance and modernisation of transport facilities and services and to intermodal linkages for proper logistic support (World Bank 1997c: 11).

The strategy paper presents a comprehensive analysis of the issues and problems facing the Colombo region and the country's main highways and ports, and an integrated set of plans for their improvement, but gives scant attention to poverty-focused investments in the transport sector. While acknowledging the constraints that inadequate transport facilities impose on rural mobility and incomes, it ignores the role of transport in supporting rural non-farm development and fails to provide a convincing plan for addressing deficiencies in rural transport (World Bank 1997c). Substantial recent investment in Sri Lanka's ports (Central Bank 1998a, World Bank 1997c) is expected to generate national income by improving Colombo's attractiveness as an international transshipment hub and is of considerable importance to large manufacturers and agricultural exporters, but has little direct significance for microenterprises, few of which export or use imported inputs. Similarly, the concentration of investment in the greater Colombo area, which supplies 54 per cent of exports, and on national highways linking Colombo and the ports with key export-agriculture producing regions in the Central, North Central and North Western Provinces will generate few benefits for microenterprises outside the target areas (Central Bank 1998a, World Bank 1997c). In 1998 almost all road development funding was dedicated to improving the quality of strategic national highways, while tertiary roads continue to bear the brunt of funding neglect (Central Bank 1998a).

Of some significance for the Hambantota region is a proposal to construct a highway linking Colombo with the southern cities of Galle and Matara by 2005, using a combination of donor and government funds. Although the proposed route stops 80 kilometres short of Hambantota town it will, if established, substantially reduce travel times and should generate an increase in non-local traffic in Hambantota and improve the access of Hambantota producers to non-local markets. The current status of the project is in doubt, due to disputes between politicians about the direction of the proposed route, and the recent intensification of the civil war which has led to the suspension of key development projects.

To the extent that they occur, improvements in infrastructure are likely to have a polarising effect, further widening the gap between poor and less-poor population groups, for several reasons. First, services tend to be targeted to less-poor locations. Second, within given locations less-poor households are more likely to use services when they are available, particularly when they involve high installation and recurrent costs, as indicated by lower rates of electrification in poorer semi-urban households, described in chapter 6. Third, less-poor households derive higher returns from infrastructure services than poor households using the same services, due to their superior skills and information endowments and access to equipment; and because their HVEs are more responsive to technical innovations than the LVEs of the poor. Fourth, although lack of infrastructure facilities places severe limitations on productive capacity and demand, poor communications and transport arrangements may protect inefficient local firms from competition: thus the broadening of markets may have a disproportionately negative impact on some LVEs. Some observers argue that infrastructure development may have adverse consequences for the microenterprise sector in the long run:

In the early stages of economic development, while the national market is still poorly integrated, local producers may enjoy a degree of "natural protection" from outside competition as a result of high transportation and communication costs. As these costs fall, markets widen and firms that can realise economies of scale are able to increase their market shares. This is one of the major reasons why larger enterprises tend to displace smaller ones as countries grow richer (Snodgrass 1996:23).

The threat constituted by non-local competition varies across occupations. The Hambantota microenterprises most likely to suffer from increased competition are non-farm production-oriented LVEs which make undifferentiated products without any outstanding local competitive advantage, such as brick-making, garment-making and coir production activities. Microenterprises which have a location-related comparative advantage in production, such as the Uda Walawe banana cultivators, or in their proximity to customers, such as local retail traders and service and specialised production activities including mechanical repairs, hair-dressing, retail food production and carpentry, are considerably less exposed to non-local competition. The latter group includes LVEs in the petty trade and semi-subsistence fishing and livestock categories, and most HVEs.

Although infrastructure development may produce differential benefits for HVEs and LVEs, and may even reduce the incomes of some LVEs by increasing their exposure to competition, any disadvantages are more than offset by its generally positive impacts on production, market access and local economic growth, and consequent expansion of the quality and range of economic opportunities. Given the intense fiscal pressures facing the government, however, exacerbated by the intensification of the civil war and consequent diversion of development expenditures to defence, and donor and government policies which prioritise economic growth over distribution, the prospects for a significant reorientation of investment towards rural infrastructure are not promising in the foreseeable future, particularly in the transport sector which is arguably the most important potential contributor to rural poverty reduction. While the revival of investment in physical infrastructure is likely to benefit some microenterprises through improved market linkages and the indirect effects of economic growth, especially in regions where investment is concentrated, the emphasis on growth sectors rather than the most severely undercapitalised rural areas, privatised modes of provision and full cost-recovery, may be inconsistent with a poverty reduction strategy based on microenterprise development.

### 8.3 Non-financial microenterprise development services

Many researchers argue that non-financial business development services should be an integral component of microenterprise development programs. They point out that given the deficiencies in human capital, information and technology which face most microentrepreneurs, a "credit-plus" approach which combines lending with appropriate information services, technical and business training and assistance in identifying new supply and market opportunities and technologies strengthens the impact of loans and is likely to be of considerably more use than minimalist credit-only services, particularly to poor borrowers (Dawson and Jeans 1997, Hulme and Mosley 1996, Barton 1997, Asian Development Bank 1997).

Both NGOs provide business development services as part of their microenterprise development programs. The WDF takes a relatively minimalist approach to microenterprise development, confining most of its non-financial assistance to low-value microenterprises with a semi-subsistence component such as home garden maintenance and backyard livestock-rearing and confining its services mostly to short-term training courses. In SEEDS by contrast business development services are a significant and high-profile feature of its national operations. About 15 per cent of SEEDS financial resources are allocated to its business development services arm, the Rural Enterprise Development Services (REDS) program, which is Sri Lanka's most prominent provider of non-financial microenterprise development services, attracting considerable support from international donors with whom it has collaborated on a variety of projects. In addition to assisting existing enterprises the REDS program identifies and promotes new opportunities. Its services to microenterprises include vocational training in a wide variety of occupations, the trialling and promotion of new low-cost technologies, an advisory service for individual businesses and the development of linkages with markets and suppliers.

While training and technical inputs may generate significant benefits for enterprises with the necessary infrastructure and where markets are responsive to quality and productivity improvements, the utility of non-financial assistance is limited in low-value occupations facing severe production and demand constraints. Consequently, while both NGOs provide some basic enterprise assistance to the owners of LVEs, the more intensive business development services provided by SEEDS are targeted towards higher-value occupations. The main users and beneficiaries of business development services to existing enterprises are therefore the non-poor urban and Uda Walawe owners of HVEs. Given the limited impacts of training and other services on LVE earnings, interventions aimed at encouraging the selection of higher-value activities, where such opportunities exist, may be more effective for poorer borrowers than assistance to existing LVEs. SEEDS is actively involved in the identification of new enterprises and in making them accessible to borrowers through training programs and the facilitation of linkages with buyers and suppliers. In Hambantota success in attracting poorer borrowers into new occupations is adversely affected by their reluctance and limited ability to invest in new technologies, attend training and negotiate advantageous arrangements with new business contacts. Moreover, distance and small local markets impose a ceiling on the capacity of the region to support new HVEs. With limited scope for the development of non-local markets, the best prospects for Hambantota microenterprises appear to lie in the emerging markets created by tourism and the growth of non-local vehicle traffic. Their capacity to support new entrants is limited however and interventions aimed at influencing borrowers' selection of projects must take care to avoid problems of over-supply.

#### 8.3.1 Services targeting existing enterprises

As Table 8.1 shows, nearly half of the sample borrowers have received some non-financial enterprise assistance. With the exception of a technical assistance program for Uda Walawe farmers, discussed below, all non-financial services target the non-farm sector: single-season

farmers receive no non-financial services from either NGO. In the non-farm sector SEEDS is a far more active provider of enterprise development services, with participation rates of well over 90 per cent among SEEDS borrowers, in comparison to the WDF where fewer than 15 per cent of non-farm borrowers have received assistance. Most borrowers who participate in business development activities receive low-level services. These include a generic two-day introductory seminar which covers simple book-keeping, inventory management and other basic business principles, which is nominally compulsory for all new non-farm SEEDS borrowers (although as Table 8.1 indicates a handful have not taken the course) as well as a range of two- or three-day vocational training programs operated by both NGOs, focusing on low-value unskilled non-farm occupations such as brick-making, and a goat-breeding program operated by the WDF. About 17 per cent of borrowers have participated in more intensive business development services which include longer vocational training courses of up to six months and assistance to individual enterprises in locating markets and suppliers, and in accessing and applying technical innovations. As Table 8.1 shows, among non-farm enterprises LVEs are slightly more likely than HVEs to receive low-level services, with participation rates of 47 and 41 per cent respectively. Intensive services however are heavily skewed towards HVEs, with a participation rate of 25 per cent, in comparison with only 8 per cent for LVEs.

**Table 8.1: Participation in business development services**

	Intensive BDS*	Low-level BDS**	No BDS	Total
<b>WDF</b>	<b>2</b>	<b>10</b>	<b>105</b>	<b>117</b>
Farm enterprises	-	-	44	44
Non-farm LVEs	-	8	29	37
Non-farm HVEs	2	2	32	36
<b>SEEDS</b>	<b>40</b>	<b>68</b>	<b>28</b>	<b>136</b>
Farm enterprises	12	-	18	30
Non-farm LVEs	7	32	10	49
Non-farm HVEs	21	36	-	57
<b>Total</b>	<b>42</b>	<b>78</b>	<b>133</b>	<b>253</b>

\* Vocational or business training of more than 3 days duration, assistance in identifying and accessing new technologies, suppliers and markets, individual project advisory services.

\*\* Up to 3 days' vocational or business training, participation in goat-breeding program.

While the Hambantota data does not permit a reliable assessment of the impact of business development services on existing enterprises, the available evidence suggests that non-financial assistance has little impact on the performance of LVEs. Table 8.2 compares the median incomes of enterprises receiving various levels of non-financial assistance. Due to the small number of observations in each cell the data must be treated with caution. As Table 8.2 shows, among small-scale livestock and trading enterprises there is little income difference between participants and non-participants in low-level non-financial services although, for reasons which are not clear, low-value manual enterprises which have received low-level services earn significantly higher incomes than those which have not.

There is little income difference between manual LVEs receiving low-level and intensive services, indicating that non-financial assistance measures may be insufficient to transcend the production and demand constraints facing LVEs. Returns on investments in new technology or training are marginal in LVEs where the costs of innovations may be very high in relation to enterprise income, and which may face binding constraints on expansion of output or markets - in remote locations, where raw materials are scarce, where saturated markets cannot absorb increases in output, or where customers are poor and demand is inelastic, limiting the returns on investments in product quality improvements. While business development services may generate minor improvements in the profitability of LVEs, often by reducing production costs



rather than fostering expansion, they are unlikely to raise their incomes to poverty-clearing levels given their generally limited growth potential and the saturated markets in which they operate. The handful of LVE owners participating in intensive services consisted mostly of garment-makers who had attended SEEDS vocational training programs. Garment-making is a skilled occupation which, unlike other LVEs, requires a degree of training, but due to the severity of the market constraints facing the micro-level industry, discussed in chapter 6, additional training provides at most a marginal competitive advantage.

**Table 8.2: Occupation and median enterprise income by level of business development services (non-farm enterprises)**

Enterprise occupation	Median enterprise income		
	Intensive BDS	Low-level BDS	No BDS
<b>LVEs</b>			
Low-value manual occupations	2,240	2,200	1,500
Fishing and small-scale livestock	-	1,500	1,500
Kades and house-to-house mobile trade	-	1,573	1,500
<b>HVEs</b>			
Mobile <i>pola</i> trade	5,000	3,750	4,000
Specialised retail trade, tea-shops, vegetable wholesale trade	13,000	6,000	3,000
High-value manual occupations	8,060	5,800	3,520
Services and high value n.e.s	14,300	-	4,500
<b>Total</b>	<b>8,000</b>	<b>3,000</b>	<b>2,700</b>

Among HVEs there is a much stronger positive association between enterprise income and the level of non-financial services. In most occupations HVEs which received no enterprise assistance earned significantly less than those receiving low-level services, which in turn earned significantly less than those receiving intensive services. The extent to which the observed income differences among HVEs are directly attributable to participation in non-financial services is unclear, as the data also reflects the greater propensity of the least-poor borrowers and the best-performing enterprises to avail themselves of non-financial services, due in part to the SEEDS practice of singling out the strongest microenterprises for intensive assistance: thus the enterprises most likely to engage in intensive BDS were those which had the highest incomes to start with. The substantially higher earnings of HVEs which have received business development services do however suggest that such services may have considerable potential for improving the performance of other enterprises in similar occupations, whereas the impact of non-financial services on the earnings of LVEs appears to be limited.

Neither NGO offers non-financial assistance to single-season agriculture. Farmers do not participate in the generic two-day business training courses which are compulsory for other SEEDS borrowers; more importantly, farmers outside the Uda Walawe scheme are excluded from an intensive training program sponsored by the UN Food and Agriculture Organisation and delivered by SEEDS in a promising organic pest-control technology known as Integrated Pest Management (IPM). Sri Lankan trials indicate that IPM is well-adapted to the paddy sector and offers considerable non-economic benefits in the form of reduced ground water pollution and health hazards from exposure to agro-chemicals, as well as economic benefits in the form of substantial savings on pesticides (Silva et al 1998). Uda Walawe paddy-farmers who have participated in a pilot program claim that IPM has reduced their pesticide costs by up to Rs.4,000 per season on their one-hectare plots, saving about 10 per cent of total production costs. There is some potential for non-financial interventions to assist in the marketing of paddy as well as in production. In one of the survey villages in an area where crops were at risk from wild elephants, another NGO had provided funds to renovate an old paddy storage facility, enabling farmers to



reduce the risk of losses by harvesting their crops earlier, while increasing their control over the timing of crop sales. In this village local SEEDS officials and members strongly opposed the district office's policy of restricting its farm services to credit only, and claimed that a number of farmers had left SEEDS to join the credit-plus program offered by the new NGO.

SEEDS excludes single-season farmers from non-financial services partly because of limitations imposed by cost factors, as the services rely heavily on donor subsidies although participants contribute a share of costs; consequently limited resources are targeted to regions which are believed to generate the highest returns on non-financial inputs. Secondly, as discussed in chapter 4, while the continuing high demand of members for cultivation loans constrains SEEDS from further reducing its farm portfolio, its policy is to "steer beneficiaries away from paddy" where possible, in the interests of its own financial stability and on grounds of environmental and economic sustainability. Furthermore there are difficulties involved with providing IPM to poorer single season paddy-farmers: its success requires that all farms in a target area apply the technique, which may present problems in locations where some farmers are not SEEDS members. Poorer farmers may also be deterred by training costs and the attendance requirements of one day a week over an entire season. Nevertheless a majority of the sample farmers had heard of IPM and were keen to apply it, and the SEEDS policy of providing a minimalist service to single-season paddy-farmers seems misguided, given that non-financial assistance can increase profitability with minimal additional risk, as well as generating positive environmental and health impacts, and that in the absence of viable non-farm alternatives for remote-area borrowers the withholding of non-financial services to agriculture is unlikely to deter them from farming.

### 8.3.2 Services targeting enterprise selection

In addition to improving the performance of existing microenterprises business development services may promote optimum project selection through information, training and technical assistance services which reduce the risks of investing in untried activities. As chapter 2 showed, there is considerable evidence that minimalist credit tends to support familiar low-value activities, suggesting that additional non-credit services are necessary to encourage movement into new higher-value occupations.

Where geographic conditions impose a binding constraint on HVE development, as they do in most rural locations, enterprise support services are necessarily limited to the shoring up of LVEs. In urban and semi-urban locations, however, which offer scope for the development of higher-value activities, non-financial interventions may assist poverty exit. A more effective alternative to providing loans for low-income activities with limited growth potential may be a strategy which encourages the selection of higher-value occupations, where such opportunities exist, while continuing to support LVEs for borrowers who are unable or unwilling to engage in riskier, higher-value alternatives. The deterrents to HVE selection among poor urban and semi-urban borrowers are often related to human capital and sociocultural issues which may be amenable to information, training and technical assistance services. As chapter 7 showed, even though the asset requirements of many urban and semi-urban HVEs place them within their financial reach, HVE take-up rates are low among initially poor and near-poor semi-urban and urban borrowers, just over half of whom select LVEs, indicating that there may be scope for influencing project choice by disseminating information about potential opportunities and promoting appropriate skills and attitudes.

SEEDS offers a wide variety of vocational training programs which range from two to three day seminars in unskilled occupations such as brick-making, to intensive courses which run for up to six months in more complex higher-value occupations such as mechanical repairs, carpentry and food processing. While NGO training is no substitute for the years of experience and in some

cases formal vocational training needed for the most highly-skilled occupations such as electrical and motor mechanics, it provides the base-level skills sufficient for entry into food-processing and other HVEs with less demanding skills requirements. In addition to well-known occupations, SEEDS offers training in a variety of activities which are new to the Hambantota microenterprise sector. Recent training programs available to Hambantota borrowers have included a variety of non-traditional occupations, some of which - bee-keeping, screen printing, production of fibreglass goods and beautician training - have potential for development as VEs, although the small size of local markets renders them vulnerable to flooding. While SEEDS has had some success in attracting participants for training in well-known HVEs such as food processing and carpentry, participation rates are generally low in courses which focus on unfamiliar activities. The most well-attended programs continue to be in traditional LVEs: a recent SEEDS report indicates that of the 17 non-farm occupations in which SEEDS offered training early in 1999, more than a quarter of participants opted for training in garment-making or coir production (SEEDS 1999).

The structure and content of training programs is sometimes poorly-adapted to the needs of poorer borrowers, many of whom complained that training programs were made inaccessible, especially for poor households and those in more remote semi-urban areas, by time, distance and cost factors. Restrictions on course attendance affect the owners of existing microenterprises who seek to upgrade their skills as well as those considering new activities. Although training is free for SEEDS members in their first year of membership, and for the next three years subsidised so that borrowers pay only 30 per cent of course costs, which amount to Rs.400-700 for a two week course, some find the fees prohibitive. More importantly, few are in a position to forgo their regular income-generating activities in order to attend courses, most of which are offered only on a full-time basis and sometimes require residential attendance in Galle or Matara.

While SEEDS provides comprehensive advisory services to the owners of existing enterprises, including assistance in accessing and applying new technologies and resolution of marketing and supply problems, its assistance in the selection of new projects is usually confined to vocational training, although as discussed below there have been attempts to develop input and market linkages in selected occupations. Low take-up rates for unfamiliar occupations, particularly among poor borrowers, even where they would appear to stand a reasonable chance of succeeding, indicate that vocational training alone is insufficient to encourage poor borrowers to adopt unfamiliar activities, and may need to be supplemented with additional assistance. The need for additional support services is illustrated by the example of a semi-urban SEEDS member who after taking a ten-day screen-printing course decided against persevering with the project, although SEEDS had offered to lend the Rs.25,000 to cover initial start-up costs. His decision was motivated not by an informed assessment of potential risks and benefits, but by a poor knowledge of the market: he knew of no successful screen-printing projects in his locality and had little awareness of demand conditions and opportunities. The facilitation of informed choices regarding the selection of unfamiliar occupations requires the integration of vocational training with information on markets, input supply issues and available technologies.

NGO staff need to be alert to new micro-level opportunities, particularly in the emerging services and tourism sectors. The rapid increase in non-local vehicle traffic in the district in the 1990s has fuelled significant growth in roadside motor repair workshops, retail traders, tea-shops and small-scale artisan establishments, and the completion of the southern highway project is likely to generate further increases in non-local visitors. International tourists are another market which offer potential for local microenterprises. Tourism in Sri Lanka is a small but potentially significant sector, contributing 2 per cent of GDP and generating an estimated 90,000 jobs (Central Bank 1998a), which has been kept well below its potential by the civil conflict and a

poor understanding of the market on the part of Sri Lankan businesses. Although international tourism is concentrated in the Central Province and beach resorts on the island's south-western coast, the national parks, beaches and pilgrimage centres in the Hambantota area attract a percentage of foreign visitors and offer considerable potential for further development as tourist attractions. The district's popularity among tourists appears to be growing and in addition to a number of smaller guest houses two major international tourist hotels have recently opened in the Hambantota-Amabalantota area. Although tourism has generated vigorous micro-level industries in the production of food, handicrafts, jewellery and garments in the south-western resorts, microenterprises targeting tourists are virtually non-existent within Hambantota district. Given the potential of local tourist markets, together with reliable bus services linking the coastal regions of Hambantota with the south-west coast, there are considerable opportunities for the development of new, potentially high-value activities in the handicrafts and hospitality trades. As tourism favours the female-dominated food and garment trades, it presents opportunities for the development of women's enterprises. The NGOs are in an excellent position to encourage such activities through appropriate awareness-raising and training interventions, including language training and cultural awareness programs aimed at addressing an anti-foreigner sentiment which prevails among Sinhalese villagers.

While there is some scope for the development of viable new urban and semi-urban activities, indicated by the generally high earnings of microenterprises in specialised occupations or targeting growing and niche markets, finite local demand can support only a limited number of enterprises in any occupation. Even the strongest urban HVEs which trade locally are vulnerable to competition; and are protected by high barriers to entry which are a key factor in their prosperity. There is therefore a need for careful rationing and targeting of vocational training and other interventions aimed at promoting new occupations or in existing sectors which are already well-supplied and may be at risk of overcrowding. Poorly-conceived interventions which have little regard for local conditions may generate a fallacy of composition problem with an influx of new entrants into markets which are unable to support them. Some observers suggest that in order to prevent market collapse, microfinance providers need to take an interventionist role in project selection, restricting the supply of credit to new starts in crowded markets to those with demonstrated aptitude or prior experience (Liedholm and Mead 1999).

Conversely, there is a need to ensure that occupations targeted for training are appropriate for the local environment. Training programs are typically planned and designed in the SEEDS head office and delivered by Colombo consultants with little local input. While some recent courses offer considerable potential for Hambantota microentrepreneurs, district-level SEEDS staff believe that others have limited relevance to local market conditions, citing as an example a recent poorly-attended course in the production of hand-bags, an activity which may be well-suited to Colombo markets but for which there is little local demand. An abundance of training programs in occupations which have little chance of succeeding locally is wasteful of resources and may lead to enterprise failures, reducing the relevance of SEEDS training activities and the credibility of non-traditional enterprises as an option for poor borrowers.

In order to overcome the problem of finite local demand SEEDS has been involved in a number of projects linking micro-level producers with the metropolitan, industrial and export sectors. Its recent initiatives have included the export-oriented production of ornamental fish and cut flowers, the retailing of plastic and glassware products by *pola* traders supplied by Colombo wholesalers, sub-contracting arrangements linking coir yarn and mat producers with a Colombo manufacturer and the marketing of coir dust, a by-product of coir production. Like other microenterprise development programs in Sri Lanka, which have had difficulty in establishing linkages with local and national manufacturers (Gunatilaka 1997), the SEEDS efforts have met with limited success.

According to a recent internal evaluation the outreach of linkage projects is low and while there have been a few outstanding successes their performance is mostly poor: the new *pola* enterprises have high failure rates, with only 20-25 per cent remaining in business after twelve months, the coir dust marketing initiative was terminated after manufacturers withdrew from the project and the viability of the ornamental fish enterprises is in doubt, with profits falling by a third early in 1999 due to a decline in export demand. Remote-area producers are disadvantaged by distance which reduces their competitiveness relative to those in centrally located regions, and the vast majority of participants in linkage projects are concentrated in localised activities in the south-western districts (SEEDS 1999).

There is little industrial demand for microenterprise products. Although the recent rapid growth in Sri Lanka's large manufacturing sector might have been expected to stimulate micro-level input supply industries there is little evidence indicates that it has done so. Local products are not internationally competitive on price and quality; the poor quality of regional infrastructure reduces the advantages of local suppliers in terms of rapid communication and timeliness of deliveries, and trade liberalisation has made it easier for manufacturers to import. Consequently, although many industrial inputs are produced in Sri Lanka, garment manufacturers import over three-quarters of their inputs (Kelegama and Foley 1996). Moreover as microenterprises have difficulty in meeting the volume, quality and product standardisation requirements of industrial customers, Sri Lanka's small domestic input supply industry tends to favour SMEs rather than micro-level firms.

Where sub-contracting linkages between microenterprises and manufacturers exist they are usually insecure arrangements in which LVEs produce very simple low-value-added goods, and involve significant costs and risks for both parties: manufacturers face problems of variable quality and unreliable delivery, while microentrepreneurs, especially when linked to a single corporate customer, lack bargaining power and are subject to exploitative rates of pay and the risk of unilateral demand and price fluctuations. As timeliness and quality considerations deter large commercial customers direct sub-contracting arrangements are rare. Some moderate successes have been achieved where an NGO or other third party acts as an intermediary between microenterprises and larger customers, coordinating training, production scheduling, quality standardisation and sales (Shaw 1999b). Such arrangements are of doubtful commercial viability, however, and may not be sustainable in the long run as they involve substantial overhead costs and typically rely heavily on external subsidies, without which they would probably fail.

Structural limitations on the capacity and competitiveness of micro-level firms, together with distance and low population density, impose an overarching constraint on the capacity of the Hambantota microenterprise sector to absorb new entrants. Microenterprises which compete with larger firms such as those in the garment and coir production industries, are at a severe disadvantage due to their undercapitalisation and inability to realise economies of scale. While there is some scope for expansion into non-local markets, Hambantota producers do not possess any outstanding advantage which offsets cost and distance constraints, and are therefore uncompetitive with their counterparts in more favourably located regions. There is little industrial demand for sub-contracting or other forms of linkage between microenterprises and larger firms, and such arrangements have proved costly and difficult to implement successfully. The most promising microenterprise opportunities are in semi-urban and urban occupations which can take advantage of proximity to their customer bases. Such occupations include personal services, urban retail trades, the food and hospitality trades, electrical and mechanical repairs, the local construction industry and a range of activities in the underdeveloped micro-level tourist industry. The supplementation of loans with carefully-designed training and technical assistance services targeting the most promising occupations may well prove highly effective in

attracting poorer semi-urban and urban borrowers into these higher-value activities. Such interventions do not offer a large-scale solution to poverty, however, as their magnitude is limited by finite markets, and they do not reach rural households.

#### 8.4 Conclusion

In summary, evidence from the Hambantota sample does not support claims that microenterprise credit is a broadly effective solution to poverty, although it has generated widespread and significant benefits for borrowers who were initially above the poverty line. It has assisted about a quarter of initially-below-poverty line borrowers to exit poverty, and for another quarter has contributed to improvements in incomes which do not clear the poverty line. Three-quarters of initially-poor borrowers remain in poverty after taking loans, however, including a half who have derived little or no income benefit from their participation.

Among the poor microfinance offers some groups better prospects of poverty exit than others: those whose initial incomes are more than two thirds of the poverty line are far more likely to exit poverty than the extreme-poor, and the urban and semi-urban poor are twice as likely to exit poverty as those in arid rural areas. It appears that microfinance is most effective in eliminating poverty where borrowers have reached a minimum economic threshold and in environments which support the development of poverty-clearing microenterprises. In such circumstances the provision of training and other non-financial interventions encouraging poor borrowers to select higher-value enterprises is likely to further improve prospects of poverty exit.

In remote rural areas, however, where most of the poor live, the utility of microenterprise credit is problematic. It is unrealistic to expect that large numbers will be able to exit poverty via their microenterprises, as unfavourable demand and production conditions virtually rule out the development of HVEs for all except the most well-off households. As we have seen, the micro-level rural non-farm sector is limited by lack of infrastructure and weak demand to a narrow range of mostly very low-value occupations, and the few higher-value enterprise opportunities which exist involve very high capital requirements which effectively close them to the poor. For most rural households paddy-farming is by far the most rewarding available microenterprise activity, as it yields higher cash incomes than the alternatives in addition to improving food security and is a mark of social status. Few paddy-farms however generate poverty-clearing incomes, and the signs all point to future deteriorations in farm earnings given an unfavourable macroeconomic and policy environment and increasing pressure on resources.

For microfinance programs which base their existence largely on their claims to a poverty focus, and for the donors who fund them, evidence that the benefits of microcredit flow disproportionately to the urban and less-poor rather than to the rural and poorest should prompt a re-evaluation of their activities and objectives. The evidence from Hambantota and elsewhere suggests strongly that promotional microfinance attracts a "natural" constituency of low-risk urban, mostly less-poor clients who derive substantial benefits from microcredit and present a minimal threat to institutional financial stability. While there may be some scope for improving services to rural borrowers by adapting lending and non-financial assistance practices to better meet their needs - for example, by extending the IPM training program to single-season paddy-farmers - adjustments to program design features are unlikely to produce significant improvements in impact, as the chief impediments to rural microenterprise development lie in external environmental factors which are largely beyond the control of the programs. Given the formidable obstacles that the programs face in generating significant improvements in rural incomes, there is a strong argument for reorienting their microenterprise credit interventions away from the rural poor to concentrate on a semi-urban and urban target group. While such a reorientation would necessarily involve a dilution of poverty focus, it would effectively improve

the well-being of many borrowers - some of whom are poor - who lack access to alternative affordable sources of finance, and moreover may generate second-round poverty reduction effects through local economic growth and wage employment. The targeting of urban and semi-urban borrowers is thus likely to generate social benefits which provide a strong justification for continued donor support, as long as they take care not to exclude the poorer urban segments.

There is little doubt that microenterprise credit generates a net benefit for the rural poor: in the aggregate they are better off with microfinance than without it. Even though they may not facilitate poverty exit, small income improvements are of considerable importance at the margins of survival. Microenterprise credit may also serve important protectional functions in poor households by helping to offset falling incomes, facilitating diversification and providing off-season income sources and, for paddy-farmers, contributing to food security. The persistence of demand for microcredit among poor rural borrowers, particularly paddy-farmers, indicates that the service is of some value to them. Demand alone is not however a sufficient justification for continuing a costly and ineffective service. The NGOs and their donors need to assess the costs and benefits of providing rural clients with a service which may both compromise overall program sustainability and hence their ability to deliver effective services to other clients, and generate high social opportunity costs by diverting donor funds from other more effective poverty reduction strategies.

The benefits which borrowers receive from paddy cultivation loans are small and short-term, as most paddy-farms are unlikely to be viable in the long-term; moreover they involve considerable financial and social trade-offs. Exposure to the relatively high-risk smallholder paddy sector may compromise institutional profitability, and in the event of climatic or economic shocks may jeopardise lenders' financial stability. The availability of low-cost credit may encourage marginal cultivation projects, contributing to negative environmental externalities which threaten the livelihoods of other farmers in the longer term. In response to these problems the NGOs have reduced their exposure to single-season farming, capping loan sizes and in the case of SEEDS, effectively excluding *chena* cultivators and the most marginal paddy-growers who encroach on government land on the peripheries of village tank systems. Such policies produce inevitable trade-offs in the form of reduced poverty impacts, as they oblige farmers to supplement their microcredit loans with costly informal sector borrowings, and the exclusion of the riskiest and most environmentally harmful activities bears most heavily on very poor remote households which are least able to develop non-farm alternatives.

From a lender's point of view microcredit for rural non-farm microenterprises is less risky than cultivation lending because they require smaller loans and although rural project failure rates are high, the non-farm sector is less subject to the destabilising *en masse* failures which are a chronic risk in single-season agriculture. The social benefits of rural non-farm microcredit call for scrutiny, however, given the meagre incomes of the microenterprises they assist and the risk that, as with the farm sector, lending may generate negative externalities by promoting unsustainable competition in small rural markets, increasing the incidence of project failures and leading to sector-wide declines in income.

Low impacts on rural income poverty indicate that there may be a high social opportunity cost associated with a concentration on microenterprise credit while forgoing alternative, perhaps more effective means of improving the well-being of rural households. The popularity of the NGOs' protectional microfinance facilities and non-financial social services and community development activities among their poorer clients, many of whom value such services above microenterprise loans, suggests scope for their expansion. High rates of undernutrition indicate an ongoing need for the promotion of food security through such interventions as the promotion



of home garden cultivation and animal husbandry, latrine construction and infant nutrition counselling, in which both NGOs have a demonstrated capability. In addition, the NGOs should investigate the feasibility of supplementing their microcredit programs with vocational training and other interventions aimed at improving access to non-local labour markets, which for most rural households offer the most viable route out of poverty.

If the NGOs choose to maintain their microenterprise credit services to rural borrowers, they need to recognise the limitations imposed by external physical constraints and develop strategies to address them. It is no coincidence that the recent growth of enthusiasm for microfinance is taking place in a global context of shrinking investment in rural development and social services, reflecting a neoliberal economic paradigm which emphasises the privatisation of welfare, shifting the costs of poverty reduction away from LIC national governments and OECD tax-payers to the poor themselves. Poverty reduction strategies based on self-reliance are unlikely to have much effect, however, in the absence of an enabling environment which supports the efforts of the poor to develop their productive capacity. Microenterprise development programs need to be complemented by investment in social and physical infrastructure; they are no substitute for it. A reorientation of development spending in favour of poverty-focused capital projects such as the rehabilitation of the rural road network may well go further than any other investment towards reducing rural poverty by expanding the scope and competitiveness of the rural non-farm sector. Although the current fiscal and policy environment in Sri Lanka appears unfavourable for a major revival of investment in rural infrastructure, the recent implementation of aid-funded rural electrification and similar projects indicates the existence of some scope for improvements. As large and professionally-managed development agencies which are well-recognised as major contributors to social welfare in Hambantota district, both SEEDS and the WDF should make use of their considerable credibility with the Sri Lankan government and international donors to lobby for expanded capital spending on rural development.



## Appendix 1

NO. \_\_\_\_\_

DATE: \_\_\_\_\_

**PRODUCER QUESTIONNAIRE**

Respondent Name [\_\_\_\_\_] Fieldworker name [\_\_\_\_\_]
   
GN Division [\_\_\_\_\_] NGO [\_\_\_\_\_]

**RESPONDENT DETAILS**

A1 Respondent's age at last birthday [\_\_\_\_\_] A2 Gender [\_\_\_\_\_]
   
A3 Is respondent the household head? YES [ ] NO [ ] A4 Education level [\_\_\_\_\_]

**MICROENTERPRISE DETAILS**

B1 Type of microenterprise

Cultivation [\_\_\_\_\_] Service [\_\_\_\_\_] Livestock [\_\_\_\_\_]
   
Production [\_\_\_\_\_] Trade [\_\_\_\_\_] Other [\_\_\_\_\_]

B2 Brief description of products/services provided by microenterprise

B3 When did you start the microenterprise? MONTH [\_\_\_\_\_] YEAR [\_\_\_\_\_]
   
B4 Is the microenterprise seasonal? (If NO go to B8) YES [ ] NO [ ]

B5 What are the seasons of high and low activity?

Month	J	F	M	A	M	J	J	A	S	O	N	D
High activity												
Low activity												

B6 Microenterprise income during highest activity month over the last 12 months: [Rs]

B7 Microenterprise income during lowest activity month over the last 12 months: [Rs]

B8 Number of microenterprise employees and working hours per week:

	At start of Project		At June 1999	
	Number of workers	Total weekly working hours	Number of workers	Total weekly working hours
Respondent	XXX		XXX	
Other household members				
Non-household members				

B9 Since beginning the microenterprise have you done any of the following?

	YES	NO
Increase the amount of products/services produced	[ ]	[ ]
Improve the quality of products/services produced	[ ]	[ ]
Diversify into new products/services	[ ]	[ ]
Purchase new tools or equipment	[ ]	[ ]
Find new markets	[ ]	[ ]
Move to better premises	[ ]	[ ]

B10 Is the microenterprise located at your residence?

YES [ ] NO [ ]

B11 Where is your microenterprise located?

In a town (give name of town) [\_\_\_\_\_]

In a village (give name of village)

Less than 1 km from a village ☐

More than 1 km from a village ☐

B12 Do you have electrical power at your workplace? YES ☐ NO ☐

B13 Can your workplace be reached by four-wheeled vehicle? YES ☐ NO ☐

B14 Who buys your products/services? (if respondent gives more than one answer, number in order of importance: 1=most important)

Trader/middleman ☐

NGO/cooperative ☐

Local public (within 1 km of your workplace) ☐

Public in non-local area (specify location)..... ☐

Tourists ☐

Local firms ☐

Non-local firms ☐

Other (specify)..... ☐

B15 State reasons for selecting this project (if respondent gives more than one answer, number in order of importance: 1=most important)

Previous experience in this type of work ☐

Copying others in local area ☐

Recommended by NGO ☐

Recommended by other source ☐

(specify)..... ☐

Received training for this type of work ☐

Other (specify)..... ☐

B16 Did you receive any assistance from the NGO in the following areas (give details)

Selecting your project

.....

.....

Training (state type of training provided and duration of training)

.....

.....

Product improvement/technical assistance

.....

.....

Access to supplies

.....

.....

Access to buyers

.....

.....

B17 Microenterprise expenses

	At start of project	June 1999
Loan repayments	[Rs <input type="text"/>	[Rs <input type="text"/>
Rent	[Rs <input type="text"/>	[Rs <input type="text"/>

Fuel light and power	[Rs _____]	[Rs _____]
Supplies	[Rs _____]	[Rs _____]
Wages	[Rs _____]	[Rs _____]
Transport	[Rs _____]	[Rs _____]
Other (specify: _____)	[Rs _____]	[Rs _____]
Total	[Rs _____]	[Rs _____]

B18 Gross microenterprise income (before deducting expenses) At start of project: [Rs \_\_\_\_\_]  
June 1999: [Rs \_\_\_\_\_]

B19 Net monthly profit after subtracting expenses At start of project: [Rs \_\_\_\_\_]  
June 1999: [Rs \_\_\_\_\_]

(If no improvement in profits between start of project and June 1999 go to B21)

B20 What have you done with the improved profits (if respondent gives more than one answer, number in order of importance: 1=most important)

Purchased food and other daily consumption needs	[ ]
Purchased household goods (specify: _____)	[ ]
Improvements to dwelling	[ ]
Reinvested in microenterprise (specify _____)	[ ]
Invested in other activity (specify _____)	[ ]
Deposited in savings account	[ ]

B21 How has your household standard of living changed since you began the microenterprise?

Better [ ]  
Worse [ ]  
About the same [ ]

B22 Is the microenterprise your main occupation? YES [ ] NO [ ]

B23 Respondent's other economic activities (do not include the microenterprise)

Occupation	At start of Project		At June 1999	
	Hours per week	Monthly income	Hours per week	Monthly income
Wage employment (specify: _____)				
Agriculture				
Livestock				
Other self-employment (specify _____)				

Total income [Rs \_\_\_\_\_] Total income [Rs \_\_\_\_\_]

#### LOAN DETAILS

C1 What is the amount of your most recent loan from the NGO? [Rs \_\_\_\_\_]

C2 Date of taking current loan: MONTH [\_\_\_\_\_] YEAR [\_\_\_\_\_] [ ]

C3 What is the amount of your monthly repayment? [Rs \_\_\_\_\_]

C4 On what items was the loan spent?

1..... [Rs \_\_\_\_\_]

2..... [Rs \_\_\_\_\_]

3..... [Rs \_\_\_\_\_]

4..... [Rs \_\_\_\_\_]

TOTAL: [Rs \_\_\_\_\_]

FIELDWORKER: Total C4 should be equal to C1.

C5 Are you in arrears with your loan repayments? (If NO go to C7) YES ☐ NO ☐  
 C6 Reasons for arrears with loan repayments

C7 Have you previously taken loans? (If NO go to D1) YES ☐ NO ☐  
 C8 Number of previous loans ☐  
 C9 Date of first loan MONTH  YEAR   
 C10 Details of previous loans  
 Loan no. 1 Purpose..... [Rs   
 Loan no. 2 Purpose..... [Rs   
 Loan no. 3 Purpose..... [Rs   
 Loan no. 4 Purpose..... [Rs

#### DETAILS OF OTHER HOUSEHOLD MEMBERS

D1 Details of all household members (apart from yourself) including those not currently living at home.

Number	Relationship to respondent	Age at last birthday	Primary activity status(*)
2			
3			
4			
5			
6			
7			

(\*): Activity status categories:

- |                               |                                |
|-------------------------------|--------------------------------|
| 1. Employed for pay or profit | 2. Unpaid family worker        |
| 3. Student                    | 4. Unemployed but seeking work |
| 5. Retired                    | 6. Other (specify).....        |

D2 Details of economically active household members apart from yourself (include wage-earners, unpaid household workers and other categories if engaged in part-time economic activity) in June 1999.  
 Person No ..... (as per D1)

Occupation	At start of Project		At June 1999	
	Hours per week	Monthly income or remittance	Hours per week	Monthly income or remittance
Wage employment (specify)				
Wage employment outside local area (specify location and occupation)				
Agriculture				
Livestock				
Other self-employment (specify)				
Subtotal		[Rs <input type="text"/>	Subtotal	[Rs <input type="text"/>

Person No ..... (as per D1)

Occupation	At start of Project		At June 1999	
	Hours per week	Monthly income or remittance	Hours per week	Monthly income or remittance

Wage employment (specify)				
Wage employment outside local area (specify location and occupation)				
Agriculture				
Livestock				
Other self-employment (specify)				

Subtotal [Rs \_\_\_\_\_] Subtotal [Rs \_\_\_\_\_]

Person No ..... (as per D1)

Occupation	At start of Project		At June 1999	
	Hours per week	Monthly income or remittance	Hours per week	Monthly income or remittance
Wage employment (specify)				
Wage employment outside local area (specify location and occupation)				
Agriculture				
Livestock				
Other self-employment (specify)				

Subtotal [Rs \_\_\_\_\_] Subtotal [Rs \_\_\_\_\_]

D3 Does the household receive income from any other source:

Samurdhi [Rs \_\_\_\_\_]

Transfers from non-household members (specify: [Rs \_\_\_\_\_]

)

Other (specify: [Rs \_\_\_\_\_]

)

TOTAL [Rs \_\_\_\_\_]

D4 Total household income in the month of June 1999 (refer to relevant questions and check with respondent):

Microenterprise net profit (B19) [Rs \_\_\_\_\_]

Respondent's other economic activities (B23) [Rs \_\_\_\_\_]

Income of other household members (Add subtotals of Column 5, D2) [Rs \_\_\_\_\_]

Income from other sources (D3) [Rs \_\_\_\_\_]

TOTAL HOUSEHOLD INCOME [Rs \_\_\_\_\_]

# DETAILS OF HOUSING AND HOUSEHOLD ASSETS

E1 Number of rooms in house ☐

E2 Wall type

Wattle and daub ☐

Kabok/metal ☐

Clay ☐

Bricks/cement ☐

Other (specify) ☐

.....

E3 Toilet facilities

Inside latrine ☐

Common latrine ☐

Outside latrine ☐

No latrine ☐

E4 Source of drinking water

Pipe-borne ☐

Common well ☐

Own well ☐

River ☐

Other (specify) ☐

.....

E5 Energy for lighting

Mains electricity ☐

Kerosene ☐

Generator ☐

Other (specify) ☐ .....

E6 Land area cultivated by household:

No land ☐

Less than 0.25 ☐

acre

0.25 - 0.5 acre ☐

0.5 - 1 acre ☐

1-2 acres ☐

More than 2 acres ☐

Crop(s)

grown):.....

E7 Details of land tenure:

Owned by household ☐

Leased from landlord ☐

Leased from ☐

Encroached crown land ☐

government

Other (specify) ☐

.....

..

E8 Household goods and livestock owned (tick where applicable):

At start of  
project

June 1999

Television ☐

Sewing machine ☐

Tractor ☐

Motorcycle ☐

Bicycle ☐

Cow or buffalo (specify number)..... ☐

Poultry (specify number)..... ☐

Other livestock (specify type and number) ☐

.....

**HOUSEHOLD SAVINGS AND EXPENDITURE**

F1 Household expenditure in June 1999:

	Food	[Rs _____]
	Clothing	[Rs _____]
	Fuel and light	[Rs _____]
	Transport	[Rs _____]
	Education	[Rs _____]
	Health/medical	[Rs _____]
Household goods (specify: _____)	)	[Rs _____]
Other (specify: _____)	)	[Rs _____]
TOTAL EXPENDITURE		[Rs _____]

F2 Is household expenditure greater than total household income stated in D4? YES ☐ NO ☐

F3 How often is monthly household expenditure greater than household income?

Hardly ever	<input type="checkbox"/>	Less than half the time	<input type="checkbox"/>
About half the time	<input type="checkbox"/>	Most of the time	<input type="checkbox"/>
All the time	<input type="checkbox"/>		

F4 When expenditure is greater than income how does the household finance the gap?

Withdraw from personal savings	<input type="checkbox"/>	Borrow from trader/shopkeeper	<input type="checkbox"/>
Borrow from small group account	<input type="checkbox"/>	Borrow from moneylender	<input type="checkbox"/>
Borrow from friends/relatives	<input type="checkbox"/>	Other (specify).....	<input type="checkbox"/>

F5 Do you have a savings account? YES ☐ NO ☐

F6 If you have a savings account, what is the current balance? [Rs \_\_\_\_\_]

Fieldworker's observations

.....

.....

.....

.....

.....



## FOOTNOTES

### Chapter 1

1. Expectations that most microfinance institutions will eventually become entirely self-funding may be excessively optimistic, given that in practice few meet strict tests of financial sustainability even after a decade or more of assistance. While most institutions are able to cover the bulk of their operating costs, their capital expenses are financed at least in part by grants and low-interest loans from donors, and only a few have achieved complete self-sufficiency, financing their operations entirely from depositors' savings and commercial borrowings (Rhyne and Otero 1994:18). The majority of microfinance providers, including widely publicised success stories such as the Grameen Bank and Bangladesh Rural Advancement Committee (BRAC), are in receipt of donor funds and are likely to remain so in the foreseeable future (Microbanking Bulletin 1998). It has been estimated that perhaps 1 per cent of NGO-led microfinance programs are fully self-sufficient, and perhaps 5 per cent will reach self-sufficiency in the future (Morduch 1999:1587).

2. There are concerns that influential donors are steering microfinance in a policy direction which is inconsistent with a poverty focus. Microfinance institutions are under increasing pressure to raise loan interest rates and other user charges to support higher levels of cost recovery, in some cases as a condition of continued donor support. The extent to which microfinance programs should proceed down the path of commercialisation has been the subject of heated debate. The institutionist camp argues that full commercialisation is necessary in order to enable access to private capital markets, without which microfinance will never achieve the scale necessary to make a significant dent in aggregate poverty (Christen et al 1995, Otero and Rhyne 1994, Rhyne 1998). They are strongly opposed by the welfarist camp, which argues that in the push towards commercialisation donors and service providers are at risk of forgetting their original poverty reduction objectives (Woller et al 1999, Dunford 1999a, 1999b, Rogaly 1996). At real annual rates approaching 40 per cent many poor borrowers simply cannot afford fully commercialised microfinance services (Morduch 1999). Furthermore as unit transaction costs are a more or less fixed quantity regardless of loan size, and as the poor are relatively difficult to reach, programs concerned with their financial bottom lines have a powerful incentive to avoid them in favour of larger, cheaper, lower-risk loans to non-poor clients.

Institutionists argue that the greater access to funds of fully commercial programs will enable them to operate at a larger scale and hence to have a greater impact on poverty, even if not all their clients are poor, because they can reach larger absolute numbers of poor people than programs whose expansion is constrained by dependence on uncertain and limited donor funds (Christen et al 1995, Otero and Rhyne 1994, Rhyne 1998). They claim that lenders can set interest rates at full cost recovery levels without losing poor clients, arguing that the use by the poor of moneylenders and other informal credit sources, whose interest rates are well above those charged by most microfinance agencies, and evidence of strong demand for microfinance even at very high interest rates, demonstrate that the poor are willing and able to finance full cost recovery (CGAP 1996, Robinson 1996).

Welfarists dispute the institutionist claim that most poor households can pay very high interest rates, arguing that full cost-recovery interest rates are unaffordable not only by the extreme-poor, but also by many other poor borrowers, given the generally low rates of return of their economic activities (Khandker 1998, Morduch 1998). They argue that it is misleading to infer from strong demand for high-interest informal sector loans that poor borrowers can afford commercial microfinance, pointing out that most informal sector borrowings are small and finance short-term consumption needs rather than the larger, longer-term productive investments which are needed for sustainable poverty reduction (Morduch 1998). Even if demand for microfinance were shown to be insensitive to interest rates, as institutionists claim, it does not follow that there is no poverty trade-off, as an increase in costs may simply change the composition of the client base without reducing aggregate demand. There may be no shortage of borrowers who are prepared to pay high rates of interest, but they are not necessarily from the same group as those who would borrow at a subsidised rate, and are likely to be less poor (Morduch 1998).

Institutionists believe that evidence of an income-related impact gap lends support to their claim that there is little or no trade-off between commercialisation and poverty reduction. They agree that commercially viable programs will inevitably exclude some very poor clients who cannot afford loans at commercial rates, but argue that as microfinance impacts are lowest among the very poor, these clients are not well-served by microfinance in any case and are therefore not appropriate targets for financial services, whether subsidised or not (CGAP 1996). Very poor households, institutionists suggest, would benefit more from non-financial poverty-focused interventions which could be supported by donor funds released from microfinance subsidies (Robinson 1996). Welfarists reject the claim that borrowers who cannot afford commercial interest rates are by definition unsuitable for microfinance. They argue that the institutionists' conflation of the two categories is misleading and ignores the importance of the interest rate in determining the utility of credit for poor borrowers. The setting of interest rates at commercially viable levels runs the risk of excluding not only the destitute and near-destitute poor who lack the minimum productive capacity required to support loan repayments, but also "working-poor" clients who, while well below the poverty line, are capable of using loans productively, and are served well by subsidised programs, but cannot pay high rates (Morduch 1998). They also argue that evidence of lower income impact is no reason for excluding the very poor as they can and do benefit from financial services. Even very small income increments may be critically important for households on the margins of survival, and protectional services, while having little impact on income poverty in the short-term, may improve well-being and facilitate eventual poverty exit.

3. Nevertheless, the contribution of protectional services to the well-being of the poorer sample households should not be overlooked. Although microenterprise development has become the principal activity of both of the case study NGOs, they also provide savings facilities and consumption loans, as well as a wide range of non-financial social and community development services. Both give gender issues a high priority and one, the WDF, targets women exclusively. During fieldwork many respondents, particularly women and those from poorer households, reported receiving significant benefits from consumption loans and other non-enterprise services. Some of the sample microenterprises also served semi-protectional purposes, being very small semi-subsistence activities which assisted in promoting food security through home production and smoothing income during annual lean seasons. Although the income-based evaluation methodology used in this study finds most of these microenterprises wanting in terms of their income-generating capacity, some semi-protectional enterprises contribute significantly to the well-being of their mostly poor owners despite earning meagre cash incomes.

4. The Colombo Consumer Price Index (CCPI) measures changes in the changes in the price of a representative basket of goods and services consumed by households in the greater Colombo region. It is not an ideal indicator of movements in non-metropolitan prices, for two reasons. First, the composition of household expenditures varies between Colombo and rural areas, with non-food expenditures taking up a significantly higher proportion of household spending in Colombo. According to the Central Bank's 1996-97 Consumer Finances Survey food purchases account for 38 per cent of average household expenditure in urban regions, in comparison with 50 per cent in rural areas (Central Bank 1999). Second, significant variations exist between rural and urban prices: food is relatively expensive in Colombo, while non-food items are cheaper. The CCPI is, however, used as the basis for calculating the national rate of inflation, and remains the most widely used cost of living index in Sri Lankan poverty research.

5. All dollar values given in this paper are in US dollars. In June 1999 the rupee:US dollar exchange rate was approximately 70:1.

## Chapter 2

1. Unfortunately most studies of women's empowerment under credit programs suffer from a methodological flaw in their failure to isolate the effects of credit from those of group membership and training, which appear to play a highly significant role - perhaps more so than credit - in key social and educational dimensions of empowerment.

## Chapter 3

1. For the purposes of this study the metropolitan region consists of the three districts of the Western Province, which contain the capital Colombo and 25 per cent of Sri Lanka's population. All other regions

are non-metropolitan. Non-metropolitan urban households are located in the central precincts of regional towns with populations of 5,000 or more; semi-urban households are located on the outskirts of regional towns and along the country's main transport routes; households which are not located on a main road and are more than 5 kilometres from a regional town are defined as rural.

2. Sri Lanka's "outlier" status as a poor country with an impressive performance on human development indicators since independence in 1948 is well known. The puzzle of the mismatch between the country's national income and its living standards attracted considerable attention in the 1970s and 80s and was a significant point of interest in a wider growth versus equity debate among development theorists, with each side claiming Sri Lanka as a vindication of its argument. Welfarists saw the country's pre-1977 history as an illustration of the remarkable human development gains that a committed welfare state can produce, even with a low national income (Pyatt 1987, Isenman 1987, Sen 1988, Osmani 1994). Growth adherents argued that a focus on economic growth rather than social expenditure ultimately delivers higher human development returns (Bhalla and Glewwe 1986, Bhalla 1988a, 1988b, Lal and Rajapatirana 1989). They argued that Sri Lanka's strong performance on social indicators in the 1970s and 1980s was a consequence of very high pre-1960 standards, and that minimal improvements in welfare occurred between 1960 and 1978, despite high social spending. In comparison with other countries with similar 1960 per capita incomes, Sri Lanka had significantly higher social indicators in 1960, but probably performed worse in improving living standards after 1960. Sri Lankan social indicators in 1978, impressive as they were, would have been even higher if the country had pursued growth rather than welfare objectives in the 1960-1978 period. They compare Sri Lanka's growth record unfavourably with that of Asian "tigers" such as South Korea, whose 1960 per capita income was comparable with Sri Lanka's, arguing that South Korea's pursuit of a growth policy during the 1960s and 1970s led directly to the present situation where it is not only much wealthier than Sri Lanka but also rates higher on most human development indicators.

3. Some observers dispute the World Bank's claim that poverty fell in the 1980s. The combined effects of devaluation, inflation and the removal of the rice subsidy led to massive food price increases in the early 1980s and there is a convincing body of evidence showing that high growth rates notwithstanding, food consumption in the poorest households fell significantly in the years immediately following economic liberalisation (Sahn 1987, Edirisinghe 1987, Anand and Kanbur 1995). There is some evidence that the periodisation of the DCS surveys which form the basis of the World Bank's analysis exaggerates changes in poverty incidence between the mid-1980s and the early 1990s, as 1985/86 saw a sharp downturn in the rural economy and 1990/91 saw a mini-boom in rural incomes following the end of an armed insurgency in the south (Dunham and Edwards 1997). Dunham and Edwards (1997) are sceptical of the Bank's claim of a sharp reduction in poverty in the second half of the 1980s, given the stagnation during that period of the rural smallholder sector, where most of the poor are located, and in particular falling paddy producer prices and slow rates of off-farm job creation.

4. The estate sector, which is concentrated in the country's central highland region and accounts for about 7 per cent of the national population, consists mostly of the Tamil-speaking descendants of Indian labourers imported in the 19th century to work on the then British-owned tea plantations. They are segregated from the mostly Sinhalese rural smallholder population by ethnicity, language and the location of their dwellings and employment on the estates, and there is little labour migration or social interaction between the two groups. The Indian Tamil population of the central highlands is politically and geographically distinct from the country's larger Sri Lankan Tamil population which is concentrated in the sites of the secessionist conflict in the Northern and Eastern Provinces.

5. Official statistics understate unemployment because they do not take into account widespread labour underutilisation and underemployment: a person who worked even for one hour during the reference period is classified as "employed".

6. In lower-level white collar categories entry-level public sector monthly salaries are slightly lower on average than those available in the private sector. A secretary in the public sector earns just over Rs.4,000, while a similar job in the private sector earns Rs.4,500-8,000. At higher levels the differential widens, with entry-level salaries of Rs.7,225 for public sector administrative officers and Rs.10,000 - 16,500 for their private sector counterparts (World Bank 1999).

7. The EPZs, which are enclosed by electrified barbed wire fences, with guard towers and a large contingent of security staff, have the appearance of concentration camps rather than industrial estates. They are notoriously difficult for outsiders to enter, reportedly denying entrance on occasion even to Labour Department officials (Heward 1997). In the export-oriented manufacturing sector both within and outside the EPZs trade unions have been suppressed and replaced by enterprise-based "workers' councils". Substandard living conditions contribute to a situation where despite very high unemployment rates among young rural women, the EPZs have difficulty attracting and retaining workers, with problems of high turnover and a chronic labour shortage, and vacancy rates of 30-40,000 (World Bank 1999a). In a boarding house observed by the author adjacent to the Katunayake EPZ 4-5 workers at a time share small rooms, sleeping on coir mats on a concrete floor. When they are at work their sleeping berths are occupied by other workers off-shift. Buildings lack running water and kitchen facilities are limited to a fireplace outside the building. Lighting and transport arrangements in the dormitory regions which have grown up around the EPZs are poor and female workers are subject to harassment and the threat of violence from gangs of local youths.

8. Interviews with a group of garment factory workers and staff at the Centre for the Welfare of Garment Workers indicated that most workers remit part of their wages. Wages range between Rs.2,500 - 3,000, a large proportion of which is spent on accommodation and food (Rs.1,000 - 1,200). The average value of remittances is about Rs.1,000.

9. As Mick Moore argues, mainstream Sri Lankan political culture is strongly influenced by a backward-looking mythology based on the idea of an idyllic peasantry in which every household is a paddy-growing smallholder. A widespread reluctance to acknowledge the existence of a class which is for all practical purposes landless extends from the framers of the national census (whose categories make it difficult to identify the extent of landlessness) to the landless themselves, who identify themselves as landholders even if their holding is only one eighth of an acre or less, and their primary source of income is wage labour on larger holdings. Shaw (1999b) found that among a group of Kurunegala smallholders who reported own-land farming as their primary occupation, a third occupied holdings smaller than one-eighth of an acre. Moore argues that the lack of organisation and political invisibility of the landless can be explained by the social and ideological pressure exerted by the nationalist myth, combined with a minute element of reality, in that "every household maintains at least a toe-hold in the landowning class" - even if that toe-hold amounts to only one eighth of an acre (Moore 1985:42).

#### Chapter 4

1. The other is the SANASA federation of village credit unions, which is probably the country's largest NGO credit provider, with a membership of 700,000 in 1992. For a comprehensive evaluation of SANASA see Hulme et al (1996).

2. The growing influence of SEEDS within the Sarvodaya organisation, during a period of rapid organisational change between 1985 and 1995, has not been without controversy. In 1986 Sarvodaya entered into a funding arrangement with a consortium of official donors from four OECD countries, which led to a massive influx of funds and a significant expansion in operations, but also to a weakening of its traditionally voluntarist and informal operational style, with the appointment of a highly-paid top-heavy administration, and what some have argued was an excessive emphasis on financial and administrative controls. Perera (1997) provides a penetrating analysis of the cultural gap between the Sarvodaya leadership and its donors, and the damaging effects of donor interventions on the organisation's morale and operations. Under advice from donors Sarvodaya separated its community development functions, hitherto its principal activities, from its relatively small economic component, which was re-established as SEEDS, a separate, effectively independent entity. Perera argues that from Sarvodaya's point of view, the separation of economic from social programs was a "devastating mistake" made under pressure from donors, which led to the relative impoverishment of the movement's non-economic activities in favour of the new economic program. Mutual dissatisfaction between Sarvodaya and its donors led in 1994 to an abrupt 42 per cent reduction in funding. SEEDS was largely exempted from the funding cut, which had

devastating effects on the rest of the organization, and was further protected by support from the National Development Trust Fund, a Sri Lankan organization which funded NGO microfinance programs. Since the mid-1990s SEEDS has received half of the total allocation to Sarvodaya from NORAD, the principal donor agency.

3. Although voluntarist principles continue to be reflected in Sarvodaya's mission statements, a number of recent consultancy reports have noted a weakening of voluntarism due to a combination of increasing economic pressures on village households, and a shift towards a more individualistic ethic among local members and village society leaders. Some note that the reduced emphasis on voluntarism poses a threat to the achievement of Sarvodaya's social empowerment objectives, which rely heavily on the mobilisation of voluntary labour (Poudyal 1998).

4. In SEEDS the number of microenterprise loans issued fell from 1,139 in 1996 to 870 in 1997, a decline of 24 per cent (Poudyal 1998), while in the WDF it fell from 10,021 to 7256 over the same period, a decline of 28 per cent (WDF financial reports, various years).

5. The tendency of low-value microenterprises to cluster in a narrow range of occupations magnifies the covariate risk to the lender, as a single external event such as a drought or rise in the cost of key input may threaten the viability of a large number of loans.

## Chapter 5

1. The rewarding of village-level party activists with public sector jobs is a well-established tradition among both major political parties. In an authoritative account of the developing role of patronage in Sri Lankan political culture, de Silva (1993) shows how high levels of state control of the economy provided politicians with the means to secure political support and after 1956 "access to political power and powerful politicians became the principal means of acquiring wealth" (de Silva 1993:20). The 1972 constitution reduced the independence of the civil service and increased opportunities for the exercise of political patronage by bringing recruitment and staffing under the control of ministers. By the end of the 1970s, "politicised decision-making in recruitment for government employment, allocation of land or houses and targeting of water supply or electricity schemes, for example, and political victimisation or favouritism in matters concerning promotions and transfers of those in government employment, had hardened into a convention, and one which hardly ever needed to be concealed from the public" (de Silva 1993:93).

The trend intensified with the 1994 election of Chandrika Kumaratunga's Peoples' Alliance government: seventeen years out of office had built up irresistible pressures among PA supporters for their share of the spoils. In acceding to Samurdhi animators' demands for permanent tenure in their jobs the Minister for Samurdhi proclaimed that "Most of the Samurdhi animators were those who had supported the government which would never be so ungrateful as to forget them" (Daily News 6 October 1998). Political activism, formerly the sole province of the most well-off and influential village families, has shifted as during the 1970s the mobilising role of local notables, the traditional mainstay of village politics, began to be taken over by lower-status young men (Moore 1990, De Silva 1993). "Traditionally the vote, and especially the village vote, was delivered or controlled by an educated village elite, coming generally from 'respectable' families . . . Today this has changed or is fast changing; political power on the village level is in the hands of those who can control the unemployed and the discontented, primarily the youth" (Obeyesekere 1984:162).

2. All WDF borrowers are women. Among the sample the percentage of female SEEDS borrowers was 57 per cent, slightly higher than the district ratio of 52 per cent (SEEDS 1999).

3. In practice access to military pensions appears to be a function of political patronage. At least one respondent household reported being unable to access its military pension entitlements due to its lack of political connections and similar cases were reported second-hand by other respondents.

## Chapter 6

1. In the Hambantota Divisional Secretary Division, where the arid sample sites were located, the population density is 94 persons per square kilometer. In the extremely remote Tissamaharama division to the east the average population density falls to 60 (DCS 1998b).
2. Official requirements for lime-producers to obtain licences to collect sea-shells are widely disregarded. The proliferation of unlicensed quarrying on crown land for sea-shell deposits and clay has caused significant local environmental damage.
3. About 5 per cent of the sample farmers were illegal encroachers, most of whom had migrated from the Matara district. This is certainly an under-estimate of the district-wide dimensions of the problem because being ineligible for SEEDS loans, encroachers were under-represented in the sample. In all of the semi-irrigated survey areas farmers reported the presence of encroachers.
4. For the sample borrowers the effect of switching to microcredit was to reduce the term of the loan rather than the size of monthly repayments. A microcredit loan of Rs.5,000, for example, is typically repaid over twelve months in monthly instalments of Rs.500 - 600. The size of the monthly instalments on a similar loan from a moneylender would be similar or slightly lower, but the loan would take several years to repay. As borrowing for both business and consumption purposes is a regular event in the typical household economy, the borrower would most probably have incurred additional debts while still repaying the original loan. Many borrowers reported being in a condition of chronic indebtedness before joining the NGOs. Some borrowers no longer resort to moneylenders; others combine informal sector borrowings with microcredit but with reduced reliance on moneylenders. The freeing of many borrowers from chronic indebtedness - not only through lower cost microenterprise credit but also through the provision of the NGOs' lower-cost consumption loans and savings programs - is a protectional strategy which has made a significant contribution to well-being.
5. Since the mid-1980s there has been little improvement in paddy yields per hectare (Central Bank 1998) and the scope for further increasing productivity or reducing costs is limited (personal communication, David Dunham). In Hambantota district well over 95 per cent of paddy-farmers use the most recently-available high-yield seed varieties, they use tractors to prepare their land rather than the traditional draught animals or hand tools, and use more efficient broadcast seeding rather than row transplanting or seeding (DCS 1998a).

## Chapter 7

1. Reported actions against defaulters include public humiliation at village meetings and the destruction of their property by other borrowers (Montgomery et al 1996).
2. Fishing has a low social status in a predominantly Buddhist culture based on paddy-growing, as it involves the taking of life. It is interesting to note that families engaged in sea-fishing, a much higher-income occupation, attract less social stigma than lagoon-fishers. This may be because a significant proportion of sea-fishing families are Muslims, who are exempt from the social rules and sanctions governing the Sinhalese caste system. Low caste is not an insurmountable barrier to economic improvement, and caste disadvantages appear to be offset by economic success, as wealthy members of the relatively low *Karawe* (fishing) caste are accepted at all levels of Sinhalese society. To be both poor and low-caste, however, is to suffer from a severe dual disadvantage, especially in socially conservative rural communities.

## Chapter 8

1. In the mid-1990s Sri Lanka's investment in core infrastructure which has averaged about 4.5 per cent of GDP compared unfavourably with that of Indonesia (5.5-6 per cent), Thailand (6-6.5 per cent) and the Philippines (7 per cent) (World Bank 1996a).
2. The two rural electrification projects are the Asian Development Bank's Third Rural Electrification project, commenced in 1997, which aims to reach 110,000 rural consumers (Central Bank 1998a), and the World Bank's Energy Services Delivery Project, which aims to reach 32,000 rural households and businesses.



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