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EFFECTIVENESS OF MICROFINANCE IN REDUCING RURAL POVERTY: A CASE STUDY OF SELECTED DISTRICTS IN SRI LANKA [1]

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Abstract

The major objective of this study is to assess the outreach and impact of the microfinance industry in dealing with rural poverty in Sri Lanka taking into account a multitude of factors affecting the performance of microfinance clients and small enterprises. The study is based on a random household sample survey conducted in five districts, and the information gathered from major microfinance providers in the selected areas. By applying the relevant statistical techniques, various hypotheses on the nexus between micro credit and different socio-economic variables are tested in this analysis using quantitative and qualitative information gathered in the field. The findings of this study cast doubts on the popular belief that microfinance fosters small enterprises, and thereby uplifts the standard of living of the poor. Factors such as unprofessional business practices, lack of economies of scale, clients' risk aversion, inadequate technological and business guidance on new products, non-availability of resources, lack of research and development initiatives and lack of innovation have inhibited the growth of small enterprises supported by microfinance. The unfavourable natural environment, poor infrastructure and weak market linkages have further deteriorated the profitability of these enterprises. Meanwhile, the lack of a proper regulatory and supervisory framework has adversely affected the financial viability of the microfinance industry. Unless the policy makers and microfinance providers address these issues adequately and urgently, it is doubtful whether the household-based small enterprises backed by microfinance could sustain for long in the open economy environment, as clearly proved by the findings of this study.

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1 This is a summary of the findings of a field study conducted by the authors during 2003-2005. It was a collaborative research project between the Department of Social Studies, the Open University of Sri Lanka and the Department of Economics, University of Lund, Sweden. The authors are grateful to the Swedish International Development Co-operative Agency (SIDA) for funding the project. They also acknowledge the assistance provided by the staff of the Department of Social Studies and the teams of investigators from other organizations in carrying out the study.

1. Introduction

Microfinance (MF) can be defined as the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, insurance cover and business development services to the poor and low-income households and their micro-enterprises (ADB, 2000). In the context of Sri Lanka, micro-credit generally refers to loans up to Rs. 40,000 (about US dollars 400) – although the industry's average micro-credit amount is much lower, at around Rs. 10,000 (about US dollars 100) – and other similar small-scale financial services (Charitonenko and de Silva, 2002).

In general, people in the lower income layers do not have access to credit and other financial facilities provided by commercial banks and other formal financial institutions owing to factors like lack of collateral, inadequate regular earnings, strict debt service requirements and complicated loan application procedures. In spite of the substantial growth in commercial banks and other financial institutions, as much as 55 percent of households still depend on non-institutional sources for borrowing. In fact, the amount of loans taken from non-institutional sources rose from 33 percent to 39 percent between 1996/97 and 2003/04 (CBSL, 1996/97 and 2003/04). Microfinance institutions (MFIs) meet less than 10 percent of the total household loan demand.

Microfinance is generally attractive to poor people for reasons such as group-based lending, less or no collateral requirements and reasonable interest rates. Microfinance is increasingly recognized as an effective instrument for poverty reduction. It is widely believed that microfinance enables poor people to engage in their own small enterprises, and thereby to raise their incomes, and to accumulate assets. This brings about a progress in living conditions of the poor; improvements in food intake, health, housing, education etc. Savings and insurance facilities provided by MFIs help to reduce various kinds of risks faced by the vulnerable poor. Microfinance institutions (MFIs) also provide a variety of enterprise services like skills development training, advisory and counseling services, technical advice and market guidance. Hence, microfinance is said to be based on a "credit plus" approach. Another major benefit of microfinance is its "empowering" effect, which goes beyond increased economic returns. In particular, microfinance is considered to have potential to empower rural women through its group saving and lending mechanisms. Thus, the contributions that are being made by the MFIs with regard to poverty reduction, employment generation and women's empowerment cannot be underestimated.

In Sri Lanka, microfinance as a separate industry emerged in the late 1980s when the government shifted its social welfare policy strategies from the provision of consumer subsidies to delivery of credit to the targeted poor for income-generating economic activities as a major instrument to deal with poverty. A major obstacle in developing income generating activities of the poor people is their lack of access to capital in the formal financial sector due to stringent regulations including rigid collateral requirements for loans, irksome loan procedures and the need to have regular incomes. As a result, the poor largely resort to informal borrowing sources like money lenders, friends, relatives, boutiques and employers. Terms and conditions applicable to such borrowings are generally unfavourable to the borrower resulting in a further deterioration of the living conditions of the poor. Microfinance, placed between the two extremes of formal and informal financial markets, has emerged as an alternative source of borrowing for the poor.

The successive governments in Sri Lanka have recognized microfinance as a major component in their safety net schemes, mainly the previous 'Janasaviya' programme and the current 'Samurdhi' programme. Apart from the government, a large number of institutions including cooperative societies, local and foreign NGOs, commercial and specialized banks, and international donor agencies provide various types of microfinance products and services such as micro-credit, insurance, business development services and training with a greater focus on the poor.. The lending technologies adopted by the microfinance institutions (MFIs) include cooperative method, Grameen Bank type group-lending, primary bank societies, credit plus approach and barefoot banking. These innovative methods have largely eliminated the collateral and other requirements, usually insisted by the traditional financial institutions in credit delivery.

There are a few studies focusing on the performance of selected microfinance institutions and programmes in Sri Lanka. Dias (2001), Hewavitharana, (1994) and Mithraratna (2003) have reviewed the progress of the Women's Development Federation (WDF), also known as Janashakthi banks, in Hambantota. In a more rigorous analysis, Wickrama (1998) evaluates the Social Mobilization Programme in the Hambantota district by using quantitative and qualitative data collected through a sample survey. In a more recent study, Tilakaratna et al (2005) have conducted a household survey on microfinance outreach and its impact on poverty covering all the districts except those in Northern and Eastern areas. A major shortcoming in these currently available studies is that they are restricted to either supply-side or demand-side of the microfinance industry, and therefore they are mostly partial. Also, some of these studies do not adequately capture the effects of exogenous factors like natural environment, physical infrastructure and distance to towns. Our study expects to fill these lacunae.

The objective of this study is to assess the outreach and impact of the microfinance industry in tackling rural poverty in Sri Lanka taking into account a multitude of factors affecting the performance of microfinance clients and small enterprises. For this purpose, we conducted a supply-side survey as well as a demand-side survey. Thus, we have adopted a broader approach in our study. By applying the relevant statistical techniques, various hypotheses on the nexus between micro credit and different socio-economic variables are tested in this analysis using quantitative and qualitative information gathered in the field.

The next section of the paper describes the conceptual framework and sample design of the survey. Outreach of microfinance services is assessed in section 3 by using quantitative data. Impact of microfinance on enterprises and households will be assessed in sections 4 and 5, respectively. In section 6, constraints faced by small enterprises run by the poor will be analyzed. In section 7, the effectiveness of microfinance in empowering women is examined using quantitative and qualitative information. Summary and conclusions based on the study are presented in the final section.

2. Conceptual Framework and Sample Design

As mentioned earlier, the major focus of this study is to analyze the impact of microfinance on poverty reduction in the rural sector. The link between microfinance and poverty reduction is rather complex, because a wide range of mediating and external factors intervene in the living conditions of the clients and performance of their small enterprises. Mediating variables are those factors that foster or inhibit opportunities for change, but are not directly linked to a particular microfinance programme, e.g. social and cultural background, gender of client, number of household members, environmental conditions and price of enterprise inputs. External factors lead to changes, irrespective of the programme, e.g. increases in household income due to factors other than clients' activities such as changes in macroeconomic conditions. Therefore, we have attempted to take into account such mediating and external factors in collecting and analyzing data in this study.

The study is based on a household sample survey conducted in five selected districts, namely Hambantota, Moneragala, Nuwara Eliya, Badulla and Batticoloa. These districts were selected taking into account their diverse characteristics pertaining to geographical conditions, ethnicity, economic activities, socio-economic conditions, poverty levels and presence of MFIs. Three of the districts (Badulla and Nuwara Eliya) belong to the wet zone while the other three districts (Battticaloa, Hambantota and Moneragala) belong to the dry zone. Moneragala is the poorest district in the island excluding North and East. Badulla is the second poorest district, and Hambantota is in the fourth position. Batticaloa, which does not have recent poverty data, can also be characterized as a poor district. Among the districts selected in this study, Nuwara Eliya has the least proportion of poor households. Batticola, located in the eastern coast, is adversely affected by both the recent tsunami and the prolonged ethnic conflict. Hambantota district located in the southern coast was also severely affected by the tsunami.

The main survey instrument used was a structured questionnaire focusing on socio-economic effects of microfinance. Information was gathered mainly through quantitative tools. As regards women's empowerment through microfinance, quantitative data have been supplemented by the qualitative information collected by means of in-depth interviews and focus group discussions.

Broadly, microfinance is considered to be beneficial to the clients in view of factors such as easy access, absence of collateral requirements, flexible repayment mechanism and low interest rates, in comparison with other rural lending arrangements. As the poor are generally excluded from credit facilities of commercial banks and other formal financial institutions, microfinance has been increasingly recognized as an alternative and trouble-free source of credit. However, considerable disagreements on microfinance can be found in the literature. Some writers (Holcmbe, 1995; Hossain, 1988; Otero and Rhyne, 1994; Remenyi, 1991; Schuler, Hashemi and Riley, 1997) argue that microfinance brings about immense socio economic benefits. In contrast, some other researchers (Adams and von Pischke, 1992; Buckley, 1997; Montgomery et al, 1996; Rogaly, 1996; Wood and Shariff, 1997) point to the negative impacts of microfinance. Between these two extremes, there are some other writers (Hulme and Mosley, 1996; Mosley and Hulme, 1998) who believe that although microfinance has several beneficial effects, it does not help the poorest, as is so often claimed.

Given the above diverse views, it is important to assess the impact of microfinance on households and micro enterprises in the context of Sri Lanka. The methodology underlying the survey of this study is partly based on a framework developed by the SEEP Network (2000) as part of the wider AIMS programme funded by the USAID.[2]This conceptual framework places the family/household at the centre of its analysis. The reason is that small enterprises are closely linked with the family/household. Accordingly, it is theorized that microfinance exerts its impact at four levels:

1. At the family/household level: Small enterprises backed by microfinance contribute to net increases in family/household income, asset accumulation and labour productivity. Increased income also leads to improvements in education and health conditions of the family/household.
2. At the enterprise level: Microfinance leads to improvements in production, employment, assets and profits of small enterprises.
3. At the individual level: Microfinance has positive effects on individual's income, decision making capacity, which in turn, lead to strengthen the economic portfolio of the family/household
4. At the community level: Small enterprises generate new employment opportunities and backward and forward linkage industries, and also attract new investment and income from outside the community.

Using the above framework a structured questionnaire was designed in this study to collect data on a wide range of dimensions covering (a) natural environment and physical infrastructure, (b) characteristics of households and clients, (c) utilization of micro credit, (d) soundness of enterprises, labour inputs and profitability, (e) savings and entrepreneurship of clients, (f) fixed assets and durable consumer goods in households, (g) housing improvements, (h) dietary changes and

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[2] The Small Enterprise Education and Promotion (SEEP) Network is an association of more than forty U.S. and Canadian NGOs that work with hundreds of local organizations on microfinance development. SEEP engages in research, documentation, and training activities aimed at improving member practice. Since its inception, SEEP has focused on monitoring and evaluation issues as a critical part of its program; its Evaluation Working Group facilitates SEEP's work under the Assessing the Impact of Microenterprise Services (AIMS) project.

food security, (i) empowerment of women, and (j) clients' assessments about microfinance institutions/programmes.

The household sample survey was conducted in the five districts during 2003-2005. It was done on a staggered basis to avoid seasonality problems. It covered a total of 1,235 households consisting of 1,078 clients and 157 non-clients. The number of households selected from each district was proportionate to the total population of each of them. The sample selection was conducted in two stages.

Stage I: A few major MFIs were selected from each district for the survey to prepare the sample frame which consisted of their clients. These MFIs are the primary sampling units of the survey.

Stage II: A total of 150 banking societies were chosen on a random basis from selected microfinance providers in the five districts. These formed the Secondary Sampling Units (SSUs) of the survey. Each banking society has about 80-100 groups each consisting of five members or microfinance clients. The group/member lists provided by the banking societies of the respective MFIs were used as the sampling frame for the survey. By applying the systematic sampling method, 8-10 clients were chosen from these societies. Altogether, a sample of 1,078 clients was used in the study as shown in Table 2.1.

Table 2.1

District-wise Composition of the Sample

District	No. of Clients
Hambantota	226
Moneragala	182
Nuwara Eliya	260
Badulla	350
Batticoloa	60
Total	1,078

In addition to the above, we selected 157 individuals who were waiting to obtain their membership or credit facilities from microfinance institutions. These prospective clients or non-clients are treated as the control group in our study.

The selected clients belong to three types of institutions or schemes that provide microfinance services as follows:

Community-Based Organizations: Sarvodaya Economic Enterprise Development Services, Women's Development Federation/Janshakthi banks (Hambantota District), Social Mobilization Foundation (Hambantota District), Rural Women's Organization (Nuwara Eliya District), Upcountry Development Council (Badulla District), Sareeram (Batticaloa District) and CARE;

Government's Welfare Scheme: Samurdhi scheme/banks; and

Commercial and Licensed Specialized Banks: Ruhuna Development Bank, Uva Development Bank, Sanasa Development Bank, Seylan Bank.

The survey covered all three types of institution that provide microfinance facilities. It specifically selected the three largest CBOs that carry out microfinance as their core activity in a more professional manner. They are SEEDS, Janshakthi and SMF. The Samurdhi scheme, which is the government's main arm of poverty reduction covering the entire country, was also given adequate coverage in the sample. Two major development banks and a commercial bank were selected for the banking sector.

Adequate caution was taken to minimize the sampling and non-sampling errors of the survey. Probability sampling that was used in this survey to select the samples from different districts and MFIs, greatly helped to obtain unbiased estimates. Estimates given in Table 2.2 indicate that the probability that an estimate from a given sample differs by a given amount from the average of those from all possible samples of the same type is very low. Thus, the sampling errors are expected to be minimal in this survey. As the computation of statistics in this study is largely based on ratio estimates which capture the relationship between different variables, a further improvement in the reliability of estimates could be expected.

Table 2.2

Estimates of Standard Error, Coefficient of Variation and Confidence Limits

Variable	Mean Statistic	Standard Error	Coefficient of of Variation %	95% Confidence Limits of Estimates Lower Limit	Upper Limit
Number of Persons per Household	4.45	0.049	1.10	4.35	4.55
Average Income per Household per month (Rs.)	10,102	437	4.32	9,228	10,975
Average Expenditure per Household per month (Rs.)	11,662	501	4.30	10,659	12,664
Average Amount of Loans taken (Rs.)	33,586	1,900	5.66	29,785	37,386
Amount of the Last Loan (Rs.)	17,059	901	5.28	15,257	18,861
Length of Membership (No. of Months)	86.05	3.262	3.79	79.52	92.57

3. Outreach of Microfinance

This section examines the breadth and depth of MFI outreach. Breadth of outreach refers to distribution of MFI services in terms of scale, gender, age and geographical spread. Depth of outreach refers to socio-economic status of clients, with particular reference to "reaching the unreached".

3.1 Breath of Outreach

The major MFIs that are covered in this survey have nearly 3.5 million clients (Table 3.1) accounting for about 18 percent of the population of the country. The Samurdhi program serves the majority of the clients.

Table 3.1

Number of MFI Clients

Institution/ Scheme	Total Membership
Samurdhi	2,018,096
Janshakthi	35,000
SEEDS	561,321
SANASA	854,583
Total	3,469,000

In the MFIs covered by the survey, the majority of clients are women except in the case of banks (Table 3.2). Participation of women is highest among CBOs. In particular, the Women's Development Federation (WDF) in Hambantota is exclusively dedicated to female clients. Greater participation of women is a common feature that can be observed in MF sector in most countries. For instance, the Grameen Bank scheme in Bangladesh, which is considered as a pioneering model of microfinance, is exclusively a bank for women.

Table 3.2

MFI Women Clients

MFI Category	Percentage
CBOs	68.2
Samurdhi	53.7
Banks	29.4
Total	58.3

Age-wise, about 55 percent of the MF clients covered in the survey are in the age group between 26 and 45 years (Table 3.3).

Table 3.3

Percentage of Clients by Age and Gender

Years	Male	Female	Total
< 18	0.2	0.8	0.6
19 - 25	6.3	4.6	5.3
26 - 35	22.7	22.0	22.3
36 - 45	30.8	34.7	33.1
46 - 55	24.1	28.3	26.5
56 >	15.9	9.6	12.3
Total	100.0	100.0	100.0

Around 90 percent of microfinance clients have educational qualifications less than GCE (A/L) (Table 3.4). This implies that the less-educated have benefited from microfinance facilities.

Table 3.4

Highest Educational Attainment of Microfinance Clients

	Percentages		
	Male	Female	All
No schooling	1.9	2.7	2.4
Less than primary	15.4	18.2	17.0
Primary passed	31.7	29.2	30.2
GCE(O/L) passed	40.2	41.2	40.8
GCE (A/L) passed	9.5	7.5	8.3
Graduate	1.4	1.2	1.3
Total	100.0	100.0	100.0

Over 70 percent of the total number of microfinance clients interviewed did not have employment (Table 3.5).They were either self-employed or unpaid family workers. This means that such unemployed managed to develop their livelihood with the help of microfinance.

Table 3.5

Employment Status of Microfinance Clients

Percentages

Status	Male	Female	Total
Regular	15.3	7.9	11.0
Casual	17.2	12.3	14.3
Contractual	2.2	2.1	2.1
Self-employed	51.2	41.6	45.6
Unpaid family workers	14.1	36.1	26.9
Total	100.0	100.0	100.0

3.2 Depth of Outreach

The MFIs provide their services to clients living in villages far away from towns (Table 3.6). Overall, 40 percent of the clients covered in this survey live beyond a distance of more than 5 Kms. from a town. The CBOs are prominent with regard to serving the remote areas. About 43 percent of their clients are from locations more than 5 Kms. Approximately, 31 percent of MFI clients live at a distance of 2-5 Kms. from the town. Only 28 percent of the clients are from town areas. Samurdhi and banks also serve a greater proportion of remote villagers. Thus, microfinance outreach to under-privileged rural areas seems to be satisfactory.

Table 3.6

Clients' Distance to Closest Town by MFI Category

(Percentages)

MFI Category	< 2 Kms.	2-5 Kms.	5 Kms. >	Total
CBOs	23.3	33.5	43.2	100.0
Samurdhi	33.2	27.6	39.2	100.0
Banks	31.1	32.8	36.1	100.0
All	27.9	31.2	40.9	100.0

The survey reveals that 58 percent of the total number of clients covered is poor and very poor (Table 3.7). Interestingly, the proportion of very poor is relatively higher in banks. This might be due to the pro-poor targeted programmes adopted by commercial and development banks in recent times

Table 3.7

MFI Clients by Poverty Levels

(Percentages)

MFI Category	Non-poor	Poor	Very Poor	Total
CBOs	56.4	29.6	14.0	100.0
Samurdhi	18.9	64.8	16.3	100.0
Banks	58.0	21.8	20.2	100.0
All	41.9	42.2	15.8	100.0

4. Impact of Microfinance on Enterprises

We attempted to evaluate the impact of microfinance on small enterprises by using several indicators such as profitability, changes in businesses, business criteria and practices, resource base, and utilization of micro credit. According to the survey, a little over 40 percent of the clients and 30 percent of non-clients gained profits from their enterprises. Thus, the performance of clients looks better.

We also examined whether the two groups changed their business practices (Table 4.1). About 20 percent of the clients expanded the size of their enterprises while about 6 percent of the non-clients did such expansion. Approximately, 15 percent of the clients and 5 percent of non-clients added new products. Clients took more positive steps as regards all other business practices as well. Therefore, we could infer that microfinance has helped the borrowers to develop their enterprises.

Table 4.1

Changes in Business Practices (in the last 12 months)

Change	% of Clients	% of Non-clients
Expanded size of enterprise facility	20.7	6.4
Added new products	15.0	4.5
Hired more workers	5.0	1.9
Improved product quality	10.3	2.5
Reduced costs by buying inputs in bulk	10.9	2.5
Reduced costs with cheaper credit	12.4	3.2
Developed new enterprise/s	10.2	6.4
Sold in new markets/locations	8.2	3.8

When starting a business, both clients and others based their decisions largely on family traditions (Table 4.2). A large proportion of both groups also consider demand for the product when opening a new venture. Skills of the family are taken into account by both groups. Overall, most of the clients as well as non-clients are inclined to carry on the family-based traditional ventures even after taking micro credit. Clients follow the traditional occupations, in spite of the technical and market guidance given by certain micro credit providers to promote innovative enterprises. Also, we have observed that the clients do not consider project feasibility when they start a new venture.

Table 4.2

Business Criteria Used When Starting a New Business

Criteria	% of Clients	% of Non-clients
By tradition	78.0	83.4
Based on demand for product/service	69.8	63.1
Based on working capital requirements	42.5	36.9
Based on skills of the family	55.2	61.1
Other	11.6	3.2

Clients appear to have performed more rationally with regard to business practices (Table 4.3). However, their performance with respect to money management and accounting practices does not seem to be very satisfactory. Less than 20 percent of the clients keep cash balances of the enterprises separately from their personal money. About 35 percent of the clients were unable to show any proper records of their enterprises. Only 22 percent of the clients had a permanent outlet for sales, and only 8 percent had separate storage facilities. Thus, MFIs need to pay more attention to provide training and financial facilities to improve their accounting practices and to improve infrastructure.

Table 4.3

Business Practices Adopted When Operating a Business

Business Practice	% Non-clients	% Clients
Keeping enterprise money seperately	19.3	17.1
Calculating profits based on records of costs & earnings	35.1	26.9
Identifying highly profitable products	49.2	35.9
Clients who pay themselves a wage for their work in enterprise	5.7	6.4
Have a fixed location with protection for selling the products	21.7	11.0
Have a fixed location separate from house for storing	8.3	7.9

Technological improvements are vital in enhancing productivity and profitability of an enterprise.3 Technology fosters labour productivity by enabling workers to produce more output using the same amount of capital. A country's ability to improve its standard of living over time depends entirely on its ability to raise its output per worker (Krugman, 1997).4 New technology is hardly used in the small enterprises covered by this survey (Table 4.4). Apart from buying small tools and accessories, both clients and non-clients did not expand their resource base in the immediate period prior to the survey. Inadequate technological progress prevents any significant improvement in factor productivity. The survey results clearly illustrate that the small enterprises backed by microfinance in the five districts are handicapped by the lack of any technological advancement.

[3] Recent growth theories extend the traditional approach by making the rate of technological change endogenous. The production function for an individual firm can be expressed as:

$$Y = F(K,N,A)$$

Where Y = Output
K = Capital
N = Labour
A= Technology

Thus, advances in technological applications and knowledge enhance the productivity of a firm.

[4] Krugman states, "Productivity isn't everything, but in the long run it is almost everything."

Table 4.4

Changes in Resource Base

change	% of Clients	% of Non-clients
Purchased small tools/ accessories	24.1	3.3
Purchased major tools/ equipment/ machinery	5.5	0.5
Purchased light transport equipment	2.8	0.4
Purchased medium-size transport equipment	3.0	0.3
Invested in storage structure	2.0	0.4
Made minor investment in production site	4.0	0.6
Invested in srtuctures for marketing site	4.7	0.4
Invested in buildings	1.0	0.1
Invested in lands	4.8	0.3

Around 85 percent of the clients reported that they utilized their MF loans for business (Table 4.5). Thus, the bulk of micro credit seems to have been used for productive purposes. However, there might be some exaggeration in this figure, as clients are generally reluctant to declare that the loans are used for other purposes fearing that that they may not receive loans in the future. A few clients have used a part of their loans to meet domestic expenses as well.

Table 4.5

Utilization of Loans

Purpose	% of Clients
Used part of loan for	
Business	74.4
Buying Food	6.7
Buying Clothes or household items	4.3
Granting / lending to spouse or other person	5.4
Keeping money in hand for emergency or repaying debt	3.1
Meeting medical expenses	3.4
Meeting children's school expenses	2.3
Housing purposes	5.8

Approximately 85 percent of the clients used their profits to buy food (Table 4.6). Profits were used also to meet other basic needs like health, clothing and education. Thus, small enterprises help to raise the living conditions among the low-income families to a certain extent. Only 2 percent of the clients were able to save a part of their profits reflecting the low rates of return of enterprises. Nevertheless, 32 percent of clients used their profits for reinvestment.

Table 4.6

Utilization of Profits

Purpose	% of Clients
Food	85.7
Education	12.2
Health Care	14.8
Repay Loans	36.3
Re-investments	31.8
Miscellaneous expenses	5.8
Clothing	5.5
Items for Housing	0.9
Savings	2.1
Transport & Communication	18.4
Fuel & Lighting	24.5
Consumer Durables	0.6
Entertainment	8.3
Lands & Buildings	16.7

Now, let us attempt to test the null hypotheses that the mean value of sales and mean value of profits are the same for all clients irrespective of the duration of their membership with MFIs. For this purpose, we categorized the clients into four groups depending on their membership duration; 0-2 years, 3-5 years, 6-10 years and above 11 years. The One-way Analysis of Variance (ANOVA) results indicated that both null hypotheses can be rejected at 99 percent confidence interval (Table 4.7). This means that sales and profits vary with the duration of the membership.

Table 4.7

ANOVA: Profits and Sales by Membership Duration

			Sum of Squares	df	Mean Square	F	Sig.
SALES	Between Groups	(Combined)	5.89E+09	3	1.96E+09	5.039371	0.00194
	Within Groups		1.57E+11	404	3.89E+08		
	Total		1.63E+11	407			
PROFITS	Between Groups	(Combined)	3.78E+09	3	1.26E+09	5.907119	0.000594
	Within Groups		8.61E+10	404	2.13E+08		
	Total		8.99E+10	407			

5. Impact of Microfinance on Households

The "credit plus" approach adopted by many MFIs is expected to uplift the living conditions of low-income families in the under-privileged villages. Specifically, group formation enhances organizational capacity among the villagers. The clients are offered a variety of services including savings, credit, insurance and skills development. This Section attempts to gauge the effects of these services on household welfare.

About 17 percent of the clients, as compared with 26 percent of non-clients, reported that their income increased in the 12 months preceding the survey (Table 5.1). But the income changes between clients and non-clients are not statistically significant.

Table 5.1

Changes in Income Over the Last 12 Months

Change	% of Clients	% of Non-clients
Household income		
Declined substantially	2.5	1.9
Declined	17.3	22.9
Remained unchanged	25.2	40.1
Increased	8.6	21.0
Increased substantially	8.2	5.7
Client's income		
Declined substantially	3.0	0.6
Declined	19.1	26.1
Remained unchanged	24.8	47.8
Increased	15.9	22.9
Increased substantially	0.7	0.6

In comparison with the non-clients, we could not identify any major factor that contributed to income increases of clients (Table 5.2).Perhaps, this may be due to insignificant income increases of clients as reported in the previous Table.

Table 5.2

Resons for Increase in Income

Reason	% of Clients	% of Non-clients
Expanded the enterprise	9.5	5.1
Started a new enterprise	5.4	3.8
Bought inputs at low cost	1.1	0.0
Sold goods to new markets	1.4	0.0
Got a job	1.4	5.1
Got the loan without delay	1.5	0.0
Other	3.8	7.0

Meanwhile, around 9 percent of clients and 13 percent of non-clients reported that their incomes declined as a result of crop failures (Table 5.3). This reflects the over- dependence of the clients on agriculture. Family illnesses, loss of jobs and low sales were the other major factors that adversely affected income levels.

Table 5.3

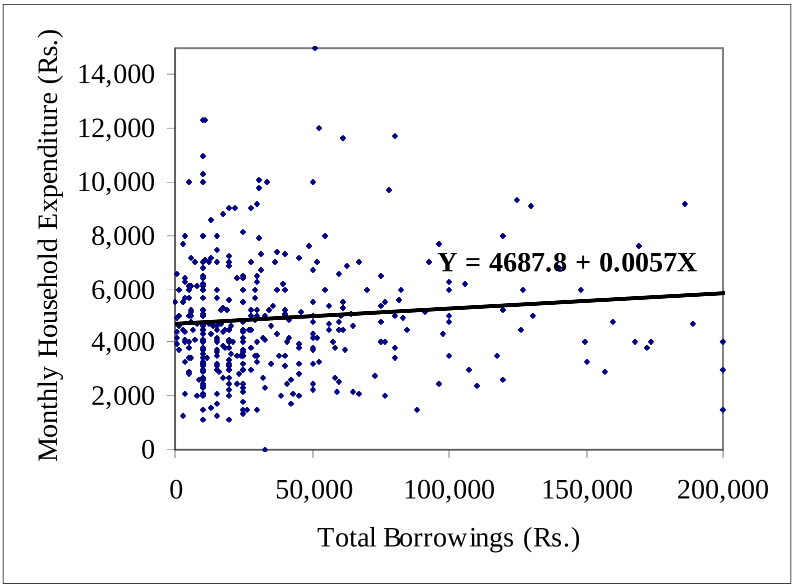
Reasons for the Decrease in Income

Reason	Clients	Non-clients
Illness of the client or a houshold member	9.0	9.6
Decline in sales	5.2	1.9
Difficult to find Inputs	3.8	1.9
Decline in agricultural output	9.2	12.7
Loss of job	1.7	0.6
Inability to get the loan in time	0.6	0.0
Other	5.1	2.5

We have observed that there is a moderate positive relationship between the total amount of MF loans taken by clients and their household expenditure (Figure 5.1). The expenditure of households hovers around Rs. 5,000 per month. This can be mainly attributed to the fact that around 90 percent of the clients fall within this category as explained earlier in this paper.

Figure 5.1

Relationship Between Expenditure and Borrowings



We have also attempted to ascertain the causal relationship between household expenditure and several independent variables, namely, the total amount of loans, land size and distance from the closest town. The log linear regression results show that the coefficient for loans is significant at 95 percent confidence level (Table 5.4). These statistical computations indicate that a 1 percent increase in MF loans results in a 0.06 percent increase in the household expenditure. However, this needs to be interpreted carefully, because the low R2 indicates that this is a poor statistical fit. Therefore, we cannot infer that there is any significant causal link between household expenditure and micro credit.

Table 5.4

Log Linear Regression

Dependent variable: Household expenditure Number of observations: 408 Variable	Coefficient		Std. Error	t-Statistic	Prob.
No. of employees	0.3174		0.0951	3.3384	0.0009
Total amount of loans	0.0626		0.0248	2.5201	0.0122
Size of land	0.0164		0.0249	0.6576	0.5113
Distance from town	-0.0293		0.0329	-0.8914	0.3734
Constant	7.7677		0.2596	29.9277	0.0000
R-squared	0.056603	Mean dependent var			8.408346
Adjusted R-squared	0.045168	S.D. dependent var			0.483419
S.E. of regression	0.472376	Akaike info criterion			-1.485149
Sum squared resid	73.63574	Schwarz criterion			-1.428222
Log likelihood	-221.5819	F-statistic			4.949967
Durbin-Watson stat	1.748996	Prob(F-statistic)			0.00069

We tested the null hypothesis that there is no difference between the mean expenditures of clients and that of non-clients (Table 5.5). The test shows that this hypothesis cannot be rejected, implying that there is no significant difference between the average household expenditures of clients and non-clients. This can be mainly attributable to external factors like drought and other natural disasters in the two districts. The impact of such disasters on agricultural output is felt frequently by both groups resulting in low income, low expenditure and low savings.

Table 5.5

Independent Samples t-Test
Mean Household Expenditure of Clients and Non-clients

	Levene's Tests for Equality of Variances		t-test for equality of means			
					Sig	Mean
	F	Sig	t	df	(2-tailed)	Difference
Equal variances assumed	5.582	0.019	0.511	518	0.610	147.0361
Equal variances no assumed			0.656	280	0.512	147.0361

As regards saving habits, there does not seem to be any significant difference between the two groups. Around 55 percent of the interviewed clients and 49 percent of non-clients reported that they have some amount of personal savings. Meanwhile, around 35 percent of clients and non-clients experienced a decline in their savings while about 20 percent of them had a rise in savings. Although MFIs inculcate the habit of savings habit, there is no statistically significant difference between the savings levels of the two groups.

We used the Pearson correlation technique to test the null hypotheses that micro credit does not affect income, expenditure or savings among clients (Table 5.6). The correlation coefficient for income and savings against micro credit is significant at 0.01 level while that of household expenditure is significant at 0.05 level.

Table 5.6

Pearson Correlation Matrix

		Income	Expend-iture	Savings	Micro Credit	Profit
Income	Pearson Correlation	1.000	.306**	.349**	.190**	.130**
	Sig. (2-tailed)	.	.000	.000	.000	.009
Expend-iture	Pearson Correlation		1.000	.003	.120*	.070
	Sig. (2-tailed)		.	.950	.015	.155
Savings	Pearson Correlation			1.000	.140**	-.036
	Sig. (2-tailed)			.	.005	.463
Micro Credit	Pearson Correlation				1.000	-.074
	Sig. (2-tailed)				.	.134
Profit	Pearson Correlation					1.000
	Sig. (2-tailed)					.

**. Correlation is significant at the 0.01 level (2-tailed).

*. Correlation is significant at the 0.05 level (2-tailed).

As regards household assets, more or less similar proportions of both clients and others own durable consumer goods (Table 5.7). However, more clients own high-valued assets like three-wheelers, cars and tractors.

Table 5.7

Ownership of Household Assets

Asset	% of Clients	% of Non-clients
Value less than Rs. 2,000		
Radio	66.5	69.4
Tape Recorder	50.0	65.0
Chairs/Tables/Benches	87.8	93.6
Value Rs. 2,000 - Rs. 20,000		
Bicycle	35.1	63.1
Bed with Mattress	77.8	82.2
Cooker/Refrigerator	14.2	21.7
Telephone	62.5	66.9
Value above Rs.20,000		
Motor Bicycle	10.3	19.1
Motor Car/ Pickup	1.3	0.6
Three Wheeler	2.1	1.9
Tractor	4.1	5.1
Telephone	7.6	13.4

The study also assessed the effects of micro credit on household welfare conditions like dietary levels, education and housing. As regards diet and food security, both groups experienced similar changes. Around 80 percent of clients and non-clients reported that there was no change in diet or food security in the period immediately preceding the survey. Approximately, 10 percent of them indicated an increase in the food intake and the balance 10 percent experienced a decline. Also, we could not identify any remarkable difference in school expenditure between the two groups. As regards housing, clients made more improvements to their houses as compared to non-clients (Table 5.8). But again, the differences are marginal. This indicates that the profits earned by the clients from small enterprises are not sufficient to make any significant impact on housing conditions.

Table 5.8

Housing Improvements made by Clients

Nature of improvement	% of Clients	% of Non-clients
Bought a new house	11.76	11.61
Repaired/improved the house	22.30	17.86
Extended the house	7.35	6.25
Improved water/sanitary etc.	4.90	1.79
Lighting/electricity	6.62	5.36

6. Constraints faced by Small Enterprises Run by the Poor

Although MFIs provide a multitude of services, the small enterprises do not seem to have grown sufficiently owing to various mediating and external factors. For instance, the unfavourable natural environment in Hambantota and Moneragala districts is a major constraint to growth. In the 6 months prior to the survey, 32 percent of the clients faced drought condition, 4 percent faced floods and another 4 percent were attacked by wild elephants. The small enterprises are also handicapped by inadequate physical infrastructure. About 22 percent of the MF clients are living in areas where there are no proper access roads and other basic infrastructure facilities like hospitals, schools, markets, electricity and water.

Approximately, 41 percent of the clients had difficulties in repaying their loans mainly on account of crop failures (Table 6.1). This reflects the heavy dependence of the clients on agriculture. Other factors are illness in the family, low sales of products and low profitability.

Table 6.1

Reasons for Loan Repayment Defaults
(Percentage of clients)

Crop failures	41
Illness	26
No sale proceeds	9
Household commitments	4
Low profitability	1
Other	19
Total	100

The MF loans are offered to the clients on the assumption that all of them are good entrepreneurs. Obviously, this is not a realistic assumption. A majority of the clients do not display entrepreneurial skills in accounting, book keeping, business management or money management.

Limited product diversification is another major impediment to growth of small enterprises (Table 6.2). As much as one third of the total amount of MF loans were used to run a boutique or to carry out small trading. Other major MF activities are brick making, food processing, confectionary, dressmaking, carpentry and cement products. All these activities have low value added, and new technology is hardly used in such activities. Only 40 percent of the total number of clients had engaged in an income generating activity other than cultivation in the preceding four weeks.

Table 6.2

Product-wise Classification of Small Enterprises, %

Trading	33
Food processing	13
Brick manufacturing	13
Dress making	11
Carpentry	10
Cottage industry	9
Livestock	3
Other	8
	100

Small enterprises also suffer from the lack of economies of scale. As we noted earlier, these enterprises are very small. Three fourths of the total number of enterprises surveyed has only one employee, i.e. the client (Table 6.3). Only 10 percent of the enterprises have two employees including the client. The other few enterprises had 3 to 10 employees.

Table 6.3

Small Enterprises by Number of Employees

No. of employees	%
1	76
2	10
3	7
4	4
5-10	3
Total	100

The loans taken by the clients are very small. About one half of the total number of clients took loans of less than Rs. 10,000. About 90 percent of the loans are less than Rs. 30,000. By investing such small loans, the clients are not in a position to start a sizeable enterprise. As a result, they are compelled to carry on their very small cottage industries.

In today's open economy environment, a country's economic growth largely depends on productivity improvements through skills and knowledge development rather than increases in production inputs. Specifically, development is expected to be achieved mainly through E-Economy, K-Economy etc. In this context, it is questionable how small enterprises could survive in such an environment. Of course, they are supported by the services provided by MFIs. But the potential to enhance productivity in such enterprises is rather limited, given their inherent weaknesses like small size and outmoded technology.

Increasing productivity and innovation are results of competition. They depend on (a) macroeconomic, political, legal, social and cultural environment, and (b) microeconomic foundations. Overall, small enterprises backed by MFIs have competitive advantages like access to credit without collateral, technical guidance and training, group solidarity, marketing guidance and insurance coverage. But they also have many competitive disadvantages as discussed in the above sections. These include lack of economies of scale, skills and knowledge deficiencies, absence of technology diffusion, natural calamities, poor physical infrastructure, lack of research and development (R&D) investment, limited market integration and lack of product diversification.[5]

7. Empowerment of Women through Microfinance

Empowerment of women is considered to be a major outcome of microfinance. Broadly, empowerment refers to an enhancement of "power" of an individual or a group. MkNelly and McCord (2001) articulate how microfinance can foster women's empowerment. By offering poor households access to formal or semi-formal financial services, microfinance has the potential to empower its clients in a

[5] Wickrama (1998) argues that although microfinance programmes have accomplished a lot, and have revealed the potentials, they have yet to prove their long-term financial, economic and institutional sustainability by overcoming several constraints.

variety of ways;(a) income-generating opportunities created through microfinance could provide greater economic security and power to clients, and (b) group formation and management could link clients with networks beyond their neighborhood or community. It is widely accepted that the microfinance programmes that target women have greater empowering potential, because they are usually marginalized in the society. Microfinance services enable women to develop their own income-generating activities, and thereby to foster internal attitudes (self-reliance, self-confidence and self-worth). The participating women in microfinance are also able to develop their external relations (greater bargaining power within the household and leadership in the community). Small groups, which form the foundation of most microfinance schemes, empower women through mutual support, exchanging of new ideas, group responsibility and leadership.

Information on the extent of women's empowerment and capacity building facilitated by the microfinance providers covered under our survey was collected mainly by means of the discussions with the managers of microfinance institutions, and focus group discussions with the microfinance clients. It was observed that the group mechanism adopted by the Janshathi Bank Societies, Social Mobilization Foundation, SEEDS, Ruhuna Development Bank, Uva Development Bank and Seylan Bank have substantially contributed to women's empowerment and capacity building.

For example, let us consider the role played by the Women's Development Federation (WDF), known as Janashakhthi, in the Hambantota District. The Janashakthi programme has five fundamental principles, namely, (a) respect for humanity and social justice, (b) commitment towards development of poor families, (c) participation of women, (d) strong belief in the individual and collective potentials of poor families, and (e) multi-dimensional development approach. This microfinance scheme widely uses the method of group lending for loan disbursements. The WDF, placed at the top of the organization, coordinates and supervises the activities of the 67 Janashakti Bank Societies (JBS). In turn, the JBS oversee the 463 village level Rural Women Development Societies (RWDS). The RWDS consist of 5,528 smaller 5-member groups. The Janashakthi's organizational structure is based on a bottom-up approach. Its leadership, management and staff are drawn from the grass-root level membership. Each 5-member group guarantees repayment of loans by its members.

The small groups operating at the bottom of the organizational structure of the WDF have greatly facilitated to enhance women's empowerment and capacity building in many ways. These small groups made up of mothers or women from each family meet every week. These group meetings have given the members the opportunity to exchange knowledge and experience with regard to savings, credit, enterprise development etc. The mutual cooperation evolved through this mechanism has helped women to develop self-confidence. They have been able to build up savings within each group through common funds. The groups deposit their surplus funds with the JBS. The group members have the facility to obtain loans from the JBSs. The respective group recommends loan applications, and guarantees the repayment of loans taken by its members. This mechanism has eliminated the traditional requirement of collateral or outside guarantee. Thus, the small group mechanism has enabled the female members to develop "self-help" between families, and to uplift their living conditions.

7.1 Quantifying Women's Empowerment

Following the study of Houssain, Bose and Ahmad (2004), we consider the female participation in decision making as the proxy for agricultural and non-agricultural activities. We assessed women's power in decision making in three domains, namely agricultural activities, domestic affairs and business activities:

Agriculture: Selection of crops for cultivation, management of farm/crops, purchase of inputs such as fertilizer, and livestock/poultry management

Domestic affairs: Cash management, tours and recreation, children's education, purchase of durable goods, and housing improvements

Business activities: To obtain loans, to start a business, to purchase machinery/equipment, to sell output, and to save money

We have used rating values from the lowest value (=1) to the highest value (=5). At the lowest rating, women are least empowered, and at the highest rating they are most empowered. Thus, higher values reflect higher empowerment of women as follows:

1 = Decision is made by other members in the absence of the husband;

2 = By the husband, when he is present without consulting the wife;
3 = By the wife in the absence of the husband;
4 = Jointly by husband and wife, or jointly with others in the absence of the husband;
5 = By the wife, even when the husband is present.

Accordingly, the Women' Empowerment Index (WEI) for each domain is computed as follows:

$$WEIag = \frac{\sum_{i=1}^{5}}{5} \quad ; \quad WEIdo = \frac{\sum_{i=1}^{5}}{5} \quad ; \quad WEIbu = \frac{\sum_{i=1}^{5}}{5}$$

where $WEIag$ = WEI for agriculture
$WEIdo$ = WEI for domestic affairs
$WEIbs$ = WEI for business activities

Now, the overall WEI can be expressed as follows:

$$WEI = \frac{WEIag + WEIdo + WEIbu}{3}$$

The sectoral and overall WEIs clearly show an improvement after joining the MFIs (Table 7.1). This supports the argument that microfinance enables women to enhance their empowerment.

Table 7.1

Women's Empowerment Index

	Activity	Nuwara Eliya Before	Nuwara Eliya After	Badulla Before	Badulla After	Both districts Before	Both districts After	Percentage Difference
1.	Agriculture	2.75	2.98	2.99	3.41	2.90	3.21	10.72
2.	Domestic Affairs	3.21	3.35	3.60	3.62	3.42	3.50	2.40
3.	Enterprise	2.41	2.88	3.42	3.43	2.90	3.18	9.45
	Overall	2.81	3.09	3.36	3.50	3.09	3.31	7.01

7.2 Qualitative Findings6

Several qualitative case studies conducted in the survey reveal how SHGs have helped female clients to improve their attitudes and to enhance their status within the family and community as follows:

At individual level: Before joining the MFI programmes, the female clients were mostly restricted to the traditional housewife's functions such as cooking, looking after children and housekeeping. They had poor self-confidence. They mainly depended on the husband's income and did not possess any savings. Male dominance was prevalent. But since joining the programmes female clients have been able to improve their self-confidence and self-worth. Now they are more social and they have gained ability to express their ideas and views in public. They are engaged in income-generating activities and as a result they have more decision making power. Most of the female clients interviewed have access to borrowing, savings and insurance facilities. Nutrition and health awareness programmes provided by MFIs, mainly CBOs, have helped women to improve health conditions of their families.

At family level: Before joining the programmes rural women were largely confined to the traditional wife/mother role in the family while the husband used to be the sole breadwinner. Thus, there was gender-based division of labour in the family. Apart from housework, the wife often supported her husband's income generating activities providing unpaid labour. Decision making was largely made by the husband or another male family member. A gradual transformation of these family relationships in favour of females can be observed after they joined the programmes. The self-help groups (SHGs) have given them the opportunity to widen their horizon beyond the traditional wife/mother role. Now they have interaction with others, and engage in income-generating activities. As a result, they have gained more bargaining and decision making power within the family.

Business: As the poor rural women did not have access to commercial banks and other formal financial institutions, they did not have any opportunity to start business enterprises before joining the programmes. As most of the rural women are not well educated, they lack entrepreneurship skills. MFIs have provided opportunities to rural

6 The authors are grateful to Ms. Samudra Dissanayake and Ms. Kanchana Bulumulla of the Department of Social Studies, the Open University of Sri Lanka, for successfully carrying out these qualitative surveys in the field and analyzing the findings.

women to overcome most of these barriers. Borrowing, saving and insurance facilities provided through SHGs have enabled them to start their own businesses and to improve the financial position.

At community level: Before joining the programmes, the female clients did not have much relationship with the community. There was hardly any responsibility or consciousness towards the community. No collective efforts were made for community development. But active relations with SHG members have led to a change in this scenario immensely. Active participation in village-level CBO activities and other community work have empowered women to build up their self-confidence, attitudes and income generation capabilities. Various awareness programmes conducted at the village level have enhanced collective consciousness and societal harmony. Regular attendance is observed in societal meetings and social events like weddings, funerals and sicknesses. The general opinion among SHG members is, “we feel like a one big family, now with a greater unity among us”.

8. Summary and Conclusion

This study analyzed the effectiveness microfinance industry in dealing with rural poverty in Sri Lanka. Various types of microfinance institutions and programmes that are geared to promote self-employment and small enterprises among the poor, particularly among women, have evolved in Sri Lanka during the last three decades. These schemes provide financial services to the poor, who are usually excluded from commercial banks and other formal financial institutions. Based on the “credit plus” approach, microfinance institutions provide different kinds of financial services like micro-saving, micro-credit, micro-insurance and business development services. Group-based saving and lending, easy access, and less or no collateral requirements are some of the key characteristics of microfinance. The contribution of microfinance to the poor extends beyond its positive impact on households’ economic conditions. Microfinance has the potential to empower its clients, particularly female clients, by providing them with self-reliance, self-confidence, self- worth and decision making powers through interactions with the group members and the rest of the community. The capability of microfinance in empowering poor women has been well established by numerous empirical studies conducted in developing countries.

Given the above positive effects, it is generally believed that microfinance fosters small enterprises, and thereby uplifts the standard of living of the poor. However, there is considerable ambiguity with regard to the robustness of this popular belief, as there are hardly any in-depth studies on the effectiveness of microfinance schemes in countries like Sri Lanka. Some of the currently available studies, without applying any statistical tests, merely accept the hypothesis that microfinance does have positive socio-economic effects. In the absence of any objective impact assessments, the vast amount of financial and other resources put into these schemes would be rendered fruitless. Filling this lacuna is a major objective of this study. By adopting a broader approach focusing on both supply and demand, we have taken into account a multitude of variables affecting the performance of microfinance clients and small enterprises.

On the supply side, the loans provided by MFIs account for only about 5 percent of the total borrowings of households. In spite of the growth of the banking sector and MFIs after the liberalization of the economy, about 40 percent of household borrowings are still provided by informal sources such as friends, relatives and money lenders. There is potential to expand microfinance by about USD 2.5 billion. Most MFIs are weak with regard to financial management, accounting, auditing and staff training. There is no single regulatory or supervisory body for microfinance industry. Therefore, deposits and savings of some of them are unsafe. Both the government and the Central Bank are providers of microfinance resulting in conflict of interests as regards their regulatory and supervisory roles. However, major MFIs like SEEDS and Janashakthi have their own self-regulatory mechanisms.

The survey reveals that the limited product diversification is a major drawback of small enterprises. Most microfinance clients are inclined to carry on their traditional family enterprises without making any effort to engage in new income-generating activities. This is an outcome of various factors including clients' risk aversion, inadequate technological and business guidance on new products, non-availability of resources, lack of research and development (R&D) initiatives and lack of innovation. As a result, the client's small enterprises largely concentrate on a few products like small trading, brick manufacturing, basic food processing, dressmaking and carpentry. Such activities are generally associated with low value added products. Most investments supported by microfinance soon reach a plateau due to the low value added. This is a major reason for the low profit and low productivity levels of small enterprises, as revealed in this study. The outcome is that most microfinance clients have not been able to move from "below the poverty line" to "above the poverty line" situation, in spite of their small enterprise activities.

Policy makers and microfinance providers need to pay attention to initiate product diversification so as to overcome the above problems. In this regard, actions like project identification and planning, training, R&D, innovation and business development services are crucial. We have observed that, most commonly, loans were obtained to finance the existing activities rather than to diversify into new fields. This can be attributed to the lack of application of any feasibility studies or project identification. In this context, microfinance clients as well as microfinance providers need to be provided with basic training in fields like selecting a small business, managing a small business, marketing, and accounting and finance7. Lack of technological application is a major cause of low productivity and poor product quality. Therefore, policy makers and microfinance providers should take initiatives to raise general awareness about the role of technology in promoting productivity and product quality.

Another drawback of small enterprises that we have observed is the lack of economies of scale. This is largely due to the fact that most of these enterprises are run by the client herself or himself, and there are no other employees. Most of the micro loans provided for these enterprises are fairly small in size. Such loans are hardly adequate to set up a factory or to buy machinery. Thus, these enterprises, very often, remain as cottage industries. Moreover, the underlying assumption in providing microfinance is that each and every client would be a successful entrepreneur. Obviously, this is not a realistic assumption, as reflected in the poor performance of most small enterprises covered in this survey. In the background of the lack of economies of scale, under-capitalization and limited ability of individual entrepreneurs, most ventures ended up with low profits and low incomes as elaborated earlier. These problems need to be dealt with immediately.

One way of overcoming the problem of limited economies of scale would be to network the small enterprises. At present, several enterprises in each village are built around same types of activities. Networking of such enterprises would bring about benefits like greater economies of scale, higher productivity and profits, common purchase of raw materials, optimal use of resources, market gains and minimization of wastage. Once the small enterprises evolve through such networking gather momentum, they could jointly invest in bigger projects, thus overcoming limitations of economies of scale. Networking may also be

[7] Some of these training facilities are already provided by institutions like the SEEDS, Janashakthi Bank Societies and SANASA.

used to develop backward and forward linkages which are hardly available now. Access to markets beyond the village level should also be pursued through enterprise networks. There might be potential to access new markets not only locally but globally as well. Product quality is crucial to compete in such markets, and therefore, necessary mechanisms should be evolved to ensure high standards of the products[8]. Unless the Government, Central Bank, MFIs, NGOs and foreign donors address these problems effectively and urgently, it is doubtful whether the household-based small enterprises could sustain for long in the open economy environment, as clearly proved by the findings of this survey.

An appropriate financial infrastructure is a prerequisite to sustainable operations and outreach of microfinance institutions. In this regard, practices such as efficient management information systems, accounting and auditing standards, and self-regulatory mechanisms are crucial. The survey reveals that some microfinance institutions have not been able to adopt such virtuous practices due to factors like inadequate resources and lack of training facilities. Such facilities should be given to the microfinance providers, wherever possible, to improve the situation. A proper legal framework for supervision and regulation of microfinance institutions is also needed not only to ensure sustainability of microfinance providers but also to safeguard the interests of the depositors. However, legal and regulatory systems should not be detrimental to the growth of the microfinance sector.

Provision of microfinance services alone is insufficient to develop small enterprises. Apart from the unfavourable natural environment in the areas covered in this study, unsatisfactory infrastructure was also found to hamper the development of small enterprises to a large extent. These problems might be common to many other areas in the country as well. The government and other stakeholders, therefore, need to pay attention to improve infrastructure facilities pertaining to road network, water supply, electricity, telecommunications etc., so as to create an enabling environment for sustainable development of small enterprises.

Macroeconomic setting also should be conducive to the growth of small enterprises. In Sri Lanka, the financial sector reforms adopted as part of the structural adjustment package over the years have gradually

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[8] The Forward Sales Contract System (Govi Sahanaya), which was initiated by the Central Bank of Sri Lanka in 1999, is such a mechanism aimed at ensuring the quality of products as well as a fair price for the farmers' produce.

paved the way to evolve a more market-oriented financial system, partly in the form of microfinance for small enterprises. The other structural adjustments include trade liberalization, tax reforms, privatization, flexible exchange rates and labour market reforms. The impact of such structural adjustments on the microfinance sector or small enterprises is not very clear, as such issues have not yet been empirically analyzed yet. The ongoing structural reforms have been accompanied by stabilization policies, mainly monetary and fiscal policies. Despite the demand management policies adopted by the monetary and fiscal authorities to achieve macroeconomic stability, the country has been facing imbalances from time to time. These include high inflation, budget deficits and external payments disequilibrium. These are an outcome of various internal and external factors. Such imbalances, particularly high inflation rates, are unfavourable not only to consumers but also to the business community including small enterprises. In this context, the recent initiative taken by the Central Bank to prioritize price stability, as its major objective, is commendable. In sum, a coherent macroeconomic policy framework, among other prerequisites outlined above, is imperative to enable MFIs to effectively contribute to poverty reduction.

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