



Microenterprise Occupation and Poverty Reduction in Microfinance Programs: Evidence from Sri Lanka

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Summary. — The microenterprise earnings of microfinance clients in southeastern Sri Lanka are linked to their initial incomes. Poorer clients face geographic, financial and sociocultural barriers to entry to the most promising microenterprise occupations, leading them to select low-value activities with poor growth prospects. In semi-urban areas, poverty impacts could be strengthened by supplementing loans with nonfinancial interventions encouraging poor clients to select higher-value occupations. In arid rural areas, where microenterprises face severe market and infrastructure constraints, microenterprise development is unlikely to facilitate poverty exit.

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1. INTRODUCTION

Most observers agree that in the right circumstances microfinance can increase household incomes, but its impact on poor clients remains controversial. Several recent impact evaluations have emphasized the nonuniform distribution of benefits. Most households are better off with microfinance, but income impacts vary in magnitude and durability, and a sizeable proportion of clients find that their post-credit incomes stagnate or fall (Copestake, Bhalotra, & Johnson, 2001; MKNelly & Dunford, 1998, 1999; Mosley, 2001; Sebstad & Chen, 1996; Todd, 2000). Initial income has been identified as a key determinant of impact. An influential cross-country study found that loans produce the greatest percentage increases in the incomes of “upper-poor” and nonpoor borrowers who are close to or above national poverty lines. The “extreme”—or “core-poor”—the poorest 50% or thereabouts of those in poverty—were not only less likely to participate in microfinance programs; when they did participate their post-credit incomes were less likely to increase. Moreover, such increases as occurred were often too small and short-lived to enable sustainable poverty exit (Hulme & Mosley, 1996). Subsequent studies provide further evidence of a relationship between initial income and microcredit

impact (Hashemi, 1997; Rahman, 1997; Zaman, 1999).

Income promotion through microenterprise lending remains the primary strategy of most microfinance institutions (MFIs), including many which serve poor clients. For poverty-focused MFIs, the questionable efficacy of microenterprise lending at the low end of the income spectrum makes impact monitoring particularly important. If their interventions are not effective, or are producing differential outcomes in different client groups, they need to know why. An understanding of the reasons for low poverty impacts yields important information for program design and targeting. It may be feasible to improve impacts by redesigning services to better meet the needs of poor clients, within the limits imposed by the need to maintain institutional viability. On the other hand, the poor commonly face nonprogram obstacles to microenterprise development, in the form of unfavorable market environments or inadequate physical infrastructure, over which MFIs have little influence. In such circumstances, a more socially beneficial allocation of resources may result from targeting less-poor borrowers who derive greater benefits from microenterprise loans or,

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for MFIs which choose to maintain a poverty focus, reorienting their activities away from income promotion in favor of protectional or nonfinancial interventions.

This paper examines the underlying causes of the income-related impact gap, a topic which has received surprisingly little scholarly attention, given its implications for the effectiveness of microenterprise lending in reducing poverty. It investigates the reasons for disparities in microenterprise earnings among clients of two MFIs in southeastern Sri Lanka. As expected, the microenterprises of less poor clients do better than those of the poor. Another important finding is that poverty impacts are differentiated by location: poor clients in semi-urban areas have considerably greater opportunities than their rural counterparts to exit poverty through microenterprise development services. The semi-urban/rural differential raises important policy issues for the MFIs, which provide a useful and highly valued service to their near-poor and nonpoor clients, but face challenges in meeting the needs of the poor. There is considerable potential for improving impacts on the semi-urban poor by encouraging the take-up of high-earning microenterprise occupations. In arid rural areas, however, where market and infrastructure constraints virtually rule out poverty-clearing microenterprises, the utility of microenterprise development for poor clients is more problematic. Support for rural microenterprises helps to alleviate some ill-effects of poverty—although it has little impact on poverty incidence—but its benefits are offset by significant risks and costs for borrowers and lenders, and the generation of negative externalities.

The paper is structured as follows: Sections 2 and 3 describe the research context, methodology and findings. Section 4 discusses the reasons why poor clients earn less from their microenterprises, identifying geographic, financial and sociocultural barriers to entry which deter them from selecting higher-value occupations. Section 5 evaluates the MFIs' services to poor clients and makes the case for a stronger promotional focus on the semi-urban poor.

2. THE RESEARCH CONTEXT AND METHODOLOGY

The research was conducted in Hambantota district, a remote region on Sri Lanka's south-

eastern coast, 250 km from the metropolitan Western Province and the national capital, Colombo. The district is one of the country's poorest regions, ranking well below the national average on household income, employment, literacy, and access to electricity, safe water and sanitation (United Nations Development Program, 1998). An estimated quarter of its population of 558,000 is semi-urban, living in and around five or six regional towns and along the arterial coastal road which connects the region with the Western Province. The remaining three quarters live in the mostly arid, sparsely populated rural hinterland. Microenterprises—defined as firms employing between one and 10 workers—are by far the largest category of employment. Two-thirds of the district's labor force are microenterprise owner-operators or unpaid household employees, and another 15–20% are microenterprise wage employees. The major microenterprise occupation is small-holder agriculture, which provides the principal source of livelihood for 60% of the population, and a secondary income source for a further 15% (Department of Census & Statistics, 1998). Nonfarm microenterprises—in petty trade, fishing, animal husbandry and a variety of manufacturing and service occupations—are clustered in regional towns and along the coastal road.

The case-study agencies are two nongovernmental organizations (NGOs): the Women's Development Federation (WDF) and the Hambantota district branch of Sarvodaya Economic Enterprise Development Services (SEEDS). With memberships of 28,000 and 10,000 respectively, they are the two largest MFIs in the district, overwhelmingly dominating the local microcredit market in terms of geographic spread and portfolio size.

The research was conducted over five months in 1999. The primary research instrument was a structured questionnaire administered to 253 respondents, followed by focus group discussions and in-depth interviews with 87 respondents, and interviews with MFI staff. Respondents were selected randomly from branch membership lists, the only criterion for selection being a current outstanding balance on a microenterprise loan. Three location-based categories were constructed: a semi-urban cohort of 115 households, located within 3 km of a regional town or within a kilometer of the main coastal road; and two rural groups, 28 of whom were drawn from the prosperous Uda Walawe irrigation scheme, and 110 from

Table 1. *Household income categories*^a

Household income group	Definition
Extreme poor	Up to 67% of poverty line: household income Rs. 3,350 or less
Poor	67–100% of poverty line: household income Rs. 3,351–5,000
Near-poor	100–150% of poverty line: household income Rs. 5,001–7,500
Nonpoor	More than 150% of poverty line: household income more than Rs. 7,500

^a All microenterprise and household income data are expressed in rupees per month.

the poorer and more remote semi-irrigated and rainfed regions. The household poverty line was set at Rs. 5,000 per month (about \$70 at 1999 exchange rates), an inflation-adjusted version of the national poverty line developed by the World Bank in 1995 (World Bank, 1995). Four household income categories were constructed, two below the poverty line and two above it (see Table 1).

The study compares client incomes at the time of their first MFI loan and at June 1999. Nearly 40% of respondents were recent recruits, having joined the programs in the two years prior to the survey, and another 25% had joined during 1994–97. Those who joined before 1994 were asked to make June 1994 their comparison point. Income data were derived by itemizing all household income sources, averaged over a 12-month period to take account of seasonal fluctuations. Information on pre-loan income levels was obtained principally via respondent recall. To minimize the risk of inaccuracies resulting from faulty recollections, respondents were asked to provide corroborative data in the form of lists of housing improvements and major household assets purchased and sold since taking the first loan, and subjective assessments of changes in their living standards over the relevant period. In addition, recollected income estimates were compared with historical data on agricultural wage rates, welfare payments and other common income sources, and apparent discrepancies were checked with respondents.

3. THE CLIENTS AND THEIR MICROENTERPRISES

This study draws on the classification typology developed by the Asian Development Bank and others, which groups microenterprises into low-return “survival” activities and higher-return “entrepreneurial” activities. Entrepreneurial microenterprises are larger, more highly

capitalized, employ more labor and use more sophisticated technologies. They tend to operate continuously rather than intermittently, reinvest rather than consume surpluses, and have lower closure rates. They are usually primary household income sources, while survival activities are usually secondary, and are most commonly operated by men, while survival activities are often operated by women. Their owners are better endowed with technical skills and business acumen, and with ambition, self-confidence and other personal qualities which are generally held to encourage entrepreneurship (Asian Development Bank, 1997; Cotter, 1996; Ghatte, Ballon, & Manalo, 1996; Liedholm & Mead, 1999).

The primary distinction between the two categories arises from disparities in enterprise growth potential, which in turn depends on prevailing demand and production conditions in each occupation. Entrepreneurial occupations operate without excessive pressure from competitors, while the survival occupations are characterized by low barriers to entry, undifferentiated products, saturated markets, and inefficiencies which limit their competitiveness in relation to larger producers. In entrepreneurial occupations such as motor mechanics and carpentry, microlevel producers have advantages of scale and access to suitable, affordable technologies which enable them to compete effectively with nonmicro firms. By contrast, microenterprises in many survival occupations are not competitive, as the costs and scale of the more efficient production processes employed by larger firms are well beyond the capacity of microlevel producers. As a result, microenterprises in many survival-level manual occupations face an uncertain future: Hambantota garment-makers, for example, are unable to compete with factory products; and at least one nonmicro rock-breaking firm, which uses motorized equipment rather than the mallets and chisels used by microlevel producers, has opened for business

in one of the survey locations. Furthermore, entrepreneurial activities tend to be insulated from seasonal fluctuations in input supplies, with regular access to inputs which are usually obtained in the cash economy. Survival enterprises, on the other hand, often rely on inputs which their owners gather themselves from locally available natural resources—such as coconut husks for coir production, or paddy husks to feed chickens or fuel brick-making kilns—supplies of which vary seasonally, and

are often affected by increasing scarcity. In addition, production processes in survival occupations are prone to climate fluctuations: lagoon fishing, for example, is not viable during the annual dry season, and brick-makers usually cease production during the monsoon months due to the difficulty of drying bricks in humid conditions.

The Hambantota microenterprises are classified on the basis of their median occupation incomes (Table 2). Occupations are defined as

Table 2. *Survival and entrepreneurial occupations: key characteristics*

Sector	Occupation	Frequency	Median earnings	Percentage earning more than Rs. 4,000
<i>Survival</i>				
Agriculture	Single season paddy farming, <i>chena</i> cultivation	163 59	2,000 3,000	8.7 —
Production and service	Brick-making, coir production, garment-making, rock-breaking, sea-shell crushing	40	2,200	15.0
Fishing and livestock	Lagoon-fishing with canoe, free-range poultry and goat-rearing	25	1,400	—
Trade	Small kiosk in owner's house or temporary roadside stall, house-to-house vending with hand-cart	39	1,800	15.4
<i>Entrepreneurial</i>				
Agriculture	Dual/triple season paddy farming, banana and vegetable cultivation	90 16	6,000 4,300	66.0 56.3
Production, service, fishing and livestock	Carpentry, motor mechanics, electrical repairs, food preparation and sale, jewelry-making, hair-dressing, tractor-hire, rice milling, ocean-fishing with motorized vessel, cattle herding, large-scale poultry-rearing (500–2,000 birds)	43	6,100	65.1
Trade	Agricultural wholesaling, permanent retail premises on main road or town center, licensed weekly market stall in town center	31	6,900	71.0
Total		253	3,000	36.0

entrepreneurial where their median incomes exceed Rs. 4,000, the earnings threshold which, at 80% of the household poverty line, provides a near-certain guarantee of poverty exit. The survival microenterprises fit more neatly into this categorization than do the entrepreneurial activities: fewer than 10% of survival enterprises earn more than Rs. 4,000, but around a third of entrepreneurial activities earn less. The Hambantota data nevertheless support findings elsewhere that occupation is a reliable predictor of microenterprise earnings (Asian Development Bank, 1997). Although actual earnings do not always reflect earnings potential, particularly in new microenterprises, the level at which earnings will eventually plateau can be predicted with reasonable certainty. This is especially the case in the survival occupations. Lagoon fishing microenterprises, for example, constrained as they are by seasonality, intense competition and a dwindling resource base, are unlikely ever to earn more than Rs. 2,000 per month. In entrepreneurial activities, the upper limits to earnings potential are often harder to define. Microenterprises which develop niche markets or employ new technologies may rise well above the occupational median income; conversely, those which face significant geographic or financial constraints may struggle to approach it. The underperforming entrepre-

neurial activities in the Hambantota sample include a handful in the latter category, but the majority are new projects which commenced less than 12 months before the survey, and stand a good chance of eventually crossing the Rs. 4,000 threshold.

As Table 3 shows, the association between microenterprise performance and household income is consistent at all income levels. The income-linked disparity in microenterprise earnings is explained in part by the fact that the poorest clients in each occupation tend to own the weakest microenterprises, but its principal cause is a pattern of occupational segregation in which below-poverty-line clients are clustered in survival occupations. The impact of occupation selection on earnings is striking. In all income groups except the extreme-poor, microenterprises in entrepreneurial occupations earn far more than those which are not. Only a fifth of poor clients select entrepreneurial activities, but among those who do, at least half reach the poverty-clearing threshold. Their microenterprises earn less than those of their near-poor and nonpoor competitors, but twice as much as those of other poor clients in survival occupations. The persistence of very low microenterprise earnings among the extreme-poor, regardless of occupation, suggests the existence of particular constraints facing this

Table 3. *Entrepreneurial and survival activities: median microenterprise earnings by initial income status*

Pre-loan income	Entrepreneurial occupations		Survival occupations		Total	
	Median earnings	Frequency	Median earnings	Frequency	Median earnings	Frequency
Extreme poor	1,600	3	1,400	36	1,400	39
Poor	4,000	17	2,000	63	2,500	80
Near-poor	4,700	26	3,000	42	3,400	68
Nonpoor	8,700	44	3,700	22	6,500	66
Total	6,000	90	2,000	163	3,000	253

Table 4. *Initially below-poverty-line clients: median microenterprise earnings by occupation type and location*

Location	Entrepreneurial activities		Survival activities		Total	
	Median earnings	Frequency	Median earnings	Frequency	Median earnings	Frequency
Semi-urban	5,000	13	2,000	32	2,000	45
Arid rural	4,000	3	1,600	63	1,800	66
Uda Walawe	1,900	4	1,500	4	1,600	8
Total	4,000	20	1,800	99	2,000	119

group, an issue which is explored further in the following section.

Table 4 compares the microenterprise earnings of initially below-poverty-line clients in different locations. Semi-urban clients earn more than their rural counterparts in both survival and entrepreneurial occupations. Even in semi-urban areas, however, survival activities are unlikely to enable poverty exit, with median earnings well below the poverty-clearing threshold. The evidence suggests that poor clients are considerably better off selecting entrepreneurial activities regardless of location, although this conclusion is tentative in relation to rural clients because of the very small number of observations. The most striking difference between the semi-urban and rural groups lies in occupation selection: for reasons which are discussed below, nearly a third of semi-urban clients select entrepreneurial activities, in comparison with fewer than 5% of the rural cohort.

Table 5 examines changes in income status during program participation. One-quarter of initially below-poverty-line households exited poverty after joining the program. (The net poverty exit rate is somewhat lower, at 18%, as a handful of above-poverty-line households fell into poverty during the period of participation.) While the overall poverty impact of microenterprise lending has been positive, it has not been uniform. Poverty exit was confined to those who were initially just below the poverty line: not one extreme-poor household exited poverty, although nearly a quarter graduated to "poor" status. Poverty exit rates were higher for semi-urban clients (23%) than for the arid rural and Uda Walawe cohorts (9%); and poor clients in entrepreneurial occupations (65%) were more likely to exit poverty than those in survival occupations (17%).

While the MFIs have undoubtedly made a substantial contribution to the overall improvement in living standards, it is important to note that the reduction in poverty incidence cannot be

attributed entirely to the impact of loans on microenterprise earnings, as the research did not control for macroeconomic conditions and other exogenous variables which are likely to affect microenterprise performance. Moreover, few clients 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 family members working in the Western Province and overseas, and government transfers. As microenterprises account on average for only 56% of household incomes, other income sources—notably remittances—are significant contributors to changes in poverty status.

4. WHY THE POOR SELECT SURVIVAL ACTIVITIES

As the preceding discussion showed, entrepreneurial microenterprises appear to offer a route out of poverty for the poor (although not the extreme-poor), but the vast majority continue to opt for survival activities. Rural clients in particular appear to face significant barriers to entry to the entrepreneurial occupations. This section discusses the geographic, financial and sociocultural factors which influence of these factors occupation selection. The relative importance varies between locations: the rural poor select survival activities because the physical and market environment presents few alternatives, while in semi-urban areas, where conditions favor the development of higher-value activities, human capital and sociocultural issues assume greater importance as determinants of project selection.

(a) Location

Occupations are unevenly distributed across locations, as Table 6 shows. The distribution is

Table 5. *Income status before and after program participation*

Pre-loan income status	1999 income status				
	Extreme-poor	Poor	Near-poor	Nonpoor	Total
Extreme-poor	30	9	—	—	39
Poor	3	47	25	5	80
Near-poor	1	6	33	28	68
Nonpoor	1	—	2	63	66
Total	35	62	60	96	253

Table 6. *Distribution of occupations across locations*

	Semi-urban	Arid rural	Uda Walawe	Total
<i>Nonfarm</i>	113	55	10	178
Survival	57	44	3	104
Entrepreneurial	56	11	7	74
<i>Farm</i>	2	55	18	75
Survival	2	55	2	59
Entrepreneurial	–	–	16	16
Total	115	110	28	253

particularly uneven with respect to entrepreneurial activities, fewer than 15% of which are located in arid rural areas. Occupational diversity and microenterprise incomes are highest in the densely populated, well-serviced regional towns and settlements along the coastal road, which support a variety of non-farm activities. In the Uda Walawe settlements, where there is limited scope for nonfarm entrepreneurial occupations, farming provides poverty-clearing incomes for most households. The least propitious conditions are in arid rural areas, where productivity and technological innovation are impeded by inadequate irrigation and power infrastructure, demand is limited by low local population densities and low incomes, and a narrow range of viable occupations combines with low barriers to entry to create chronic market saturation.

As Table 7 shows, there are striking location-based disparities in income distribution. With a poverty incidence of 55%, rural clients are more than twice as likely to be poor as their semi-urban and Uda Walawe counterparts. The fact that the poor are concentrated in remote and resource-deficient regions, where microenterprise prospects are weakest, makes location a key factor in the income-related microfinance impact gap. It also illustrates a central paradox of rural poverty reduction strategies based on

microenterprise development, in that they appear to be least effective precisely where they are most needed—in regions which offer few alternative income-generating opportunities, and in households which are least likely to possess the human and physical resources which enable the best use of such opportunities as are available.

Poor transport infrastructure is perhaps the single most important impediment to rural microenterprise development. While most semi-urban and Uda Walawe microenterprises are on or close to reliable bus services, road and transport quality declines dramatically in remote rural areas. Many rural roads are nominally on bus routes, but in practice bus services are infrequent and unreliable due to inadequate road maintenance and poor regulation of the privatized public transport industry. During the monsoon season some roads are inaccessible by bus, isolating remote settlements for up to two months. In the most remote areas, dwellings are located up to a kilometer from an access route and can be reached only on foot or by bicycle. Poor transport services impose multiple production and demand constraints on rural microenterprises. Restricted access to inputs rules out high-turnover manufacturing activities; and poor linkages limit the access of rural

Table 7. *Current household income distribution by location (percent)*

Household income group	Semi-urban	Uda Walawe	Arid rural	All
Extreme poor	9.6	7.1	20.0	13.8
Poor	15.7	17.9	35.5	24.6
Near-poor	23.5	32.1	21.8	23.7
Nonpoor	51.2	42.9	22.7	37.9
Total	100.0	100.0	100.0	100.0
Median household income	7,650	7,020	4,680	6,250

producers to urban customers, and of rural households to urban labor markets, with adverse impacts on local demand.

Rural clients are similarly disadvantaged with respect to power infrastructure. Two-thirds of semi-urban households are connected to a mains supply, but in arid rural areas, where mains power is confined to the centers of the larger villages and the main access routes, only a fifth of households have electricity. Lack of electrical power is a significant impediment to the development of entrepreneurial micro-enterprises, as it rules out high value-adding occupations such as carpentry and food preparation, which rely on electricity-based technologies.

The most varied and vigorous markets are in town centers, which provide a relatively prosperous local customer base and function as commercial and administrative hubs for outlying settlements. Town centers support a variety of microenterprises in various service occupations and the production and trade of food, garments and other consumer goods. Another center of economic activity lies along the arterial coastal road, which is the main route from Colombo to the popular pilgrimage center of Kataragama and Yala national park to the east. Roadside commercial activity is dominated by motor repair workshops, tea-shops and handicrafts producers serving a brisk passing trade of trucks, tourists and weekend bus loads of pilgrims.

In arid rural areas, by contrast, low population densities and low incomes impose severe market constraints. Rural nonfarm survival activities are the weakest microenterprises in the sample, with meager earnings and high failure rates, accounting for 13 of the 18 failed projects. They are disadvantaged relative to their semi-urban competitors, as their remoteness increases the cost and difficulty of reaching them, restricting turnover and producers' bargaining power. Most rely on local customers in regions where population densities are below 100 per square kilometer. As most of their customers are farmers and farm laborers, they are prone to sharp seasonal demand fluctuations and many close down during the annual lean season. High local poverty rates restrict occupational diversity: in poor communities, demand for goods traded in the cash economy is virtually limited to food needs which cannot be met from home production. As a result, rural nonfarm activities are clustered in petty trade, fishing, backyard poultry-rearing and

other occupations which combine subsistence production with trade in staple foodstuffs. The narrow range of viable occupations contributes to market saturation: in villages which can support perhaps a single food retailer, it is common to find three or four such enterprises, each with an identical product range of rice, lentils and dried fish, and each with earnings well below the poverty line. The difficulty of maintaining entrepreneurial activities in the face of location-related demand constraints is illustrated by the following example:

Example 1: Sunil lives in a sparsely populated arid rural neighborhood 3 km from the coastal road. He worked as a carpenter's assistant for several years before opening a retail furniture-making business, operating from a rented electrified workshop on the main road. During the first three years his wife borrowed a total of Rs. 50,000 from the WDF over the course of four loans, and the project's monthly earnings grew from an initial Rs. 2,000 to a peak of Rs. 6,000. After three years, Sunil was forced to vacate the workshop following a dispute with the owner. 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.

In the farm sector, entrepreneurial and survival activities are distinguished by their access to irrigation infrastructure. Hambantota district is in Sri Lanka's Dry Zone, which has a single monsoon season, making the cultivation of a second annual crop dependent on irrigation. The Uda Walawe scheme is part of a network of major government irrigation schemes designed in the 1970s and 1980s with the aim of promoting agricultural exports and national self-sufficiency in rice production. Farms in irrigated settlements are supported by considerable public investment, not only in irrigation but also in marketing and agricultural extension services, and high-quality transport networks links with the western population centers and ports. For those with a year-round water supply, Dry Zone farming is an entrepreneurial activity, enabling the cultivation of two or three annual paddy crops and diversification into commercial fruit and vegetable production.

Most farmers, however, are located in semi-irrigated or nonirrigated arid regions where agriculture is an increasingly unprofitable and risky survival activity. Single-season paddy-farmers receive their water via canals from communally maintained village reservoirs, or

“tanks,” which are usually sufficient for a single paddy crop during the *maha* monsoon season, but rarely support a second 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 practice rainfed *chena*, a form of slash-and-burn cultivation of drought-resistant cereal crops. As *chena* crops have a low market value and much of the harvest is retained for consumption, cash incomes are typically very low, averaging less than Rs. 1,000 per month.

The expansion of farming in Sri Lanka's Dry Zone has placed intense pressure on scarce land and water resources, and is threatening fragile eco-systems. In the Hambantota region population growth, low out-migration, and rising in-migration from the overpopulated Wet Zone regions to the west have exacerbated an acute shortage of arable land. The expansion of cultivation imposes environmental and economic problems, with the increasing occupation of jungle areas on the peripheries of canal networks by the poorest farmers and newcomers. Deforestation resulting from *chena* is widespread, and the extension of paddy cultivation into increasingly marginal areas strains the capacity of village tanks. Faced with declining yields, farmers either postpone the crisis by diverting water from nearby streams, or abandon their most recently cultivated fields, a process which further accelerates deforestation and evaporation. 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).

In addition, policy and economic developments have adversely affected Dry Zone farmers. The world rice price has been declining since the 1980s; and in addition, the government, under pressure to reduce public spending and liberalize trade policy, has withdrawn producer price protection measures. Rice import restrictions were removed in 1995, and the state-run Paddy Marketing Board, which traditionally provided a guaranteed floor price and acted as a buyer of last resort, was dismantled in 1999. As a consequence of these developments, the real farmgate price of paddy fell by 40% between the early 1980s and late 1990s, with most of the decline occurring since 1991 (Dunham & Edwards, 1997; Gunawardana & Somaratne, 1999). During 1997–98

alone the average producer price fell by 7%. At the same time, farmers are facing sharp increases in input costs, with the scaling back of subsidies and privatization of input distribution networks. Poverty rates among farmers are well above the national average (Aturupane, 1999), and incomes from paddy cultivation are in long-term decline, with little prospect of a reversal in the near future. The consensus in donor and government policy circles is that small-scale paddy-farming is economically unviable outside the major irrigation schemes (Central Bank, 1998).

(b) *Financial factors*

The high recurrent costs of some entrepreneurial enterprises and the “lumpiness” of their fixed assets create barriers to entry, especially where capital requirements exceed the MFIs' group-based loan size limits (Rs. 30,000 in the WDF and Rs. 50,000 in SEEDS), placing them beyond the reach of clients who lack additional finance. There is a vast gulf between the capital requirements of the highest-earning enterprises and the financial capacity of low-income clients: as Table 8 shows, the monthly expenses of high-value trade occupations represent close to a year's household income at the poverty line.

Even where sufficient credit is available, poor clients are reluctant to expose themselves to the risks associated with large loans. As example 2 illustrates, not only do the most profitable enterprises require large initial capital outlays; they may also undergo prolonged gestation periods, with low or negative returns during the first months of operation. As poor clients cannot afford to operate loss-making concerns even for short periods, they tend to opt for low-risk working capital investments, often combining production for home consumption and the market, which generate meager but immediate cash flows.

Example 2: Ranjith owns a “communications shop” in a town center, one of two local businesses providing long-distance telephone and fax services. He opened the business with an initial investment of Rs. 80,000 from his personal savings and a Rs. 200,000 loan from a local bank, with which he installed a telecommunications cable and bought a second-hand photocopier and fax machine. Since joining SEEDS he has taken three microenterprise loans with a total value of Rs. 70,000, and reinvested a substantial proportion of enterprise profits. He plans to buy a computer and set up an email and internet service. The business showed early promise, with gross monthly earnings

Table 8. *Mean expenditure on fixed assets and working capital by occupation*

Enterprise occupation	Mean monthly working capital and recurrent expenses ^a	Mean value of enterprise assets ^b
<i>Survival occupations</i>	6,900	10,300
Agriculture	9,000	14,600
Production and service	4,100	3,500
Fishing and livestock	1,100	2,700
Trade	10,400	15,700
<i>Entrepreneurial occupations</i>	30,900	60,200
Agriculture	18,700	55,000
Production, service, fishing and livestock	20,400	59,000
Trade	51,900	64,600
Total	15,600	27,400

^a Includes raw materials and supplies, wages, rent, transport, fuel and power.

^b 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. Other assets were assigned values on the basis of 1999 retail prices, and do not include depreciation.

of about Rs. 5,000; but yielded negative returns during its first year of operation, as earnings were insufficient to meet repayments on the bank loan. After three years net earnings increased to a stable Rs. 15,000. Ranjith was able to meet his high fixed capital costs and support the business through its initial lean period because he is independently well-off: his family owns four acres of irrigated paddy-land outside the town, and he combines the business with a second job as an insurance agent.

Financial barriers to entry create a severe impediment to poverty reduction in rural areas, as the main nonfarm entrepreneurial activities—tractor-hire businesses, rice mills and vegetable wholesaling—have very high capital requirements which effectively rule them out as options for poor clients. In semi-urban areas, capital constraints are less restrictive. While the largest entrepreneurial activities, such as that described in example 2, are not viable options for poor borrowers, many other activities can be established with moderate initial outlays—on electricity installation, refrigerators, or power tools—which are accessible via small loans. Example 3, which illustrates the capacity of credit to galvanize microenterprises which operate in favorable demand and production conditions but face capital constraints, shows how microenterprise lending can support incremental capital improvements which are within the reach of many poor clients. As even mid-range entrepreneurial activities involve

significantly higher costs than survival microenterprises, however, financial considerations are likely to deter the poorest, most risk-averse semi-urban households from selecting them.

Example 3: Shiranthi operates a 16-year old tea-shop on the coastal road. During its first years she financed the business with working capital loans from money-lenders at 10% interest per month. Due to the high cost of credit and limited demand, the shop earned a marginal income during its early years, and Shiranthi made few improvements. Encouraged by the improving fortunes of neighboring businesses with increases in vehicle traffic in the early 1990s, she decided that the shop would benefit from a larger injection of capital, and joined SEEDS in 1995. She has taken three loans with a total value of Rs. 50,000, with which she replaced the original thatched hut with a permanent structure, installed electricity, bought chairs and tables, and made down payments on a refrigerator and ceiling fan, the balance of which is being financed by enterprise profits. The initial customer base of local people has expanded to include truck-drivers and the weekend pilgrim trade, and net earnings grew from about Rs. 3,000 in 1995 to about Rs. 6,000 in 1999.

(c) *Human capital and sociocultural factors*

The poor are least likely to possess entrepreneurial aptitudes and aspirations. The Hambantota data lend support to findings elsewhere which indicate that poor clients often

have little understanding of market conditions and business opportunities in nontraditional occupations (Gunatilaka, 1996; Shaw, 1999), and lack the extended social networks which are key sources of information, skills and business contacts (Barton, 1997; Gunatilaka, 1997). They are reluctant to develop the unfamiliar skills required by the more complex nontraditional microenterprises, and many reported that the familiarity of the tasks and business relationships associated with traditional survival activities influenced their occupation selection decisions. Near-poor and nonpoor respondents were more likely to survey the local environment and base their decision on identified market opportunities, but the responses of poor clients indicated a tendency toward a passive approach to enterprise selection: few had investigated alternative occupations, and they were far more likely than others to cite "copying others" as the primary determinant of their choice.

There was evidence that sociocultural factors hinder the development of high-value microenterprises, particularly among poorer clients. In centers of commercial activity, where the growth of the cash economy and new forms of economic organization have broken down traditional patron-client relationships and their associated ties of mutual obligation, business decisions tend to be based on commercial considerations rather than noneconomic criteria. In more remote communities, however, social norms may discourage individualism and upward mobility in the poor (Brow, 1996). The prospect of conflict may deter poorer producers from challenging established economic relationships, for example, by introducing marketing arrangements which bypass influential village traders (Menike, 1992).

In Hambantota, the accumulation of wealth among the nonpoor appears socially acceptable, but is frowned on when it occurs in poor households. Respondents were inclined to be critical of poor neighbors who had "made good"; and some appeared to view their own improved circumstances as a mixed blessing, emphasizing its less favorable consequences in the form of unwelcome attention from envious neighbors and relatives in search of support. Conceptions of the communal good sometimes take precedence over individual gain: where identical microenterprises are clustered in a single community, a common arrangement where occupations are caste-based or require access to a localized natural resource, individ-

ual producers face strong social pressure not to engage in price competition. Among brick-makers, for example, competition in terms of output was socially acceptable, and there were no restrictions on taking on extra labor or working well into the night, but no producer was prepared to risk social ostracism by lowering his prices.

Low caste and social status may inhibit entry into entrepreneurial occupations, reducing the range of activities open to extreme-poor and some poor households. Caste appeared to have a significant impact on opportunity in fishing communities, which are physically segregated, and where interactions with members of higher castes are limited to traditional economic transactions such as fish-trading and labor-hire. While low-caste borrowers may be able to develop enterprises which trade in nonlocal markets, social discrimination is likely to restrict their access to retail and service activities which target local customers.

Where enterprises depend on the support of local politicians and officials, there are barriers to entry for the poor and unconnected. Some semi-urban microenterprises breach zoning and building regulations, occasionally giving 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 mobile market-stall trade, which is regulated by a licensing system, permits to set up stalls are scarce and fiercely contested, and were reported to depend on access to local politicians and officials. Due to the civil conflict prevailing at the time of the survey, vehicles using the main roads were regularly stopped and searched, and vegetable wholesalers transporting goods to Colombo reported that letters of introduction from the local police chief were essential in order to avoid long delays at road-blocks.

Poorer households are more likely to face human capital deficiencies. Their mobility and productivity is often limited by poor health and undernutrition. Many lack the technical and business skills required for higher-value microenterprises. They have lower levels of formal education: among below-poverty-line and above-poverty-line clients, primary school completion rates were 50% and 80% respectively. The household labor supply is more likely to be limited: poor and extreme-poor households contained an average of 1.4 able-bodied adults, in comparison with an average

of 1.9 in near-poor and nonpoor households. Extreme-poor households are far more likely to be female-headed, at 17%, in comparison with a 7% female-headedness ratio for the sample as a whole, and are also more likely to be headed by a disabled or elderly adult. In some very poor semi-urban households, entrepreneurial prospects are further restricted by illiteracy and social problems such as alcohol abuse, engagement in petty crime and family instability.

Example 4: Seela lives with her 7-year old son in a remote region 10 km from Hambantota town. Her family's main source of livelihood was single-season paddy-farming until the year prior to the survey, when the family paddy fields were occupied by her brother-in-law following her husband's death in a road accident, leaving her without a source of income. She has taken two loans from the WDF of Rs. 2,500 each to purchase trailer-loads of granite chunks to be broken into smaller rocks. As she is undernourished and lacks the stamina required for the demanding physical labor of rock-breaking, and her son is too young to assist her, she takes two months to complete each load of rocks, a task which most other producers complete in a month. The microenterprise provides a net monthly income of about Rs. 500 after loan repayments are deducted.

In rural areas, social restrictions on women's economic activity limit their entrepreneurial prospects. Paddy-farming and fishing are restricted by custom to men, often with devastating consequences for female-headed households, as example 4 illustrates. In semi-urban areas, men predominate in the profitable skilled manual occupations and mobile trading enterprises, while women are clustered in low-value home-based activities such as garment-making and coir production.

Not all high-value semi-urban occupations are reserved for men, however. Women are present in significant numbers in food processing; furthermore, the gender boundaries around nonfarm occupations are less rigid than those associated with agriculture and fishing, and they are not completely closed to women. Interestingly, female household heads appeared to have more freedom than married women in project selection and mobility. Most women who enter male-dominated entrepreneurial occupations are household heads: one widow, for example, assisted by SEEDS-sponsored technical training, was making a moderate success of a semi-urban welding workshop formerly operated by her husband; another was operating a mobile vegetable trading business.

These successes indicate that in semi-urban areas at least, femaleness is not an absolute barrier to the development of entrepreneurial activities, and suggest scope for NGO gender awareness programs promoting women's entry into higher-value nontraditional occupations.

5. THE CHALLENGE OF SERVING THE POOR

SEEDS and the WDF have traditionally targeted a poor, predominantly rural constituency of single-season farmers, landless laborers and fishing communities, but the composition of the membership base has shifted in recent years toward less-poor clients in semi-urban centers and the Uda Walawe settlements. Among the sample, only 37% of new members joining during 1996–99 were below the poverty line, compared with 65% of those who joined before 1996, and the proportion of new clients from arid rural areas fell from 56% to 21% over the same period. Both MFIs have targeted a nonpoor clientele in their recent recruitment campaigns. In addition to the group-guarantee lending schemes in which poorer clients participate, they have introduced larger, collateral-based loan packages designed to cover the capital costs of the largest entrepreneurial activities. The move up-market is in part a response to pressure from donors to reduce reliance on subsidized funds and improve institutional stability, and gained considerable momentum from a crisis in cultivation loan repayments following a drought in 1996.

The MFIs employ a two-pronged strategy to serve their increasingly diverse client base. They actively promote entrepreneurial occupations, particularly for the nonpoor, while continuing to support survival activities for rural clients and the semi-urban poor. They have, however, substantially reduced their support for cultivation in favor of nonfarm activities. Their approach has worked well for near-poor and nonpoor clients, but they face challenges in meeting the needs of the semi-urban poor, and in retaining relevance for their traditional rural poor constituencies.

(a) *Promoting entrepreneurial activities for poverty reduction*

Both MFIs supplement their lending with nonfinancial microenterprise support services. SEEDS in particular has a highly successful

business development program which has attracted considerable support from international donors, with whom it has collaborated on a variety of projects. Services provided by SEEDS include the identification and promotion of low-cost technologies, individual business advice, and assistance in developing linkages with markets and suppliers. These services have had considerable success in developing established entrepreneurial activities, but little direct impact on poverty, as the owners of such enterprises are mostly nonpoor.

There is some evidence that support for high-end microenterprises may reduce poverty indirectly, via employment generation. The general consensus is that microenterprises play a significant role in absorbing unemployment, but as the vast majority are either self-employment activities or household-level operations which employ unpaid family members, they are not significant contributors to job growth outside the household (Asian Development Bank, 1997; Daniels, 1999; Liedholm & Mead, 1999; Orlando & Pollack, 2000). The impact of credit on paid microenterprise employment, while positive, is small (Sebstad & Chen, 1996). To the extent that microenterprises do generate jobs, these effects are concentrated in the largest, most successful activities (Hulme & Mosley, 1996; Mosley, 2001). This was also the case in the Hambantota sample, as Table 9 shows. Wage employment in survival activities is predictably negligible, but nearly a third of entrepreneurial activities employed at least one nonfamily member. Although the poverty impacts of this quite impressive rate of job creation are offset to some extent by the fact that most of the jobs are of very poor quality, being low paid, part-time and intermittent, the data suggests that support for the enterprises of

the nonpoor may be justified on poverty reduction grounds.

Relatively little attention has been given to the promotion of entrepreneurial activities among the semi-urban poor. The high propensity of this group to opt for survival activities indicates a need for interventions targeting project selection. SEEDS provides little assistance at the point of project selection, however, confining its support for prospective clients mainly to vocational training in both survival and entrepreneurial occupations. The most well-attended training programs continue to be in traditional survival activities: of the 17 nonfarm occupations covered by SEEDS-sponsored training courses in the first half of 1999, more than a quarter of participants opted for just two courses in garment-making and coir production (SEEDS, 1999). The content and structure of training courses for entrepreneurial occupations could be better adapted to the needs of poor clients. Few can afford to forgo their regular income-generating activities in order to attend courses, which sometimes require full-time residential attendance outside the district. Although training costs are subsidized, some find the fees prohibitive, and there may be a case for the further subsidization of selected courses for the most promising poor clients.

Not only are poor clients unlikely to participate in training for entrepreneurial occupations; among those who do participate, post-training microenterprise take-up rates are even lower. It appears that vocational training alone is unlikely to overcome the obstacles of information deficits and anti-entrepreneurial cultural mores. The facilitation of informed selection decisions regarding unfamiliar occupations requires the integration of vocational

Table 9. *Nonfarm microenterprises: contribution to employment*

Enterprise occupation	Household members only	One wage employee	More than one wage employee
<i>Survival occupations</i>	98	3	3
Production and service	35	3	2
Fishing and livestock	24	–	1
Trade	39	–	–
<i>Entrepreneurial occupations</i>	51	10	13
Production, service, fishing and livestock	27	9	7
Trade	24	1	6
Total	149	13	16

training with information on markets, inputs and technologies. In addition, the promotion of appropriate attitudes through gender awareness and other conscientisation programs is needed to enhance the participation of women and other disadvantaged groups in nontraditional activities. The need for additional support services is illustrated by the example of a poor semi-urban client who, after taking a 10-day screen-printing course, decided against persevering with the project, although credit to cover the Rs. 25,000 start-up cost was available. 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 MFIs could take a more proactive role in identifying and promoting occupations which are suitable for poor borrowers. Food preparation, electrical and mechanical repairs, carpentry and personal services such as hair-dressing are among the most promising activities for the semi-urban poor. They are financially accessible, as they rely on human capital and incremental additions of technology rather than large initial capital investments. Furthermore, they have considerable potential for sustained growth, as they are well-positioned to take advantage of proximity to their customer bases, and operate in strong markets with little competition from larger producers.

The emerging domestic and international tourism sector offers considerable potential for microlevel development. With increased domestic activity and the growth of a metropolitan middle class following the liberalization policies of the 1980s and 1990s, together with the removal of restrictions on vehicle imports, there has been a substantial increase in non-metropolitan vehicle traffic. The wildlife parks, beaches and pilgrimage centers in the Hambantota area have potential for further development as tourist attractions, and the district's popularity among tourists appears to be growing: at the time of the survey an international hotel and a number of guest houses had recently opened on the coastal road. Although tourism has generated vigorous microlevel industries in the production of food, handicrafts, jewelery and garments in Sri Lanka's southwestern beach resorts, microenterprises targeting tourists are virtually nonexistent in Hambantota district. As tourism favors the female-dominated food and garment trades, it

presents opportunities for the development of entrepreneurial activities for women. The MFIs could encourage such activities through appropriate awareness-raising and training interventions, including language training and cultural awareness programs aimed at addressing a generally poor understanding of the market among Sinhalese microentrepreneurs.

As distance and small local markets impose a ceiling on the region's capacity to absorb new entrants, poorly conceived interventions risk creating a problem of oversupply. There may be a case for restrictions on the supply of credit to new starts in crowded markets. Furthermore, it is important to ensure that occupations targeted for training are appropriate for the local environment. District-level SEEDS staff report that vocational training programs are designed in the Colombo head office without local input, and sometimes have limited relevance to local conditions, citing as an example a recent course in the production of handbags, an activity which may be well-suited to Colombo markets but for which there is little demand in Hambantota. An abundance of training programs in occupations which have little chance of succeeding locally is wasteful and may ultimately reduce the credibility of nontraditional options.

(b) *Support for survival microenterprises*

Income promotion strategies, which remain the primary strategy of most microfinance programs, focus on poverty reduction, aiming to move clients "from a stable 'below-poverty-line' situation to a stable 'above-poverty-line' situation" (Hulme & Mosley, 1996, p. 106). Income protection strategies aim to mitigate the ill-effects of poverty by stabilizing consumption, rather than eliminate it by increasing incomes. Very poor clients derive little benefit from approaches based solely on income promotion, although their well-being may be substantially improved by services which support continuity of access to basic survival needs and empower disadvantaged individuals (Hashemi, 1997; Hulme & Mosley, 1996; Montgomery, Bhattacharya, & Hulme, 1996; Rutherford, 2000; Sebstad & Cohen, 2000; Zaman, 1999). Carefully planned combinations of protectional and promotional services may deepen outreach and enable some very poor clients to exit poverty, as found by a recent study of BRAC's poverty-focused IGVD Program.

The authors found limited impacts on the poorest and most disadvantaged clients, however, indicating that even when accompanied by protectional services, income promotion requires a minimum threshold of economic capacity (Matin & Hulme, 2003). Income effects are lowest where clients, faced with severe human capital deficiencies or a hostile physical and market environment, are least able to use credit for productive investment.

SEEDS and the WDF have judged that the costs of supporting single-season agriculture outweigh the benefits, and have adopted a policy of reducing their exposure to farming in favor of nonfarm microenterprises in arid rural areas. Their decision was prompted in part by concerns regarding the environmental and economic sustainability of single-season cultivation, and that access to microcredit may in fact work against the best interests of farming households by encouraging them to remain in a declining sector. Considerations of institutional viability also played a part in their decision, which followed a long-term deterioration in the risk profile of single-season farming, and was precipitated by a massive harvest failure following the 1996 drought, which caused up to 90% of cultivation loans to fall into arrears in some rural branches, threatening the viability of the MFIs' district-wide lending programs. From a lender's point of view, rural nonfarm activities are less risky than agriculture, as the nonfarm sector is less subject to destabilizing *en masse* failures. The lending risk is compounded by the large working capital requirements of paddy cultivation, which are more than twice as high as those of most nonfarm activities with comparable net incomes (see Table 8).

Since 1996 the MFIs have imposed a range of restrictions on single-season cultivation lending. Both have capped loan sizes at Rs. 20,000, and SEEDS has imposed an interest surcharge and a 10% insurance levy on paddy cultivation loans. These restrictions have generated anti-poor trade-offs, as they oblige farmers to supplement their microcredit loans with costly borrowings from moneylenders, and they bear most heavily on very poor remote households which are least able to develop nonfarm alternatives. For example, SEEDS requires applicants to 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.

Despite the difficulties facing the farm sector, and the obstacles to accessing credit, paddy

cultivation remains the preferred activity for most rural borrowers.¹ Farming is the most important source of livelihood in Hambantota district, and paddy remains by far the largest smallholder crop, occupying over 70% of cropland (Department of Census & Statistics, 1998). As a rule, when households can grow paddy, they do: as rice contributes around half the calorie intake of rural households, paddy cultivation supports food security in an environment where undernutrition is endemic. It is a mark of social status in Sinhalese culture, providing farming households with a secure sense of their place in the community; and it generates substantially higher cash returns than nonfarm alternatives (see Table 2). Efforts to "steer beneficiaries away from paddy" have had limited success, a fact which is privately conceded by local MFI staff. Faced with restrictions on cultivation lending, many farmers have dropped out of the MFI programs, preferring to maintain their farms with informal sector credit rather than switch to nonfarm microenterprises.

While low poverty exit rates in rural Hambantota demonstrate the limitations of microenterprise development as a promotional strategy, survival enterprises serve a variety of protectional purposes. Cultivation loans support food production and reduce farmers' dependence on moneylenders; and nonfarm loans support subsistence production of eggs and fish, facilitate risk-spreading through diversification, provide short-term stopgaps during the lean season when farm incomes and laboring work are scarce, and provide women with independent incomes. There may be a case for continuing to support rural survival enterprises on the basis of their protectional value, but the decision needs to be based on a careful cost-benefit evaluation. The considerable costs include negative externalities in the form of environmental degradation and high lending risks for farm projects; and in nonfarm projects, the creation of excessive competition in weak markets. In addition, there may be a significant opportunity cost associated with the diversion of resources from alternative promotional interventions. There is a strong case for investigating strategies which may offer better prospects for rural poverty exit, particularly those aimed at improving access to nonlocal labor markets, which for many rural households offer the most viable route out of poverty.

6. CONCLUSION

In summary, evidence from the Hambantota sample does not support claims that microenterprise credit is a broadly effective solution to poverty, although it can work well for clients who are close to the poverty line and live in environments with the conditions necessary to sustain high-value microenterprises. As occupation selection is a key determinant of poverty exit, interventions encouraging the semi-urban poor to select entrepreneurial occupations are likely to further improve their prospects. In rural areas, the chief impediments to rural microenterprise development are largely beyond the control of the programs. Rural microenterprises serve a protectional function, but offer limited prospects for poverty exit, and involve significant environmental and institutional costs and risks. For the MFIs, these ambiguities call for a close examination of their rural development strategies: the benefits of support for rural survival enterprises need to be evaluated and justified, rather than assumed.

A final point relates to the impact of public investment in rural infrastructure on microenterprise development. Sri Lanka's physical infrastructure deteriorated considerably in the 1990s, as the brunt of fiscal adjustment fell on capital expenditure, which declined as a proportion of GDP from 12% in 1988 to less than 5% by the mid-1990s, well below the average for low and lower-middle-income Asian countries.² By the late 1990s observers were warning that reductions in capital spending were jeopardizing the country's economic and human resource base (Institute of Policy Studies, 1998; World Bank, 1998).

Recently, however, there have been encouraging signs of renewed activity in infrastructure provision. The government's 2002 Poverty Reduction Strategy Paper includes a commitment to "pro-poor growth", with initiatives aimed at revitalizing rural development and improving the national infrastructure. There has been an increase in government capital spending, which rose to 5.9% of GDP in 2001, and a commitment, embodied in the PRSP, to achieve 7.3% by 2006; together with the commencement of several donor-supported projects in the power, telecommunications and transport sectors, with substantial increases in donor capital funds projected over the next three years (Government of Sri Lanka, 2002). Of particular significance for the Hambantota region is the Southern Highway Project, due for completion

in 2006, which will link Colombo with the southern cities of Galle and Matara. Although the proposed route stops 80 km short of Hambantota town it will, when established, substantially reduce travel times, increase the volume of nonlocal traffic in the region and improve the access of local producers to urban and export markets.

While the revival of infrastructure investment is a welcome development, ongoing budgetary constraints and policy decisions to target the high-growth urban and export sectors as priorities for capital spending mean that its impact on poverty-focused rural infrastructure is likely to be limited in the foreseeable future. Road development projects continue to prioritize strategic national highways and the Western Province over the rural tertiary road network, and power sector projects focus mainly on adding to the capacity of the existing grid rather than extending supplies to new rural users. Moreover, there is a risk that the privatization of utilities, a strategy actively supported by the World Bank and other donors, will further skew benefits away from the poor, given the high costs of extending infrastructure to remote areas, the limited ability of rural users to pay for it and a policy climate which is generally hostile to subsidized services.

It is no coincidence that the growth of global enthusiasm for microfinance has taken place in a context of shrinking resources for rural development and social services. The disappointing performance of microenterprise lending in rural Hambantota highlights the shortcomings of policy prescriptions which seek to privatize the costs of poverty reduction. Development strategies based on self-reliance are unlikely to have much effect 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. The reorientation of development spending towards rural capital projects may well go further than any other investment towards reducing poverty. As development agencies with a strong national profile, 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 services that are accessible and affordable by the poor.

NOTES

1. 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 1994–95, 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, record acreages were sown with paddy. A drought reduced 1996–97 output, but in 1998 paddy production bounced back, rising by 20% over 1997, despite a sharp fall in producer prices over the period (Central Bank, 1998). There is little

evidence that sectoral decline has dampened the preference for paddy: on the contrary, its continuing popularity, together with recent increases in *chena* production, suggests that many poorer farmers are withdrawing from the nonfarm sector and unstable commercial crop markets in favor of semi-subsistence crops.

2. In the mid-1990s Sri Lanka's investment in core infrastructure, at 4.5% of GDP, compared unfavorably with that of Indonesia (5.5–6%), Thailand (6–6.5%) and the Philippines (7%) (World Bank, 1998).

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