

Chapter 2

Rural Nonfarm Microenterprise: Salient Features and Issues

INTRODUCTION

Most of the rural population engaged in the nonfarm sector are either “self-employed,” i.e., working for themselves on a wide variety of activities located in the household or elsewhere in the village, or are engaged as wage laborers in microenterprises employing no more than ten workers. Thus, the rural nonfarm sector enterprises are basically split into two size categories: the first focuses on small-scale household enterprises; the second focuses on small- or medium-size microenterprises in rural areas and small towns.

The first enterprise category varies widely in size, location, gender, and sector of activity. Most are single-person, owner-operating units, or small units engaging family members. Most of these enterprises are subsistence or livelihood enterprises, providing employment opportunities in the absence of more profitable alternatives and often are one of several secondary sources of income, many of them intermittent, part-time, and seasonal. They are engaged in a wide range of activities with heavy concentration in trade and service activities, predominantly related either to agricultural inputs, outputs, or to consumption needs of farmers. They earn a small surplus which is frequently not reinvested but devoted to household expenditures, reflecting the poverty of the workers/owners. They require low-level skills and capital; hence there are low barriers to entry and they are overcrowded. Thus, in general, they have small potential for growth. A small number may grow over time and may start employing wage laborers.

The second category of nonfarm sector enterprises mostly employs wage laborers in addition to family members, relatives, or children, and uses higher skills and capital intensity. These enterprises employ anywhere between two and ten employees. Many of them hold prospects for growth in scale, capital intensity, and market size over the long run. The major differences between the two categories of enterprises may be seen in Table 2.1. The distinction is not very rigid; in many cases, they may overlap (ADB, 1997).

TABLE 2.1. Major differences between livelihood enterprises and microenterprises.

Factor	Livelihood enterprises	Microenterprises
Capitalization	Relatively low	Higher, but initial capitalization often similar
Education	Little formal education	Usually at least secondary schooling
Skills and experience	Relatively low, except for skills acquired traditionally, as in handicrafts; trading often a fertile training ground for later manufacturing of same product	Higher, more often acquired through vocational training and/or previous wage employment
Gender	High (often majority) participation of women	Lower participation of women, but still high in many cultures
Sector	Higher proportion in livestock, backyard poultry, food processing, and petty trading	Higher proportion in manufacturing and services requiring skills
Competition	Usually function in perfectly competitive markets with low barriers to entry and little scope for cutting costs by intensive use of family labor and even by offering credit	Often occupy "niche" markets with more scope for specialization and product differentiation
Seasonality	Often seasonal, tied to crop cycle, school year, major festivals	Less affected by seasonality and function throughout the year, even if at varying levels
Contribution to household income	Usually a secondary source (although vital)	Often primary
Whether only enterprise	Usually one of several "multiple" enterprises (to compensate for seasonality and low returns)	Usually the only enterprise
Use of hired labor	Infrequent, mostly use family labor	More common, often relatives or children
Surpluses and reinvestment	Surpluses limited and often plowed back into household expenditure	Reinvestment of surpluses the norm
Use of credit	Trading activities often started on a consignment basis, livestock acquired on a profit-sharing basis, boats and rickshaws on lease; however, in order to compete, often become net lenders, especially in trading and restaurants	Credit available from a wider range (informal and semiformal) and a greater two-way flow of credit so that microenterprises are more often net lenders than livelihood enterprises

TABLE 2.1 (continued)

Factor	Livelihood enterprises	Microenterprises
Potential for growth	Limited in terms of new employment generation, but offer scope for increases in sale, productivity, profitability, and income; growth blocked often by demand constraints, resource constraints (artisanal fishing), and physical constraints (space in home and yard)	Have growth potential; number of workers higher, with more paid employees; employment usually of "higher quality"

An illustrative list of activities by sectoral classification is shown in Table 2.2.

However, broadly speaking, policies to promote both livelihood enterprises and microenterprises cover provisions for credit as well as noncredit inputs such as technology, skill, training, and marketing. Many livelihood enterprises require access to credit and financial resources, especially working capital, more than any other input. Others, especially as they grow in scale and those that are more in the nature of growth-oriented enterprises, need fixed capital as well as significant noncredit inputs.

As agricultural transformation takes place and urbanization proceeds, consumption as well as input/output links with urban areas are strengthened. Many small-scale livelihood enterprises including cottage industries are unable to stand competition from urban goods. Rural households spend a larger share of income on urban goods than on low-quality but low-priced products of home-based rural industries. The rural trade and transport services rapidly expand to distribute urban goods, both consumption and production inputs, in the rural areas. The repair and maintenance services for the construction and transport sector as well as for agricultural implements expand in the rural sector.

MICROFINANCE

The most important obstacles in developing rural microenterprises for the poor has been credit constraint. Rural borrowers have no collateral to offer against loans. Without any credit history or savings of their own, the credit agencies find it too risky to lend. Administration involving the appraisal, monitoring, and supervision of the use and recovery of small loans for microenterprises is too costly for the lenders. While the delivery of other microcredit inputs or services to the microenterprises has also engaged the

TABLE 2.2. A suggested sectoral classification of microenterprises.

Sector	Livelihood enterprises	Microenterprises
Noncrop agriculture-related activities	Pig, goat raising, dairy-cattle, backyard poultry, vegetable growing on leased land, fruit trees on homestead, sericulture	Stall-fed mini-dairy of high-yielding cows, "scientific" poultry or duck raising, fish fry, and fingerling raising
Trading	Small kiosk, ambulant vegetable vending, buy-and-sell fish	Larger grocery store, vegetable wholesaling
Food and refreshments	Juice stand, small tea shop, candy and snack stall	Restaurant or tea shop at busier location with hired employees
Food and agro-processing	Rice cakes	Packaged candies, processed meat products, perhaps with labels
Manufacturing: Textiles	Pit loom, seamstress	Power loom, garment maker, bulok orders for uniforms
Wood, rattan, bamboo, and grassproducts	Mat and basket weaving, rattan furniture	Larger furniture-making unit
Footwear and leather	Wayside shoemaker	Larger ready-made footwear-making unit, leather bags
Bricks, tiles, and pottery	Village potter	Larger brick-making unit
Fabricated metal products and repair services	Hats for local market	More sophisticated handicrafts for the export market
Other manufacturing	Simple agricultural implement maker, roadside bicycle repair	Small engineering workshop doing job work, repairs to heavier agricultural implements
Fishing	Single-person fishing boat	Larger mechanized boat with crew members
Transport	Cycle rickshaw, mule, bullock-cart	Mechanized three-wheeler, hand-tractor rental services
Other services	Wayside hairdresser	Beauty parlor

attention of the policymakers, the highest priority has been assigned to devising ways and means of removing the credit constraint for the microenterprises.

Therefore, microfinance institutions (MFIs) have been a principal means of promoting nonfarm self-employment and rural microenterprises in the

various Asian countries. Given the large variety and number of rural microfinance institutions in the South Asian region, various studies have been undertaken in recent years to analyze and appraise quite a few of them, especially in Bangladesh and India.¹ This section seeks to provide, on the basis of a survey of findings of past studies, a review of some aspects and characteristics of microfinance in the nonfarm sector. The focus of the review is on the problem of poverty targeting and the impact of microcredit on the socioeconomic welfare of the poor and poverty alleviation, including disadvantaged women; it also discusses the long-run sustainability of microcredit institutions.

Poverty Targeting

In devising cost-effective poverty microcredit programs, the most widely debated issue is the pros and cons of appropriate methods of targeting. The targeting of the poor in any antipoverty credit program can be based either on self-targeting or on indicator targeting. Indicator targeting is based on income or income proxy that is closely related to income or poverty and can be observed more easily or more cheaply than income. These indicators include income, assets, geographical targeting, landholding, gender, nutritional status, household size, and kind of dwellings and access to electricity, etc. Under the system of self-targeting, in lieu of the administrators or bureaucrats choosing participants, beneficiaries select themselves in response to incentives or disincentives that are provided to induce only the poor and discourage the nonpoor to be included in the credit system. The objective in both types of targeting is (1) to bypass or exclude the nonpoor and (2) to increase the participation of the poor, i.e., to avoid what are called “type one” and “type two” errors.

The first type of error occurs when there is a leakage to the nontarget population. The second type of error involves exclusion of some of the poor in the target group. Attention must be paid to both types of targeting errors. A targeting mechanism can scarcely be devised so that some poor will not be excluded. Frequently, the focus seems to be to minimize the leakage to the nontarget population or to the nonpoor rather than to maximize the inclusion of the poor. In the interest of extending the coverage of the poor, some leakage to the nonpoor may be accepted. It is a matter of reaching an appropriate balance between the two considerations.

When an attempt to target the poor imposes high costs of (1) identification and determination of eligibility, (2) communication with the eligible, and (3) monitoring to exclude the ineligible, cost-effective strategies must be found. Time-consuming and expensive household surveys to determine, for example, prospective participants' income and consumption levels may

have to be avoided if they are not already available as part of the national statistical information. Other less expensive shortcuts may provide reasonable results. To illustrate, in one method, villages are mapped and households ranked into groups by poverty status; next, the field staff of the microcredit agency interviews those who have been identified as eligible for final selection. Another method uses the “house and compound of the house” as a crude indicator to eliminate nonpoor households from initial consideration as potential members. In the next stage, the field staff visits those who are initially chosen as poor on the basis of this criterion to verify their eligibility through a short interview that focuses on the value of their productive assets (Gibbons and Meeham, 2000).

The ownership of land or the size of the land owned is often used as an indicator of rural poverty, e.g., landless or very small landholders being poorer than those with bigger landholdings. The probability is low that the nonfarm- or nonland-based income may more than offset the poverty of the landless or smallest landholders in the rural areas, especially in the Asian developing countries.

In some cases, the size of land ownership of a household may be difficult to ascertain. For example, when sons form separate households, the land from the father may not be immediately transferred, yet they may work on the farm and receive a share of the output. Similar cases of widowed sisters who live with the brothers may be encountered. Borrowers with high dependency ratios (i.e., households with few earners to members) or households earning a major part of income from casual labor are likely to be poor.

The land- and occupation-based eligibility criteria are not perfectly correlated with poverty. Households that are marginally above the cutoff point could still fall below the poverty line. Targeting of the poor is facilitated in some cases such as the Grameen Bank in Bangladesh by the use, in addition to visible indicators such as landholding, of participatory techniques, such as local groups of population assisting in identifying the poor. Frequently, gender-based criteria (divorced, abandoned, or widowed women, female-headed households, or women relying mainly on casual labor) are used either singly or in addition to that of landlessness to identify the poor households.

Geographical targeting has also been frequently used in locating the poor households. Frequently, significant and sizable geographical effects on living standards are found after controlling for a wide range of nongeographic characteristics of households such as education, landownership, and occupational pattern, etc., characteristics that are easily observable to the policymakers (Ravallion and Wodon, 1997). Therefore, poverty targeting—its nature and extent—depends on the placement of offices or branches of

the microcredit agencies, such as location in areas or regions having the largest concentration of the poor.

However, at the same time, search for financial viability, which warrants offsetting considerations, may cause agencies to avoid areas with low returns such as remote and inaccessible areas often inhabited by very poor or disadvantaged populations. One consideration is the expected level of demand for credit services. It is important for two reasons. First, fixed costs associated with the establishment of branches imply that when demand is lower than some minimum threshold level, credit delivery becomes very costly. Second, the marginal impact of financial services on participating households is likely to be highest in areas with strongest credit demand. For these reasons, branch and service placement decisions are likely to respond to the level of physical and market infrastructure and the general economic buoyancy of the area, all of which fuel credit demand. Related to this is earning adequate returns from activities financed by credit since this affects repayment rates. Thus, a tendency exists to avoid areas with low returns such as inadequate infrastructure or susceptibility to natural disasters and other risks. Loans for financing highly market-dependent activities are not suitable for remote areas.

Another consideration is the cost of supplying services. In this regard, at least three factors influence the location of branches. First, credit transactions raise security concerns; proximity to police stations or other law-enforcement establishments is important. Second, proximity to branches of commercial banks is also important, since the microcredit agencies frequently do not provide banking services. Third, to the extent that salaries and other compensations of the credit agencies staff do not provide rewards/incentives for more remote locations, managers are likely to prefer locations that have fairly well-developed services (education, market, and health).

A recent study of the placement of three important NGOs/MFIs in Bangladesh shows that even though the placement of branches is attentive to poverty considerations, they are nevertheless more likely to be established in locations with better access to transportation and communication infrastructure. Hence, it appears that MFIs are geared more toward the poor who reside in relatively well-developed areas than the poor in more remote and less-developed regions.

Much has been said as to whether the microcredit programs can reach the low end of the rural poor. In general, the factors responsible for the inclusion of nonpoor in the microcredit programs and the exclusion of the poorest may be said to operate from two sides: from the side of the organization (supply side) and from the side of the poor households, who are the prospective clients (the demand side).

Regarding the “demand side” restrictions on reaching the poor, it is suggested that some of the poor “self-select” themselves out of the credit programs’ membership. They do not consider themselves creditworthy; they suffer from a lack of self-confidence and absence of entrepreneurial ability or feel that it is too risky for them to borrow. The poor, especially the poorest, do not always come forward to apply for credit, as they do not know or not believe that credit is really available to them. In Bangladesh, 49 percent did not join because they felt that they would be unable to repay the loan; about 25 percent did not join because to do so would violate social norms; 13 percent wanted to join but were not accepted in the groups because they constitute high risks for a variety of reasons. Under the circumstances, it may be necessary to motivate them and convince them; when they see for themselves that their poor neighbors or households have participated and benefited, they are inclined to avail themselves of the opportunity.²

To understand the problems that lead to a lack of demand for credit among the poorest, one must understand the constraints faced by the poorest that impede the proper use of finance. Inadequate control over any or a combination of factors such as land, labor, and capital may limit demand. Extreme poverty may be associated with lower labor force endowment and adverse dependency ratio. The availability of an adequate family labor force helps effective use of microcredit for generating a higher return; it helps to diversify the sources of income, thus making loan repayment through monthly installments easier. Frequently, families with only female workers face various obstacles in running an enterprise. Women burdened with the responsibility of small children and/or a sick husband are the most adversely affected. The fact that the poorest families in the rural areas often do not possess a house and/or land may prevent them from obtaining microfinance. The size of the homestead area may become a binding constraint for the entry into a self-employment activity or expansion of the scale of activity. A rickshaw puller requires a safe place to keep his rickshaw at night and thus the space around the house is important. The poorest often find shelter in a rich relative or neighbor’s house, but they will not be allowed to keep their livestock on someone else’s land. The number of livestock one can keep will depend on the availability of space. Similarly, an activity such as paddy processing requires a place for drying paddy. Frequently, the poor women are seen using a part of the highway for drying paddy.

Lack of equity capital is also a constraint; although it is not essential to obtain credit, this may influence the rate of return from enterprises through the following channels. First, when the borrowed fund is supplemented with one’s own capital, the capital labor ratio will be higher. This will increase the rate of return to labor. Second, the use of one’s own capital in a

microenterprise may affect the choice between fixed capital and working capital. This in turn will determine the type of activity one can pursue. The borrowers who do not possess any capital are likely to use a smaller proportion of the borrowed fund as fixed capital. The limitation arises because repayment usually must be made within one year through monthly or bimonthly installments and most repayments start within a month of receipt of the credit. If the entire borrowed fund is invested in fixed capital, the regular repayments as well as the interest payments must be made from current flow of income right from the beginning. If an individual has some capital of his own, then a part of the fund may be used for loan repayment, at least during the first few weeks. Moreover, households without other sources of income are likely to invest in activities that require little fixed capital and yield high returns in the short run. This often limits their choice to a few processing activities and petty trading or peddling.

A few features such as compulsory weekly savings and the lack of “grace periods” for most loans deter the poorest. At the same time, these poorest households continue to borrow in the informal credit market, primarily during times of distress. The poorest borrow to reduce vulnerability to seasonal shocks and the “moderate poor” may borrow to invest in income-generating activities.

The supply side constraints on the inclusion of the poor may arise due to (1) the objectives and policies of the microcredit agencies, and (2) the procedures and the strategies used to achieve these objectives.

With the major stated objective of most microfinance programs as “poverty alleviation and extending credit services to the poor,” they will be encouraged to include those just below the poverty line, who are termed as borderline poor, because it is easier to lift the “middle poor” or “borderline poor” above the poverty line and thus to demonstrate success in poverty alleviation.

Along with poverty alleviation, the other overriding concern has been to achieve financial sustainability and to reduce dependency on donor or external funds. A two-pronged approach may be useful to achieve financial sustainability as follows: (1) reduce cost through increasing the scale of credit activity and (2) ensure that the good repayment practice already achieved by most NGOs is sustained.

The inclusion of the poorer households may raise the cost of credit agencies and therefore inclusion of the nonpoor may be warranted by the following factors:

1. Loan size for the poorer borrowers is usually smaller than the loan size in demand by the borderline poor. The poorest do not borrow for fixed investment since they do not have other sources of income from which they may repay the initial installments at frequent intervals. Also, smaller loan

size of the poorest is also due to their lack of confidence about handling a larger amount of money. Since the cost of administration is the same for each loan, the cost of lending per unit is higher for smaller loans.³

2. A longer time is required than in the case of the nonpoor or the borderline poor to motivate the hardcore poor to participate in the credit program; this raises cost. To achieve economies of scale, there is a tendency to increase the number of borrowers to be covered by each field staff and this is more easily accomplished by including some nonpoor households in the program.⁴

In the early stage of the introduction of microfinance institutions, much time was spent on the mobilization and conscientization of the borrowers prior to extending credit. The need to extend membership and to expand the volume of lending has led them to shorten this period so that less time can now be spent in motivating the prospective clients as well as in the initial training and the social mobilization process. This change in practice discourages or leaves out the poor borrowers since they are the primary beneficiary of the longer process of training and motivation.

3. Due to compelling need on the part of the very poor to frequently divert a part of their loans toward purchasing food, and also due to the smaller scale and lower efficiency of economic activities pursued by them, it is feared that the extension of credit to this group may worsen the repayment performance.

4. It is alleged that in a few cases the members of the “target group” themselves wanted to include some influential nontarget group households to help them tide over loan repayment difficulties within the group. Also, households from the “nontarget group” were expected to improve the sustainability of credit agencies by depositing greater savings. The poorer the households in a group, the smaller will be their regular savings. Savings of the members of credit agencies are an important source of financial resources and these are used for relending. An emphasis on sustainability and self-reliance enhances the importance attached to members’ savings.

5. Forming borrowers’ groups for the purposes of group-based lending by microcredit agencies may also act as an obstacle to the entry of the poorer households into such membership groups. The collective group responsibility requires that a member who is unable to repay is motivated to find ways to do so; in some cases the group members are denied new loans if one member defaults or cannot repay within the stipulated period. The poor members are unlikely to include a poorer one who may become a burden to them.

6. Powerful factions may exist within the village who may disrupt the microfinance institutions if they do not get access to credit. Thus, the “target group” approach may need to be flexible enough to incorporate a num-

ber of socially influential households in order to maintain some link with all socioeconomic classes in the village. It is difficult to determine how important this factor is in practice.

Impact on Poverty Reduction

In assessing the impact of microcredit-financed microenterprise on poverty, it is important to remember that microcredit, provided ostensibly for productive microenterprise, is usually used for other purposes consistent with household welfare maximizing behavior; this includes financing consumption (indirect asset protection rather than asset creation because otherwise the existing asset will be sold to finance consumption); repayment of existing informal debt; and investment in housing and education. For long-term impact a borrowing household must have a source of reliable income from which to make regular weekly payments, must be free from pressing debt, have good health, and have freedom from imminent expenditures or have enough savings to cope with them.⁵

In Bangladesh, between one-fourth and one-third of loans have been used fully or partly for purposes unrelated to production in the following order of importance: subsistence expenditure on food and clothing, loan repayments, tubewells for drinking water, purchase of homestead land, and release of mortgaged land. Usually, the credit agency officials discuss the feasibility of the project with the loan applicant and once the loan is granted they often informally monitor whether the bulk of the money is invested in the proposed project. The borrowers know that if they use a large portion of the loan for a totally unrelated purpose, then they will face problems in obtaining additional credit (Zaman, 1999).

The three features of microcredit—small loan size, weekly payments, and short maturity (one year, for example)—tend to rule out long-term investments when longer-term maturity and larger loans are desirable. Each loan, therefore, has only an incremental or short-term impact on enterprises and household income and a series of loans are needed to make an income-raising impact above the poverty line.

Various estimates are available regarding the impact of microenterprise on poverty. In Bangladesh, for example, it was shown that 5 percent of the Grameen Bank borrowers rose above the poverty line each year by borrowing from the bank, whereas the corresponding percentages were 3 and 6 percent, respectively, for Bangladesh Rural Advancement Committee (BRAC) and Bangladesh Rural Development Board (BRDB). The extent of poverty gradually declines as the landless households obtain repeat loans (Khandker, 1998). Similarly, a direct comparison of household expenditure among

the borrowers and the nonborrowers covered by eight NGOs showed that household expenditures of those who obtained more than one credit was 17 percent higher than that for those who did not borrow. However, the first time borrowers obtained a 5 percent increase in household expenditure over the level of the nonborrowers (Rahman, 1996).

Access to microcredit helped the entrepreneurs accumulate nonagricultural capital, including ownership of house, which contributed substantially to productivity among low-income households. Microcredit had a positive impact on savings and asset accumulation (Khandker and Chowdhury, 1996). Current savings of those who obtained microcredit were many times higher than the savings of those who did not get credit. The amount of savings increased sharply with the number of loans obtained by a household. Among the types of assets, the greatest increases occurred in the ownership of a house, transportation, and livestock.

A study of BRAC in Bangladesh revealed that microenterprise financed by borrowing more than a threshold amount (e.g., 10,000 taka) made a significant contribution to poverty reduction among the moderate poor. Borrowing more than 10,000 taka (the mean loan size for the "10,000 plus" category is 13,090 taka) raises a moderate-poor household's consumption per adult equivalent by 18.8 percent compared to an identical nonborrowing BRAC member. Also, households that had borrowed more than this threshold amount spent significantly more in terms of nonland "productive assets" (poultry and livestock in particular) during the one year prior to the survey compared to members who had borrowed less than 10,000 taka. Sharp growth occurred in productive assets for third-time borrowers, compared to first-time borrowers (Zaman, 1999).

Significant improvements in welfare once an enterprise crossed a certain loan threshold could be possibly interpreted as the result of switching from traditional, low return on-farm activities to higher return off-farm activities over time. This also could be because initial loans were often used for consumption purposes, repaying debts, and repairing homesteads while subsequent ones were used for investment purposes. Thus, providing capital to poor households improves their socioeconomic conditions, but only when loans are large enough so that investment in both on- and off-farm enterprises can earn significant returns.

The previous study indicated that the extremely poor, proxied by those with less than 0.5 acres of land, did not appear to benefit significantly from borrowing, even for those who had borrowed more than 10,000 taka. Given the fact that the extremely poor were more risk-averse than the moderate poor, they were more likely to have borrowed for traditional low productivity activities with a view to switching into riskier higher return activities over time.⁶

Through asset creation, microcredit reduces vulnerability to shocks caused by natural or man-made calamities, sickness, or death in the family. Building up a household's asset base, which can reduce vulnerability through a number of channels, is an important form of self-insurance against crisis. To start with, some assets can be readily sold to meet immediate consumption needs. Second, asset building can improve creditworthiness, thereby improving a household's borrowing capacity during a crisis. Third, a larger and more diverse asset base can reduce covariant risk. The potential reduction in vulnerability thus takes place through a number of ways, e.g., the creation or expansion of one or more income-earning assets, improvement in housing conditions, income and consumption smoothing, savings for the lean season, and the emergency assistance provided by many microfinance organizations during periods of acute natural disasters such as the recent floods in Bangladesh.⁷

Increases in income or consumption (i.e., reduction in poverty) can occur if credit is used for an income-generating activity and that activity generates returns in excess of repayment obligations. A credit-financed investment does not reduce poverty if it does not generate a significant net profit, even though it creates an asset that can reduce vulnerability. Loan repayment takes place through a reduction in consumption and not from the returns to the investment. A temporary reduction in poverty can also occur if credit is used for noninvestment purposes such as repaying existing debt, improving housing, or meeting social obligations. However, future consumption must be sacrificed to meet repayment obligations.

Empowerment of Women

Many studies have been conducted on the impact of microcredit and microenterprise on women's empowerment.⁸ However, the studies in South Asia do not provide a uniform conclusion. Despite the mixed results within and across studies, some positive impact on women's lives has occurred. The main benefits derived by women seem to be

1. greater involvement in income earning activities;
2. increase in awareness about social-, economic-, and health-related issues;
3. increase in the adoption of family planning methods; and
4. increase in girls' education and school enrollment rate. (Rahman, 2000)⁹

Many of the studies indicate positive impact in respect to some other indicators. For example, a few of the studies obtain a positive impact on certain types of decision making, especially decisions regarding small purchases,

expenditure on food and clothing, daughter's education, etc. Most studies show an absence of positive impact on decisions regarding large expenditures and sale of large assets.

Two types of negative findings have been extensively discussed. First, most female borrowers cannot retain control over the loan, and second, family violence does not decline and may increase with the length of membership in microfinance institutions. Some controversy surrounds the interpretation of control of microcredit obtained by women. It is not expected that in all cases women would have full control of the borrowed fund because economic activities in the rural areas are usually family activities. The use of a loan in such activities usually means sharing the control of the loan. Moreover, when the male members are not eligible for membership, it is very likely that the loan would be routed through women but would be used by male members and in such cases it is not expected that women would retain 100 percent or even a major control of the loan. Therefore, studies show that microcredit might lead to women's empowerment, even if the loans are used by male members of the family.

The studies, which show a positive association between microcredit and violence against women, are subject to differing interpretation. First, it appears that studies, for example, in Bangladesh during the mid-1990s—but not the early studies—do show such results. Second, there is no analysis of the possible cross-relationship between the occurrence of violence and other indicators of empowerment. Since women continue the membership of NGOs/MFIs despite the violence inflicted on them, the perceived net benefit of program participation is likely to be positive.

The other question relating to the impact of credit on violence is whether it is the failure to utilize credit productively and the consequent hardship or the sharing of the income generated by the credit-financed enterprise that leads to violence. In the former case, the obvious answer is to help women to utilize the loan productively to earn high income. In the latter case, microcredit must be supplemented with support from organizations committed to the advancement of women's rights.¹⁰ In any case, more in-depth research on the incidence of family violence among the microcredit recipients is required. Violence against women has been a much wider problem in many countries with or without access to microcredit.

FINANCIAL SUSTAINABILITY

The financial sustainability of the microcredit agencies relies upon their administrative and managerial efficiency, depending upon efficient cost

control, appropriate accounting, and auditing procedures. It should be noted that as outreach expands, administrative costs increase due to

1. initial cost of opening new branches,
2. costs of recruitment and training of new staff to man additional workload, and
3. time lag in the attainment of efficiency by the new staff up to the level of the existing staff.

It takes approximately three to five years for the new staff to reach the required organizational level of efficiency. It will take considerable time for the economies of scale from the expansion of operations to be realized and for the extra costs of expansion to be recovered from the interest income (Gibbons et al., 2000). Sustainability, of course, also depends on the interest earnings from microcredit. The appropriate lending rate to attain self-sufficiency depends on

1. unit costs of administration,
2. loan loss,
3. cost of funds,
4. required/desired capitalization rate, and
5. expected investment income.¹¹

Should financial sustainability imply that a microcredit agency is able to meet not only (1) the cost of loans and (2) its administration, but also (3) the cost of social mobilization and awareness building among the poor? The latter encompasses the ability of the poor borrowers to understand the opportunities of and gains from self-employment, the value of savings, and their ability to manage elementary bookkeeping. As the borrowers graduate to more complicated and familiar nonfarm activities, they need to be given training in new technology and marketing. The tasks of social mobilization and training are not credit inputs. It is unlikely that returns from lending operations will, in general, meet the additional costs of noncredit inputs.

Financial sustainability conflicts with the objective of targeting the poor have been discussed in the section on targeting. The following examples illustrate the projects that are able to meet the terms and conditions that usually accompany the provision of microcredit. This is important to analyze how the microcredit provided for different varieties of nonfarm activities, with long gestation lag and moderate returns affecting their financial sustainability.

A study of microfinanced enterprises by the Centre for Agriculture and Rural Development in the Philippines (modeled after the Grameen Bank)

indicated that annual returns from investment calculated as gross returns before payment of installments and interest total more than 100 percent, 117 percent on average. With the interest rate at 39 percent, it left 78 percent with borrowers as returns from their wages and profits (Hossain and Diaz, 1997). This is quite a high rate of return and is adequate to meet the payment obligations on account of loan repayments and interest payments.

The discipline of weekly repayments and high interest rates may imply that frequently payments are made in the initial weeks from the household cash flow, which sometimes requires its members to tighten their belts; this resembles a classic form of savings based on self-denial for future gain. For example: a \$46 loan for hog fattening payable over six months requires weekly installments of \$2.32 of which \$0.21 is interest: two piglets cost \$46, each at \$23. After about six months, the fattened (mainly on household scraps, vegetables planted in the house garden for that purpose, and commercial feed supplement) pigs can be sold for about \$92 each, giving an attractive lump sum return and net profit estimated at around 100 percent on average (Gibbons et al., 2000).

For households too poor to tighten their belts, loan activities such as petty trading or small shopkeeping that result in the quick and frequent generation of additional income are more appropriate. For example, in an Indian case, petty trading of bangles and cosmetics by poor women requires a working capital of only about 1,000 Indian rupees. If this is borrowed at an interest rate of 20 percent (flat) for a term of 20 weeks, with principal and interest repaid in equal amounts weekly, then the required weekly repayment is 60 rupees of which 50 rupees is principal and 10 rupees interest. Usually the women sell house-to-house and village-to-village, carrying their wares in a basket on their heads, six days a week. They gross about 100 rupees a day or 600 per week of which about 120 rupees are net profit. Half of this goes for repayment.

For larger loan amounts, the weekly repayments can be kept small and manageable by lengthening the loan term. For example, a popular loan activity in South Asia among the poor is the purchase of a moderately yielding, say 3 kilo per day, milk buffalo, which can be purchased pregnant for around 6,000 rupees in India. If a loan of the whole amount is made available for that purpose to a very poor women at 20 percent interest (flat), or an effective rate of around 40 percent, on a declining annual rate for a term of two years with 100 equal weekly installments of principal and interest, each payment would amount to $[6,000 + (6,000 \times 0.2) + (3,000 \times 0.2)] = 7,800/100 = 78$ rupees. The 3 kilos of milk could be sold daily for approximately 12 rupees per kilo. This means that the weekly repayment money of 78 rupees could be earned in two to three days, leaving the income from the other four to five days to reduce the poverty of the household. The risk of the buf-

falo dying can be covered by livestock insurance at a premium of 4 rupees per week, or 100 rupees per year. Over the two-year period, the total cost would be 160 rupees, which could be paid from the sale of the milk. However, as the buffalo produces milk for only about nine out of twelve months, the borrower must save or engage in some other income-generating effort for the remaining three months. To fill the gap, clients frequently purchase a second buffalo as soon as they can. With two milk buffaloes they can have a good, steady income throughout the year (Gibbons et al., 2000).

The above examples explain why livestock, poultry, petty trading, and small shops predominate the activities that are usually financed by microcredit—when small amounts are lent with frequent payment of installments.

To achieve financial sustainability it is frequently necessary to customize the types, terms, and conditions of microcredit to the needs and opportunities of the poor to ensure the productive use of loans in the context of (1) their overall credit needs (so that microcredit for income generation activities is not diverted to other uses) and (2) investment opportunities which yield returns high enough to meet the interest and repayment obligations. For example, in one case it was found that a one-year term for the first loan was not suitable for clients primarily engaged in tertiary activities such as petty trading with shorter business cycles. It reduced the period to six months; at the same time, to discourage the clients from resorting to traditional money-lenders in times of economic distress or income shortfalls, a multipurpose loan was introduced; thus, a loan up to \$132 (at 2,000 exchange rate), compared with the initial average loan size of around \$80, could be used for any purpose after six months of membership in the program. After some years, an additional type of loan was introduced (called Loan Accelerated Program) for successful members who have been with the program for many years, allowing them to draw on an overdraft account based on the need of their business, subject to all the disciplines of the regular loan program (Hossain and Diaz, 1997; Gibbons et al., 2000).

With the passage of time, scope for investment in quick yielding, high-return nonfarm activities diminishes; nonfarm enterprises seeking credit will be increasingly those that have longer gestation lags and modest returns. This would require a modification of the prevailing lending modes and procedures, including adjusting the level of interest rates to suit the unfolding circumstances. This brings one to the broader issue of general development related supplementary measures and nonfinancial inputs needed for the development of rural microenterprises. The role and *modus operandi* of microfinance would be seen as part of a comprehensive framework for the promotion of microenterprise.

NONFINANCIAL INPUTS

In many nonfarm activities, finances need to be combined with such noncredit issues as transfer of technology, training facilities for workers and entrepreneurs, and support for marketing. Credit tends to be relatively more important in activities that do not require any demanding skills and in which backward and forward links are not problematic. Examples are many forms of processing where working capital requirements are high, or in transportation services where the initial fixed capital outlay is large. Retailing and wholesaling are also working-capital intensive (ADB, 1997).

However, noncredit inputs such as design, product development, market information, and marketing assistance are usually much more important for a large number of manufacturing activities, including handicrafts. Generally speaking, noncredit inputs and support services are particularly important for growth-oriented microenterprises and activities with relatively numerous backward and forward linkages, such as manufacturing. Trading and services usually require fewer nonfinancial services, with the exception of training in services that are skill-based.¹² The importance of primary and secondary education in the development of the nonfarm sector needs to be stressed. The educational level of the household head correlates with the probability of starting an enterprise. Households with primary education start new enterprises at a higher rate than those without such education. Entrepreneurs with secondary and higher education are more successful in ensuring growth in their enterprises (Shilpi, 2003).

Given the variety of noncredit inputs required for various activities, including marketing and technology, only an organization with a detailed understanding of and considerable experience in a particular subsector is in a position to identify all the inputs and support services required. It takes considerable field experience to pinpoint all the bottlenecks impeding an activity because many limitations reveal themselves only when implemented. The constraints change as implementation proceeds.

The microenterprise promotional programs need to place greater emphasis on the subsector approach, which provides a framework to identify the constraints and opportunities linked to a particular final product or raw material. Training programs have not been very successful, partly because technical training has often been provided in a very generic way rather than directed to the specific needs of one or a few subsectors. The case with marketing assistance and technology transfer is similar.

There are a number of subsector-specific promotional public organizations in most countries, such as silk boards, dairy development corporations, and handicraft training-cum-production centers. Sector/subsector specific functional organizations include

1. research institutes (for example, in leather and food processing),
2. common service institutions such as testing and other quality control facilities (for example, in diamond and gem processing “parks”), and
3. training centers.

In many cases a need exists for organizations in the private sector or among the NGOs to complement government-sector institutions. An important mechanism available both for analyzing and catering to the subsector requirements are subsector-specific NGOs. Usually operating in a smaller area, the NGOs frequently have the advantage of detailed local knowledge, better motivated staff, flexible procedures, and a focused commitment to the micro sector. They can be engaged in the diagnostic and analytical task, which is itself a continuous process. Second, they can facilitate enterprises' access in a sector/subsector to the existing support services offered by the government; thus, they can function as intermediaries and perform what is usually referred to as the “linking role.” In Bangladesh, for example, BRAC works with the Directorate of Livestock and Poultry to arrange for training women in the backyard poultry industry. Third, creating business links with services provided by the private sector is another aspect of this role. Promoting links of small microenterprises with larger firms through franchising and subcontracting has been a longstanding objective in microenterprise development.

NGOs providing noncredit services tend to be less numerous than credit NGOs, partly because many nonfinancial services require a high degree of specialized business acumen (such as in marketing) or knowledge of specific technologies. Subsector-specializing NGOs cannot be created overnight. However, many NGOs also follow a holistic approach. They recognize the importance of nonfinancial services and they require and need to receive technical assistance in acquiring the necessary skills and staff within the context of well-thought-out and timebound subsector plans. It is usually difficult to recover the costs of services such as training and technology transfer; it is hard to quantify their benefits though they are very real and of a long-term nature.

They can channel inputs and services already available elsewhere to microentrepreneurs, who, when organized into groups, can be reached more easily. The subsector-oriented institutions, be they governmental or NGOs, may organize producers into groups (often cooperatives) so as to achieve economies of scale in the delivery and reception of services. They can also link microenterprises with private exporters. These institutions can establish standardized descriptions for various product categories and disseminate them through national and local business associations. They gain

acceptance for their quality standards in the export markets; they may help strengthen mechanisms to disseminate information on input suppliers and output buyers, setting up databases through local networks.

A distinction can be made between what is called supply-driven and demand-driven assistance (Boomgaard et al., 1992). The supply-driven assistance is provided regardless of whether the enterprise or the subsector requires it, or whether there is adequate market demand for the enterprises or the subsector to utilize the type of assistance provided. In other words, supply-driven assistance is not directly linked with the requirements of the market for the product in question. Demand-linked or demand-driven assistance, on the other hand, originates because enterprises have a contract with buyers for the supply of a product, and the fulfillment of the contract requires that they utilize specific types of assistance. Examples for this kind of assistance include the following examples. When large urban enterprises buy products for their use from small-scale enterprises, either urban or rural, they often provide financial and technical assistance in the form of product design, specialized raw materials, and production technology. The subcontracting arrangements between urban large enterprises and rural small-scale enterprises also constitute an example of demand-linked or demand-driven assistance that flows between different-sized enterprises and with different expertise or specialization. These arrangements are especially popular for activities as in the case of metal fabrication and textiles in which the key components of the production process can be partitioned, and the more labor-intensive components can be contracted out to small rural firms that have relatively cheap labor costs. Subcontracting requires good rural infrastructure and communication networks, effective laws and institutions to facilitate the enforcement of contracts, and a favorable growth environment for the industrial sector in general (Hayami, 1998; Islam, 1997).

It is also possible to link promotional measures provided by the government to microenterprises with the government procurement of products and supplies. In many countries, the government procurement of goods and services constitutes a substantial portion of market demand. This is a potential market for small-scale enterprises that can provide a great stimulus, while at the same time ensuring that efficiency in production and marketing techniques is greatly improved. The traditional way of encouraging or promoting small-scale enterprises through the government procurement is to give a preferential price or to reserve a certain percentage of the total government procurement exclusively for purchases from small-scale enterprises. This policy provides a "reserved or protected market" but does not necessarily help improve the efficiency of small-scale enterprises in terms of quality, costs, or marketing methods.

However, in the demand-linked or demand-driven system of providing government assistance to microenterprises, the government procurement or the purchasing agencies need not be under any compulsion or obligation to purchase from such enterprises. The agency in charge of providing assistance or promotion should become the supplier of goods and services on behalf of the microenterprises to the government departments or purchasing agencies and guarantee the quality, price, and timely delivery of the requisite supplies. In other words, the governmental promotional agency would act as a contractor to ensure supply to the purchasing department or agencies, which are free to cancel the contract if the agency is unable to fulfill the contract, just as for any contract between private sellers and buyers.

One major obstacle to government procurement is the difficulty in dealing with a large number of small-scale suppliers and ensuring that quality is uniform and that products are delivered on time. The transaction costs of dealing with one or two large suppliers are considerably less from the viewpoint of the government bureaucracy. The intermediary role played by a different government agency charged with the task of promoting and providing assistance to the microenterprises circumvents the problem of high transaction costs incurred by the purchasing or procurement agencies. The promotional agency, in turn, deals with a large number of suppliers and ensures the fulfillment of the contract. One way of reducing transaction costs is for the promotional agency to deal with organized groups or associations of suppliers rather than with individual suppliers (Tendler and Amorin, 1996). There is a case for public subsidies to cover the transaction costs involved in entering into contract with small firms. The government could finance a special program to be run by the promotional agency to encourage the formation of associations or organizations of small firms. Furthermore, microenterprises can also pay for the services rendered; the purchasing agency of the relevant government departments can provide the usual commissions to the promotional agency for the benefit it gains from bulk purchasing and handling.

This approach accomplishes three important things. First, it links small firms to a customer who is committed to purchasing large quantities of a product. Second, by securing a contract, it brings together support and promotional agencies of the government with microenterprises, ensures that the agency provides training at the firm site rather than in classrooms, and solves problems as they are identified in the course of production. Third, this approach helps the agency to discover specific critical bottlenecks and to learn how to overcome them. The technical experts of the assistance agency concentrate on the problems brought to them by clients. If necessary, they can take the problems from the site of the enterprise to their head office or laboratory to do research and find appropriate solutions. In various

ways, the support agency can ensure the government's purchasing departments that buying from small firms is no more costly or burdensome than buying from big firms (Tendler and Amorin, 1996).

Under the supply-driven assistance program, neither the microenterprises nor the support agency of the government is subject to the tests of market demand. The support agency traditionally delivers standardized services—business advice, training, production assistance, or credit—to as large a number of firms as possible. The agency provides only generic services common to all enterprises, not client-specific services, and therefore is less effective. The success of the demand-driven approach depends on the contract or agreement with groups of firms providing identical products and on the payment being made to each producer upon the delivery and satisfactory inspection of products of the whole group. This is crucial to the reduction of transaction and monitoring costs of the government purchasing agencies. This creates the necessary peer pressure and shifts the monitoring function from the support agency to the group.

The importance of training is universally acknowledged, but its effectiveness remains little understood. The most common types of training in small- and medium-size microenterprise programs are

1. management-oriented or “business” training (in such skills as costing, accounting, bookkeeping, business plan preparation, and so on);
2. production-oriented or technical skills training; and
3. entrepreneurial development training.

Two other categories of training sometimes identified are (1) credit-oriented training, and (2) general community development or pre-entrepreneurship training. The latter targets potential entrepreneurs and focuses on more general skills such as literacy or leadership. The credit-oriented training of poor borrowers, on the other hand, in credit procedures, group discipline, and savings obligations can be considered an essential part of the “social preparation” or social intermediation component of poverty lending projects, rather than constituting a distinct training activity.

Training in business skills, unlike training in technical skills, is relevant to a large number of diverse activities so that enterprises from a variety of subsectors can be brought together conveniently to receive the training. Training in skills is important for ensuring the survival, if not growth of, existing enterprises as it is for engendering new enterprises. However, training in technical skills tends to be very activity or subsector specific, and trainers with the right specialization are usually not available. Training in technical skills is thus difficult to organize. Indeed, the only way to organize it may be

by using the subsector approach, bringing together a large number of participants from the same subsector, such as handicrafts, sericulture, poultry, and livestock. The example of the government promotional agency described previously providing job/product specific training linked to marketing is one way of providing effective training that is required by microenterprises.

Entrepreneurship development training (focusing on the motivational, attitudinal, and behavioral aspects of entrepreneurship) is prevalent in South Asian countries. In India, for example, the Entrepreneurship Development Institute (EDII) in Ahmedabad has initiated a number of programs and institutions. Every state in India has an Entrepreneurship Development Institute which is expected to reach down to microenterprises, apart from catering to the needs of larger enterprises while still recovering its costs. Proponents of entrepreneurial training do not claim that entrepreneurs can be created. However, they do believe that it is possible to develop entrepreneurship in persons who have the latent potential.

Such programs are explicitly not designed for small and traditional “livelihood” types of microenterprises. For such enterprises, pre-entrepreneurship training programs envision a “preparatory” literacy course for those who may later show interest in an entrepreneurship course. The literacy course addresses community issues relevant to their lives and provides grassroots management training to producer groups. The training material is mostly pictorial and involves simulation exercises, focusing on gender, empowerment, and enterprise management issues.

Similarly, under the Rural Industries Project (RIP) in India, started in 1993, the clients were chosen for their entrepreneurial potential rather than socioeconomic background, although 40 percent of those covered were below the poverty line and about 23 percent of the entrepreneurs were women. It attempted to provide the full package of services to its clients, including market analysis, project formulation, escort services dealing with the banks and equipment suppliers, and links with technology providers, trainers, and others. Average investment was about Rs 30,000 (about \$900) in the ratio of 7:2:1 as loan, equity, and capital subsidy. Manufacturing accounted for about two-thirds of the activities and nontrading services for one-third.

Most of the entrepreneurs already had some previous experience in the activities covered by their enterprises as apprentices and wage employees. If their enterprise failed, exit was relatively easy for them as they could go back to wage employment. About one-third of the enterprises, mostly started by relatively better-educated entrepreneurs, sought to create new markets for their products and services (such as tire carts, duck hatcheries, metal furniture, computer training, and fabric painting). The success rate of the enterprises seeking new markets/products tended to be lower (only

about one-third had succeeded), but their profitability was higher when they did succeed.

Should the recipients of noncredit assistance or services pay for such services? For livelihood enterprises run by the poor, cost recovery is difficult until they grow into bigger and more profitable enterprises. However, in microenterprises run by the nonpoor, the case for cost recovery is strong. Cost recovery, at least partial recovery, is important not only for ensuring that clients value the services provided, but it also helps to find out which services clients do value. Services for well-to-do clients should cover a higher proportion of costs than those for the poor. However, for nonfinancial services, cost-effectiveness and net social benefit may be more important in the short run than full cost recovery.