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The Impact of Credit on Small & Medium-Scale Industries (SMIs) in Sri Lanka



Tushara Williams

INSTITUTE OF POLICY STUDIES
99 St Michael's Road, Colombo 3, Sri Lanka.

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Tel: +94 1 431 368 Fax: +94 1 431 395
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T.W.

Chapter 1: Introduction

Small and Medium Scale Industries (SMIs) have been considered essential for economic development not only in less developed countries (LDCs) but also in more developed regions of the world since they are seen as being more dynamic, innovative and have higher labour absorptive capacities than their corporate counterparts.[1] The SMI sector has been the backbone of industrial development in many developed countries. For instance, SMIs have played a significant role in Japanese economic development, particularly in enhancing the mining and manufacturing industries (Economic and Social Commission for Asia and the Pacific, 1997). In Singapore, SMIs have been classified as providing 44% of total employment and have fulfilled important functions such as being the foundation for local entrepreneurship and innovation, as critical supporting industries, and as a service base for multi-national companies.

In the same vein, SMIs are increasingly becoming an important segment of the industrial sector in developing countries such as Sri Lanka. According to the 1996 Annual Survey of Industries undertaken by the Department of Census and Statistics, small firms (25 - 29 persons engaged) accounted for 46% of total firms surveyed while medium firms (30 - 199 persons engaged) accounted for 36% of total firms surveyed. The SMI sector is often quoted to account for 65% of industrial employment in Sri Lanka. However, this figure is an over estimation and according to the 1996 Annual Survey of Industries small firms accounted for 3% of total employment and medium firms accounted for 17% of total employment. In terms of value of output small and medium firms accounted for 1% and 19% respectively.

In Sri Lanka, SMIs are considered important primarily for the following reasons. Successive governments have viewed them as a vehicle for broad based industrialization and employment growth. In the present Government's industrial policy, facilitating the expansion of the SMI sector is considered a central element in achieving the overall objectives of expanding the country's existing industrial base, efficiently managing the country's physical and manpower resources, generating jobs and income in both rural and urban areas and export orientation.

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[1] What exactly is a small or medium enterprise (SMI)? There are no universally accepted definitions of SMIs. The most common criteria used is based on the level of capital investment and/or levels of employment in specific industrial establishments. For the purposes of credit allocation under the SMI credit programme for instance, the National Development Bank (and the financial network through which it operates) subsumes small industry under the mixed category of small and medium industries and uses its own cut-off point. In the last credit scheme to be implemented the firm's total investment in fixed assets could not exceed Rs.16 million (excluding land and building). (World Bank, 1997: 90) In empirical work the most commonly used measure of enterprise size refers to the number of workers. Hence, in the World Bank Evaluation of 1997 a small enterprise was one that had 1 - 49 workers; a medium enterprise that had 50 - 99 and a large one more than 100 workers. (World Bank, 1997: 94). This study adopts the World Bank definition of SMIs.

SMIs make a substantial contribution towards employment generation by providing employment opportunities for comparatively low-skilled labour. SMI development also addresses the country's unemployment problem on a cost-effective basis since small and medium firms generally create jobs at a substantially lower investment cost per job than larger industries.[2]

It is believed that small industry holds the greatest potential for rural industrialization in the short-term because it is assumed, perhaps questionably, that smaller industries demand less in terms of infrastructural and other support facilities than large industries, and will therefore be better equipped to set up production in rural areas. SMIs informally absorb excess labour in predominantly agricultural areas especially in the rural sector. At the same time they also absorb school-leavers and unskilled/semi-skilled persons in the urban sector.

SMIs are promoted not only because of their role in the economic advancement of a country but also because of its role in social development. They are considered useful to reduce poverty, not only through employment generation, but also because they use primarily local resources, so creating backward linkages with other small industries, and manufacture products that cater to mainly poor markets. Supporting small-scale entrepreneurs also addresses gender issues since many of these entrepreneurs are women who generally tend to be at a greater disadvantage than men since their major areas of economic activity such as hand-looms, pottery or coir are more vulnerable to new market pressures. Hence, the rationale behind fostering the development of such enterprises is that it would not only contribute to the growth of the national economy but would also increase the welfare of the population through a more equitable distribution of income than generally results from an undifferentiating industrial strategy.

Making credit more accessible to small and medium entrepreneurs is widely regarded as the most appropriate instrument through which to encourage this sector, as lack of access to credit is recognized as one of the most pressing problems faced by the small-scale industrialist. Traditional financial institutions are usually unwilling to lend to small industrialists because on the one hand, they lack adequate collateral, and on the other the small loans required by the sector involve high transaction costs. Providing credit is regarded as an appropriate policy tool on the basis that greater access to credit would enable entrepreneurs to upgrade their technology and expand and cater to a larger, wealthier market, and so move out of the low returns trap that most small industries find themselves in.

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[2] In 1983, the investment per employee was Rs. 9,900 in small industry, Rs. 34,800 for medium industry and Rs. 66,700 for large industry. (Bandaranaike, 1990: 52).

Thus, Post-Independence governments in Sri Lanka have frequently provided small and medium-scale industrialists with relatively cheap lines of credit.[3] During the period 1979-96, Rs. 12,036 million was granted to 16,642 enterprises under different SMI loan schemes (CBSL 1998:124). In Sri Lanka, definite and concerted efforts to provide institutional finance for small enterprises began in the late 70s. This was in tune with the industrial policy after 1970 which promoted labour-intensive small-scale enterprises. Initially, industrial financing was operated under a credit line called the Small Scale Industries Credit Scheme (SSI). The operations under this scheme commenced in 1978. Loans were granted for small industrialists through the People's Bank and Bank of Ceylon in collaboration with the Industrial Development Board (IDB). It was operated with no refinance facilities available to the commercial banks. However, these lendings were covered by a guarantee scheme established by the Central Bank on behalf of the government for loans disbursed by the credit institutions on the recommendation of the IDB. This scheme ceased its operations in 1981 with the commencement of the World Bank and ADB sponsored SMI loan scheme.

In effect, the SSI scheme was replaced by the SMI scheme. The World Bank/Asian Development Bank sponsored SMI lending scheme became operational in Sri Lanka in 1979. To date, Sri Lanka has obtained credit under four successive lines of credit - SMI I to IV. The number of loans under each scheme and the value of each line of credit is given in Table 1.

Table 1: Loan Approvals Under SMI Schemes

	SMI I	SMI II	SMI III	SMI IV	Total
Period	1979-81	1982-87	1988-91	1992-95	1979-95
No. of loans	1,741	2,491	2,439	9,065	15,736
Facility (Rs.mn)	229	1,059	1,114	5,323	7,725
Facility (US$'000)	12,729	36,467	28,593	106,695	184,484

Source: National Development Bank.

Under these loan schemes, the Central Bank took the exchange rate risk and the National Development Bank (NDB) acted as the apex lender, channelling funds through the commercial banking network in the country. (See Annex 1 for detailed descriptions of individual loan schemes).

[3] One should note that in general there are many policy instruments used to promote the SMI sector although this study only examined the effects of low-cost industrial credit on the SMI sector. These fall into two distinct categories: measures related to control, registration and supervision which flow directly from the administrative and regulatory function of government; and promotional measures directed towards entrepreneurial development, provision of cheap finance, technological support and product marketing and input procurement assistance.

This study looks at the impact these loan schemes have had on the SMI sector. It addresses issues such as how effective they have been in terms of achieving their overall objectives and what have been their shortcomings. The general objective of this study is to bring to light some of the pressing problems of financing SMIs in order to improve credit programmes in the future.

Although this study limits itself to examining the above 4 lines of credit, there have been other loan schemes that have been implemented since the end of SMI IV. (See Annex for breakdown on all loan schemes that have been implemented in Sri Lanka). The most recent have been the Small and Medium Enterprise Assistance Project (SMAP) and the Small and Micro Industries Leader & Entrepreneur Promotion Project (SMILE). Under these schemes the NDB too became a participating credit institution (PCI) through a special unit at its head office as well as through its own branch network. Along with the Development Finance Corporation (DFCC) and the Hatton National Bank (HNB), it has now overtaken the Bank of Ceylon and the People's Bank which were the front runners previously.

Finally, prior to deliberating the issue of financing SMIs, it is important in terms of a policy discussion to clarify the exact role of a strategy to develop SMIs. The view taken in this study is that SMIs should never be considered a social programme or a charity business. One has to differentiate between the specific objectives of various SMI programmes if one is to form a coherent policy framework. Generally, poverty alleviation and business growth are the twin goals that are embodied in programmes designed to support this sector. However, a fundamental problem occurs when policy makers mistakenly lump both these two very different types of support services together because of their apparent rather than actual shared purpose. It is not possible to address poverty issues of marginalised groups in rural areas and at the same time encourage the growth of efficient viable enterprises within a freemarket framework since poverty alleviation and business growth projects target different entrepreneurs, focus on different development objectives and should use different conceptual frameworks for assessing their divergent impacts. With that in mind, one has to acknowledge SMI programmes such as the *SASANA* and *Surathura* loan schemes which are associated with self-employment projects and the development of micro-enterprises for what they are - poverty alleviation projects. At the same time one has to assess the impact of programmes such as SMI I - IV in terms of its own objectives. In the latter scheme, policy towards SMIs are always based on the assumption that they are going to be financially viable undertakings that will operate in a competitive environment. Accordingly, then, the position taken in this study is that SMI programmes should be centred around equalising business opportunities faced by firms - whether large or small, urban or rural.

This encompasses a more neutral incentive structure where the industrial sector as a whole would be resuscitated and then only those small-scale industries which have a genuine comparative advantage would survive (Osmani 1987).

This paper first sets out to assess the impact of SMI loans in terms of the general objectives of these loan schemes (Chapter 2). It is contended that these loans did have a positive impact on the SMI sector but that they have not been used to their full potential or achieved all their objectives. It is also observed that despite the increased availability of credit facilities, small enterprises still find it difficult to expand. Having concluded this, the paper goes on to examine what the shortcomings are of programmes designed to finance SMIs and also what the constraints to expansion are (Chapters 3 and 4). The concluding section suggests that policy should be geared towards rectifying these shortcomings (Chapter 5).

1.1. Research Methodology

The findings of this paper are based primarily on a survey of published and unpublished literature on the subject. In addition, ten case studies were conducted, the results of which largely complement findings of the literature reviewed. The case studies were chosen from beneficiaries of SMI III and IV[4]. A number of compromises had to be made regarding research interviews due to time constraints. First, the sample size was small and the measures were often qualitative. Thus, the data do not lend themselves to rigorous tests of hypotheses. Second, the interviews were conducted only in Colombo and its environs, so the results may not apply to smaller towns or to rural areas.

We also identified problems and constraints to the establishment of new enterprises and expansion of existing enterprises, and the shortcomings and deficiencies of the relevant public sector service institutions, through structured interviews with senior staff members of private and public sector financial institutions providing services for enterprise development.

[4] Loans granted under SMI I & II have now been fully settled. What is now left to be settled by the borrowers are the loans granted under SMI IV and about 25% of the loans granted under SMI III.

Chapter 2: The Impact of SMI Loans

Have the World Bank and ADB sponsored SMI loan schemes met their objectives? Has the Sri Lankan Government met its objectives in terms of promoting the growth of SMIs? To begin with, it would be useful to elaborate on what exactly these objectives were. The Bank's SMI strategy had several objectives. Overall, it sought to correct imperfections in the financial markets which hitherto serviced a centrally-planned industrial economy structured to favour large enterprises, and restructure it into one that responded to the demands placed on it by all entrepreneurs. It sought to generate jobs at a relatively low cost per unit of capital invested in a country where unemployment was a pressing issue. The SMI credits also hoped to make credit available to those who would not normally have access to credit. Finally, besides providing resources to support the SMI sector at the firm level, the credits also intended to engage the Government of Sri Lanka in a dialogue on how to reform the impediments that prevented the spontaneous development of this sector.

On the whole, the objectives of Government in developing this sector have been to contribute significantly to an employment oriented and regionally more balanced pattern of industrialisation. SMI development is seen as key to promoting regional industrialisation. In addition to bringing economic development to the rural economy, it is expected that regional industrialisation will contribute significantly to reduce congestion in city centres. In order to ensure the availability of finances to small and medium-scale industrialists Government was also supposed to embark on a macro-economic adjustment programme by containing the budget deficit, inflation, reducing intermediation costs of banks and opening special units for loan facilities in the existing commercial banks. In addition to providing credit facilities to SMIs, the Government's role has also been to develop infrastructure in both rural and urban areas to encourage private sector investment in these areas.

How have these objectives been met? Has employment increased? Have SMI loans enabled existing firms to expand and hire more workers? Have more people in rural areas been able to access credit? Are industrial opportunities in rural areas advancing? Has there been a poverty impact? This chapter will address these issues. [5]

[5] A detailed discussion on the performance of financial institutions and loan schemes appears in Chapter 3.

2.1 Impact on Employment

SMI loans have had a positive impact on employment generation. A survey done by the World Bank in 1997 reveals that on the whole SMI support produced more employment and increased firm labour intensity (World Bank 1997:16).

Table 2.1: SMI Scheme Employment Generation as at March 27, 1998

SMI I	17,526
SMI II	25,060
SMI III	36,379
SMI IV	59,020
Total	137,985

Source: NDB.

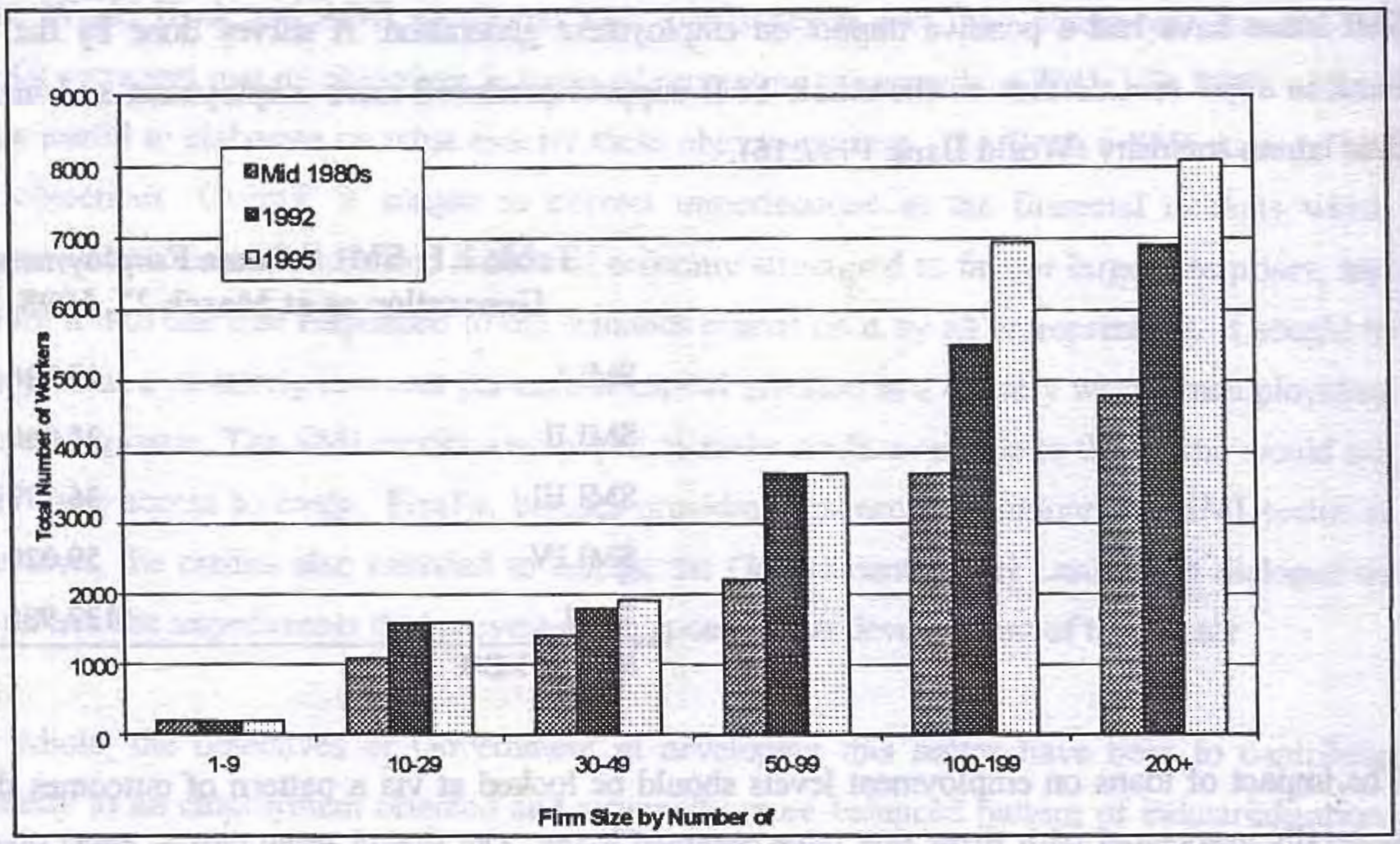
The impact of loans on employment levels should be looked at via a pattern of outcomes that are generally associated with firms that have obtained loans. The World Bank survey finds that firms were able to hire more workers because of an increase in output growth and labour use. Once loan recipients' sales grew, they altered their capital labour ratios in fundamental ways (World Bank 1997:48). SMI loans often led to the production of better quality goods. Loans enabled firms to purchase necessary equipment and tools. Beneficiaries would invariably use loan funds to purchase more sophisticated machinery and equipment or to buy better vehicles for transportation purposes. All this improved the production capacity of the firm on a sustainable basis. Superior-quality goods led to increased sales and therefore increased output growth. This in turn led to higher levels of employment.

Loan assistance has also enabled beneficiaries to undertake improvements and repairs to their worksheds, factories, stores and offices. Nine out of the ten case studies reviewed for the purposes of this report, show that loan assistance was one of the reasons for them being able to expand, improve or change their existing office premises. Such improvements also enabled firms to accommodate more workers as they expanded their operations.

Which SMIs generated the most amount of employment? Within the SMI sector, the larger SMIs seem to hire more workers than the smaller firms do, and hired them faster.[6]

[6] Within the SMI sector small SMIs are those that have upto 10 employees, medium up to 100, and large SMIs more than 100 (World Bank 1997:47).

Figure 2.1 Employment by Firm Size - Sri Lankan Manufacturing, mid 1980s-1995



Source: Econsult.

Figure 2.1 shows that employment among larger SMI firms almost doubled between the late 1980s and 1995, and the average beneficiary expanded employment by 22 to 56 employees. The World Bank Survey also found that larger SMIs employed more than twice the number of casual workers than small SMIs did, and paid them 12 percent more than the smaller firms (World Bank 1997: 54).[7]

It was also determined that larger SMIs hired more women than the small firms did. For instance, women represent less than a fifth of administrative workers in small firms whereas they account for more than half of the administrative workforce in larger firms (World Bank 1997:54).

On the whole, however, it was discovered that many of the jobs created do not last very long because not all SMIs develop and expand. It was found that within 8 years of receiving a loan only 60% of the beneficiaries still exist (World Bank 1997:53). Yet, this result is consistent with the

[7] The ten case studies conducted for this report also re-inforced the notion that larger firms have a greater labour absorption capacity. For instance, *Tharanganee Garments Ltd* which started out with 75 employees in 1984 now has 750 employees. At the same time, *Nuzla Creations* which started with 5 employees in 1989 still has the same number of employees.

general failure rate for SMIs in both developed and developing countries. Exit rates themselves are not a cause for concern. They reflect the "turnover" rate of an industry, and high levels can be very healthy as long as the corresponding entry rates are higher than the exit rates (World Bank 1997:53). Unfortunately, such exit-entry comparisons are not within the scope of this paper.

In terms of the type of jobs that were created, they were mostly low-skilled jobs in industries such as garments and textiles, chemical, rubber and plastic products, food processing, printing and packaging, manufacturing construction material, wood products, commercial transport and agricultural activities. Except for the growth in employment in the garment industry, most SMI employment in general has not been in the high-tech and export-oriented industries (World Bank 1997: 52).

The creation of low-skilled jobs directly addresses poverty issues since this type of employment is filled by lower-income groups. However, concern has been displayed about the types of jobs created. Yet, even though most of the jobs created are low-skilled, the training received for different jobs has helped workers to build on existing skills and acquire new ones. For instance, from our ten case studies, *Lanka Printing and Packaging* hires mostly unskilled workers who, with training, graduate to the category of semi-skilled or skilled. This enterprise now uses computerized machinery and equipment for printing purposes and workers are thus trained to operate the new equipment.

2.2 Impact on Earnings

Successful small and medium industrialists have enjoyed sizable earnings improvements due to the assistance offered under SMI loan schemes. However, increases in earnings are not necessarily directly associated with credit. Increases in sales are partially attributable to loans in terms of the latter's impact on productivity. The rest depends on the actual demand for the product and the product's marketability. Hence, changes in earnings levels are particularly significant in those industries that saw a notable difference in their volume of sales over the years.

The World Bank survey found that SMI support resulted in beneficiary firms hiring production workers who earned 22% less than workers from non-beneficiary firms. Still, the average value added per worker of beneficiaries was almost 20% more than that of non-beneficiaries. The survey also found that larger SMIs paid their casual workers 12 per cent more than the smaller SMIs did

and that they paid their female administrative workers 70 per cent more than smaller SMIs (World Bank 1997:54).

The ten case studies also show that workers' salaries increased proportionately more in larger SMIs than in the smaller SMIs. For example, in the export-oriented garment factory (*Tharanganee Garments*) skilled and unskilled workers salaries changed significantly over the years whereas the apparel industry that was conducted on a small-scale from a house (*Nuzla Apparels*) showed a real earnings decline for its workers over a period of 10 years.

With respect to earnings it is appropriate to note that many SMI owners (especially the smaller ones) depend on other sources of income, (primarily other jobs) to fully sustain themselves. Hence, some of these industries are characterized by "part-time entrepreneurship" (Lakshman et al, 1991:24). This is often a result of risk-aversion and the financial weakness of industries.

2.3 Regional Development: Where was most of the employment created?

It appears that SMI support had more of an impact in urban areas, because to begin with, that is where most of the credit was concentrated. Most of the loans went to enterprises that were located in the Western and North Western provinces. Between 50 and 60 per cent of total credit has gone to the Western Province (World Bank 1997: 61). In terms of other provinces, urban centres have once again been favoured over rural areas. Gampaha, Kalutara, Kurunegala, Puttalam, Ratnapura, Kandy and Matara have had an advantage over other cities in the suburbs. The Southern districts have received less than the expected amount of project financing, while the Northern and Eastern provinces have been almost completely left out. The Northern and Eastern provinces have not benefited from the loan schemes primarily because of the on-going ethnic conflict.

SMI loans have had a limited impact on rural industrialization and employment. This is an outcome of the fact that in Sri Lanka, most industrial activity is concentrated in the Western Province where almost 80% of all the industrial value added of the country is produced. Factors contributing to this development are partly historical and partly derived from urbanization coupled with infrastructure development. Market potential, diffusion of technology, availability of skills and the wide exposure of entrepreneurs are some of the reasons for the high absorption rates in urban areas (National Development Bank 1998:9). The other reason for the limited impact of SMI credits in rural areas is that very little of the credit went to the rural economy.

Table 2.1.2: SMI Scheme (I - IV) Geographical Distribution as at March 27, 1998

District	Total		
	No. of Loans	% of No. of Loans	% of Value of Loans
Ampara	34	0.3	0.1
Anuradhapura	676	4.3	2.5
Badulla	449	2.9	1.7
Batticaloa	30	0.2	0.1
Colombo	3648	23.5	33.9
Galle	903	5.8	5.9
Gampaha	1871	12.1	14.2
Hambantota	310	2	1.4
Jaffna	60	0.4	0.2
Kalutara	610	3.9	4.9
Kandy	1123	7.3	4.4
Kegalle	404	2.6	1.8
Killinochchi	-	-	-
Kurunegala	1830	11.8	7
Matara	946	6.1	5.7
Mannar	6	-	-
Matale	363	2.3	1.5
Moneragala	108	0.7	0.5
Mullativu	3	-	-
Nuwara Eliya	230	1.5	1.4
Polonnaruwa	394	2.5	2
Puttlam	990	6.4	7.2
Ratnapura	439	2.8	3.2
Trincomalee	74	0.5	0.4
Vavunia	10	0.1	-
TOTAL	**15511**	**100.0**	**100.0**

Source: NDB.

2.4 Impact on Women

In terms of the credit schemes' overall objectives of extending loan facilities to individuals who are generally excluded from such practices, its impact appears to be limited. For example, women have benefited from support to SMIs in terms of increased employment opportunities. However, women are underrepresented in terms of the number of female entrepreneurs who have obtained loans. Self-employed Sri Lankan women represent 18 percent of all self-employed according to the 1993 Labour Force Survey, but only 1 percent of the NDB beneficiaries in the World Bank sample (World Bank 1997:54). Loan recipients still seem to be predominantly men.

2.5 Conclusions

The foregoing discussion on the impact of SMI loans on small and medium industries in Sri Lanka can now be summarized as follows:

What was achieved in terms of the loan schemes' overall objectives?

- SMI support did have a positive impact on employment generation with larger SMIs having a greater labour absorption capacity;
- most of the jobs created were low-skilled thereby addressing poverty and improving income distribution given that unskilled workers are invariably drawn from the lower income groups;
- earnings increased although significant changes were visible mostly in large SMIs;

What were the shortfalls?

- despite increased access to finance, small SMIs do not last very long while medium and large ones do;
- most of the firms that benefited were in urban areas and thus the intended geographical dispersion failed to take place; and
- Women are underrepresented in terms of the number of female entrepreneurs who have obtained loans.

It appears that the overall objectives of financing SMIs have been met partially. SMIs have generated jobs but its growth in rural areas has been limited. Typically small firms still find it difficult to obtain credit facilities despite the increased availability of SMI financing. Furthermore, many of the small firms do not seem to expand easily thus limiting the impact of SMIs since, as has been found, it is the medium-large SMIs that have a greater impact. In terms of the numbers that graduated from small to medium or large, the World Bank survey found that 18% of their beneficiary firms grew to employ between 30 and 49 workers and 2% employed more than 50 workers (World Bank 1997:55). What is preventing these firms from expanding in spite of the fact that they do have increased access to formal financing mechanisms? Is the answer to be found in the design and implementation of the loan programmes? Have the participating credit institutions fulfilled their role as lender? Why are financial institutions still reluctant to lend to SMIs? The next chapter will examine these issues.

Chapter 3: Financial Institutions & their Role in Promoting SMIs

"In Sri Lanka... banking is essentially an exercise that is confined to a building. It is also largely identified with deposit banking rather than credit banking. The basic functions of the vast majority of the branches of the state banks in the rural areas, are concerned with mobilizing funds in these areas and centralising them for the use of medium and large scale businesses located in metropolitan areas." H.N.S. Karunatilake (National Development Bank, 1989:xiv).

The one variable that is common to projects with high repayment rates is competent banking. Often, the chief determinants of the financial viability of credit programmes is the retail banks' ability, commitment and in some cases freedom to select viable sub-projects, disburse funds efficiently, and supervise projects at the levels needed. With regard to the provision of efficient financial services, issues that have tended to be overlooked have been the support services needed to develop and sustain the effectiveness of this sector, including assistance in formulating and developing projects, technology upgrading, marketing as well as ensuring operating efficiency and profitability.

Have the loan schemes' objectives been met in terms of the disbursement of funds and financial sector reform? Have financial institutions accomplished their mission in promoting SMIs? How effective and sustainable are the SMI loan schemes themselves in terms of fostering the growth of the small and medium scale industrial sector? This chapter will address these issues.

3.1 Disbursement of Funds

The distribution of loans between urban and rural sectors and between smaller and larger SMIs continues to be sub-optimal. SMI loan schemes have not been of assistance, as expected, to typically small enterprises in rural areas. Credit funds still mainly finance enterprises in selected industries in a few urban areas and the Western Province is still the prime beneficiary of loan funds. Under SMI III about 50% of sub-projects were concentrated in the Colombo and Gampaha Districts. The Southern Districts received only about 15% of the project financing, despite SMI III's emphasis on employment generation in the South (World Bank 1994: II). Commercial bank branches in the South are located in the urban centres and tend to concentrate on the relatively larger projects generated in these areas. However, the level of entrepreneurship in these areas is best suited to undertake smaller projects which the Banks are reluctant to finance.

Table 3.1: Refinance Approvals by Geographical Distribution

	No.	Rs mn	%
Ampara	30	12.22	0.5
Anuradhapura	189	97.12	4.1
Badulla	59	40.44	1.7
Batticoloa	10	7.03	0.3
Colombo	508	673.37	28.1
Galle	131	102.73	4.3
Gampaha	344	261.39	10.9
Hambantota	168	57.15	2.4
Kalutara	149	148.43	6.2
Kandy	206	109.07	4.6
Kegalle	84	46.23	1.9
Kurunegala	313	213.66	8.9
Matara	221	192.94	8.1
Matale	60	36.58	1.5
Monaragala	31	12.81	0.5
Nuwara Eliya	42	31.11	1.3
Polonnaruwa	56	37.06	1.5
Puttalam	159	150.21	6.3
Ratnapura	154	142.30	5.9
Trincomalee	19	14.31	0.6
Vavuniya	17	7.72	0.3
	2,950	2,393.88	100.0

Source: NDB.

Another criticism of the SMI loan schemes centres around eligibility criteria. The eligibility criterion was gradually revised upwards from SMI I to IV. Initially, an eligible SMI was defined as one whose fixed assets did not exceed Rs. 2 million. However, by the time of SMI IV it was Rs. 16 million. Thus, the observation is that the SMI programme turned into a vehicle for helping mostly the medium-large scale industries.[8] Still, it should be noted that the NDB revised the criterion with the approval of the World Bank and the ADB. The NDB claims that these revisions were made to account for inflation and the depreciation of the rupee over the years. However, Osmani finds that raising the eligibility criteria was much more than was warranted to allow for inflation (Osmani 1987:193).

On the matter of access to finance, SMIs are still subject to higher margin requirements and other discriminatory handicaps by the commercial banks despite the refinance and credit guarantee schemes. SMIs still face high real borrowing costs of 8 - 10% and are rationed out of access to short-term credit. In terms of guarantee funds, the time and expense involved, first in legal

[8] The most recent SMAP and SMILE loan schemes implemented by the NDB have revised their eligibility criteria and offer lower interest rates but one should be aware of the above shortcomings for future considerations.

procedures and then in government formalities, for a large number of claims, each for a very small sum of money, restricts the commercial viability of the guarantee fund. Thus, financial institutions continue to insist on guarantees, and it is almost impossible for a person without assets to borrow a decent sum of money.

One of the reasons for funds being disbursed to larger firms in urban areas has to do with the fact that the SMI performance of a PCI is judged on refinance reimbursement amounts without attaching much significance to the number of projects financed. Consequently, this almost compels the PCIs to concentrate on large projects with high loan components. If, on the other hand, performance was also judged on the number of new projects financed, PCI efforts would eventually shift to finance smaller projects in rural areas.

When examining the pattern of the disbursement of funds, the issue of size comes up as being a critical determinant of financing SMIs. All lenders believe that credit risks are associated with size: the larger the enterprise the smaller the credit risk. This simplistic logic crowds out SMIs from the mainstream of the formal private sector financial institutions. Rather, private lenders must be convinced that credit risks are associated primarily with management rather than the size of the enterprise.

In terms of the outreach of financial institutions, private banks have not reached as many clients as the two State banks have.[9] In contrast to private sector financial institutions, the state-owned banks have aggressively sought out borrowers who do not ordinarily have access to formal credit in rural areas. But their operations seem mainly supply-driven, and in some cases, even politically driven. Many of them have been granted to firms that are known to have limited market potential such as handicraft industries. Loans have been granted on the basis of two personal guarantors, resulting in an average default rate of about 15 per cent. As the premium collections were grossly inadequate to meet the guarantee claims and the Central Bank could not provide the additional funds required, the two State banks had to carry the bad loans in their loan portfolios.

A further problem on the issue of disbursing funds in rural areas is that Regional Rural Development Banks (RRDBs)[10] were not included as PCIs. RRDBs were established since 1985

[9] See Annex I, Table 4 for specific breakdown of bank disbursements in SMI I - IV.

[10] In concept and design the RRDBs were planned to meet the requirements of the disadvantaged groups in the rural population. It was felt that with its area of operation restricted to a district, it may be better able to cope with requirements that are unique to a particular district.

and now consist of 80 branch networks in 11 districts. Including RRDBs will enable one to siphon-off more credit to small-scale industries as this banking network services mainly the relatively poor in rural areas.

Is easy access to affordable credit the answer? When credit is provided without the backing of careful feasibility studies it leads to the congestion of the small sector and further shrinkage of already small market shares. Therefore, credit facilities must be linked with facilities for project evaluation.

3.2 Project Monitoring

The commercial banks, especially the State banks do not seem to have equalled themselves to the task of ensuring that monies are productively utilized. Banks seem to focus more on disbursing increasing amounts of funds at concessional interest rates. The problem of weak loan management, with inadequate monitoring of the loans themselves is compounded by the perennial weaknesses of inadequate project identification, formulation, appraisal and supervision procedures on the part of the financial institutions. Financial institutions need to improve their skills in loan disbursements and project evaluation.

A frequent criticism of the NDB is that it lacks an in-built mechanism in its monitoring system to collect ex-post data on the financed sub-projects with regard to their financial and economic benefits. While NDB's data base on the credit component includes basic information (commitment, disbursement, geographical/sectoral distribution of sub-loans) on the financed sub-projects, it lacks data on SMI sub-projects with respect to output and profitability and does not have the capacity for a systematic follow up and monitoring of financed sub-projects. However, NDB claims that they do not have this information because the banks do not submit monthly or quarterly reports on sub-project performance. Banks in turn claim that doing this entailed too much paper work and was onerous. In terms of project monitoring at the bank level it has been found that bank managers themselves have no rigorous training or experience in project identification, formulation, appraisal, supervision or monitoring procedures.

Hence, to improve the general efficiency of the credit schemes it is essential to improve the quality of the personnel administering the loan scheme, provide incentives for the officers to follow up disbursed funds, enforce creditworthiness criteria, and give assistance to loan recipients in the form of extension services and financial advice (Sanderatne, 1988).

3.3 Sustainability Issues

The sustainability of specific SMI loan schemes remains a pressing issue. Can commercial banks continue lending to SMIs without the support of multilateral agencies? Thus far, the bulk of SMI lending has come from targeted, World Bank supported SMI loans, and analysts agree that once the refinancing support is withdrawn, the private banks may not on their own meet the needs of the SMI sector. This would be particularly the case in a credit market characterised by the absence of long-term private investment funding. Thus, the volume of SMI financing is likely to decline without the availability of multilateral funds that are the major source of long-term financing in Sri Lanka. The implications of this become even more serious given that the amount and duration of the loan are also key factors that determine the extent to which the loan scheme is successful in assisting small and medium enterprises. Therefore, the sustainability of SMI lending in the long-term, depends on the success of the Government in its financial sector reform programme. Unless the commercial banks are able to utilise domestically funded term savings to lend to businesses, their term lending for the SMI sector is likely to decline. The larger the loan size, and the longer the duration of the loan, then the better the firm is able to upgrade its technology, expand and cater to a larger market.

3.4 Overall Conclusions

The foregoing discussion shows that financing SMIs should be more than doling out money to creditworthy borrowers. It should be a holistic operation between borrower and lender where both parties benefit and maximize their returns. This is the crux of the change in the approach to banking that is required. There is also a definite need for policy makers to figure out how financial mechanisms can be metamorphosed into development mechanisms. One should reflect on the fact that although there is no shortage of credit to small and medium scale industries, many entrepreneurs still choose not to obtain credit. In fact a significant part of the SMI IV loan was not used. Why are funds underutilised? Is easy access to credit simply the answer to the growth of SMIs? Chapter 4 will address these issues.

Chapter 4: Problems Faced by Small and Medium Scale Industries

The overall conclusion from Chapter 3 is that programmes to finance SMIs have to be further fine-tuned in order for small-scale entrepreneurs and lending organisations to maximize returns on their investments. This chapter looks at the obstacles to SMI development from the perspective of the small-scale entrepreneur. Part I of the chapter addresses the financial constraints they face. Questions such as why small-scale industrialists are reluctant to obtain credit from formal financial sources are addressed.

Part II of the chapter looks beyond the operation of SMI loan schemes and briefly examines several other binding constraints that inhibit the growth of the SMI sector. Business constraints such as taxation and labour regulations policy, poor infrastructural services and output marketing are looked at.

Part I : Financial Constraints

4.1 Capital and Finance

4.1.1 High Interest Rates

Lakshman et al. (1994b:133) find that industrialists in Sri Lanka, big and small alike, find high interest rates to be a serious problem affecting their financial performance, international competitiveness and further growth. Lakshman et al. (1994b:131) find that there is a vicious cycle linking this constraint with the performance and progress of the SMI sector. High interest rates are argued to be a factor behind the heavy dependence among small-scale industrialists on own funds for firm operations. The more an industry depends on own funds, the less adequate are the investible resources likely to be available for expansion. Yet, despite the shortage of own funds for further investment and expansion, industrialists are not keen on obtaining loans because they find loan repayment a burden. Thus, the limitation of funds becomes a constraint to setting up an efficient and competitive production facility.

However, though previously many credit schemes targeted at the SMI sector tended to rely on subsidized interest rates to make credit more accessible, it is now internationally recognised that the price of credit should reflect the costs and risks of lending. A market rate of interest would also ensure that the loans are taken on the basis of prospective returns rather than to capture subsidies. Debtors tend to view loans with subsidized interest rates as grants rather than loans and become

delinquent in repayment. Moreover, subsidized interest rates give incorrect signals to the PCIs, eroding their financial discipline, their appraisal capacities and credit supervision practices in general. Finally, low interest rates depress the profit margins available to firms, so reducing the resources available for them to improve staffing, supervise loans and provide other facilities.

At the same time one should note that although commercial banks are reluctant to offer loans at lower interest rates, experience shows that the environment already exists for loans at lower interest rates. Some SMIs have been able to obtain loans at a rate of around 13% (Institute of Policy Studies 1997: 3). The following points should be kept in mind regarding the reasons banks charge high interest rates:

a) the banks pass the full burden of the Turnover Tax and National Security Levy to the borrowers; (the banks do this because they claim that they are operating with very thin margins in a competitive environment);

b) in comparison to other countries the margin between lending and borrowing is quite high in Sri Lanka - 6 to 10%[11]. The spread between deposit and lending rates of commercial banks is high largely because of the high administrative costs of the state-owned commercial banks. In view of their large share of the market (60%) other commercial banks tend to follow their lead in lending rates i.e. there is inadequate competition to reduce spreads and interest rates (Budget Speech 1997);

c) banks also claim that their cost of operations are high because of high loan defaults and yet, most of these defaulters are not necessarily from the SMI sector;

d) large entrepreneurs are able to borrow at a lower rate (12 -13 per cent) because they are in a stronger position to establish a good rapport with the banks.

In addition to implementing financial sector reforms that reduce the spread between borrowing and lending rates, it is also imperative that one addresses two major factors that are responsible for high interest rates if one is to consider lowering them. The two factors are the high inflation rate and the extensive borrowing operations of the Central Government. Hence, interest rates cannot be lowered without controlling the budget deficit and government borrowing.

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[11] In a financial system where banks intermediate between savers and investors loans are made for the purpose of earning the lender a positive spread between his borrowing rate (the rate that he must pay depositors) and his lending rate. This spread must pay the costs of making the loan, the commercial risk attending the loan, and some profit for the owners of the institution. Thus, commercial risk and lending costs are two factors that may make lending to SMIs relatively unattractive.

Part II : Non-Financial Constraints

At this point it is apparent that merely removing impediments in financial services alone is not going to enhance the growth of the SMI sector. The inter-connectedness of the economic system is such that what happens in terms of expansion at the level of the firm is a function of the economic climate within which one operates. For instance, it is the macro and meso policy environment that helps determine the prices small scale industrialists get for their products, the cost of the factors they use, the availability of alternative technologies and their knowledge of these alternatives and the availability of infrastructure. The rest of this chapter will go on to look at some of the non-financial constraints[12] that SMIs face with regard to expansion. The ensuing discussion is only a brief outline of such constraints and is provided to make the reader aware of the non-financial dimensions of the SMI sector. The constraints can be classified as follows:

Constraint	Type
Operational Constraints	Entrepreneurial problems
	Low technology
	Poor Infrastructure
	Weak Institutional Support
	Information and Transaction Costs
	Exogenous Constraints
Regulatory Constraints	Taxes
	Labour Regulations
Cost Constraints	Cost of materials (input costs)

4.2 Operational Constraints

4.2.1 Entrepreneurial Problems

The lack of entrepreneurial and management skills is one of the most crucial impediments to the further expansion of SMIs. Popular perception sees small firms as carrying innate qualities such as competitiveness and innovativeness. They are also viewed as showing more drive and better providing a needed element of flexibility. However, the attitudes of Sri Lankan entrepreneurs should be taken into account when formulating policy regarding SMIs. Lakshman et al. (1994b:157) found that the long-run aspirations of such entrepreneurs are not always centred around further development. Most entrepreneurs interviewed for this study were also content to

[12] The literature on SMI development cites numerous constraints to expansion. However, this study will submit only what is considered the most pressing constraints to SMI development.

remain small and earn enough to get by. They were not interested in product diversification or in developing new, more versatile marketing strategies.

The majority of small entrepreneurs are happy to continue production according to traditional methods instead of adopting new, technologically more advanced methods that would help them to improve and upgrade the quality of their products. For example, bakeries, cigar manufacturers and confectioneries[13] continue to engage in these activities using traditional methods of production. Many entrepreneurs are averse to learning new skills and claimed that this could be left to the next generation. This gives rise to the notion that not all individuals have an innate entrepreneurial talent.

The lack of management and entrepreneurial skills is often one of the reasons why small-scale industrialists face marketing problems. Small-scale, traditional, household enterprises are especially hit by the cheaper, more attractive products that are now available in the market. Items such as wood products, and metal work for instance, face stiff competition from large scale manufacturers. However, it is rarely that these small scale industrialists seek to develop wider marketing networks and expand their businesses. They are unable to figure out how they can market their products better and lack information on market conditions. From our 10 case studies, for instance, 90% of the entrepreneurs felt that the solution to their problem would be to eliminate the free flow of imports into the country.

There is also the issue of local entrepreneurs being highly risk-averse. This is naturally more prevalent with the poorer small-scale industrialists. They prefer to play it safe and be assured of some form of income rather than diversify and face the consequences of a huge loss.

The firms also have a weak institutional base due to the lack of proper accounting, management and marketing skills. Aturupane et al. (1996:20) found in their survey that hardly any of the entrepreneurs followed such practices as keeping accounts, recording input usage and production levels, book keeping and tracking product prices. Most SMIs do not employ qualified accountants to keep company accounts. The explanation given is that in addition to it being an added cost, they are small and so do not require the assistance of an accountant. However, this proves to be a hindrance in terms of obtaining financial assistance or monitoring the progress of the enterprise.

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[13] These activities are considered to be traditional domains of small industry in Sri Lanka.

Most often there are delays in obtaining loans from banks because entrepreneurs are incapable of formulating acceptable project documents for bank finance.

4.2.2 Low Technology

The use of obsolete or `inappropriate' technology often results in low productivity, low quality products, and a high rate of rejection, resulting in higher costs to the producer and a reduction in market competitiveness (Lakshman et al. 1994b:94). Sub-standard production techniques and the absence of efficient machinery and equipment often prevents small firms from competing in the larger environment because they cannot compete with the diverse substitutes and complements to the products they manufacture. Lakshman et al. found that some firms use machines produced thirty years ago thus making them operate at less than capacity (Lakshman et al. 1991:26). `Appropriate Technology' is often advocated in policy recommendations for SMI development. However, although this maybe cost efficient when small businesses have just started, the continued reliance on this type of technology prevents firms from competing with newer products in the market.

In terms of size, once again it is the smaller firms that seem to have a problem with upgrading their technological capabilities because they cannot afford to do so. Small firms also do not upgrade their facilities because they do not know any better. Lakshman et al. (1994b:98) found that some entrepreneurs viewed the technology they used as being quite adequate to produce the things made for the markets they serve, although it was very clear that improvements were needed for greater efficiency. The medium-large firms however, are generally more dynamic and are able to upgrade their machinery when needed subject to financial constraints.

Low levels of technology are also associated with management and the workforce in general. The literature on SMIs and the ten case studies show that the majority of these entrepreneurs have acquired their technical and management skills on a self-study/on-the-job basis. SMIs also survive on family traditions for operational methods. A limited number of small-scale industrialists have formal training and are not exposed to neoteric workshops to upgrade their skills.

4.2.3 Poor Infrastructure

A key determinant of enterprise success is the availability of infrastructural services such as electricity, water and waste disposal systems. Firms find it harder to compete with existing firms when they do not even have access to essential common facilities that are required for a business to

run effectively. The situation in terms of infrastructure, however, is different for urban and rural industrialists.

In most rural areas, firms do not even have access to essential common facilities such as water, electricity, telephones or road access. For example, many parts of the Kegalle district still lack electricity and pipe borne water (Aturupane et al. 1996). This prevents industries from using even simple power tools which can improve the quality of the finished product and raise productivity.

In urban areas however, most firms have access to these facilities. However, even when such facilities are available, there are numerous shortcomings in delivery. For instance, firms may have electricity but the constant power failures hamper their activities by damaging equipment. One of the firms in our sample of case studies - *Lanka Printing & Packaging Ltd (Pepiliyana)* - suffered numerous setbacks till they could afford to purchase their own generators. Furthermore, their computer system was seriously jeopardized because of the constant voltage fluctuations.

Entrepreneurs also complain about waste disposal. Many factories get no assistance from the state in terms of disposing waste. They have to incur the added cost of transporting waste material to a suitable dumping site and are faced with more problems when they cannot find places to dispose such material.

Policies to promote SMIs to bring regional development should concentrate on developing urban nodes of industrial development in second or third tier urban centres. In fact, the current drive to establish industrial estates on the provinces is based on sound economic reasoning.

4.2.4 Weak Institutional Support

Hitherto, numerous institutions have been set up in the public sector to implement the various policies designed to help and promote SMIs. Recently, a series of institutions under the supervision of Provincial Council authorities have also been added to the already existing centrally supervised institutions. However, industrialists claim that the out-reach of these institutions to intended beneficiaries has been limited (Lakshman et al. 1994b: 68). There is a need for a central institution to co-ordinate the various SMI policies. It would be useful if entrepreneurs could have a focal place to address their issues and problems.

The general impression is that the majority of organizations involved in promoting industrial development do not have mechanisms for regular co-ordination of activities among themselves,

particularly when different levels of government are involved. Hence, they sometimes adopt contradictory positions. This is particularly observable in the relationships between the Central Environment Authority and the provincial organizations. There are examples of projects identified as environmentally-friendly by provincial authorities, but being turned down as environmentally hazardous by the CEA (Lakshman et al. 1994b:61).

In terms of institutional responsibilities, it has been observed that different organizations are responsible for carrying out the same tasks. For example, in the field of technical training the IDB and ISB (Industrial Services Bureau) conducted similar training programmes for the same group of industrialists. It would have been more productive if the two organizations had co-ordinated their activities properly (Lakshman et al. 1994b:61). On the issue of training - a problem cited by a number of industrialists during the course of this study was that while there are a large number of training programmes, most of these miss the mark in terms of providing workers with the basic skills required by industries.

4.2.5 Information and Transaction Costs

As mentioned before, the lack of information often prohibits SMIs from developing an effective marketing strategy. Firms have to be able to successfully orient their production and sales activities to market conditions. However, they are unable to do so due to a variety of reasons related to the inadequacy in the resources available at their command. This is especially the case for smaller SMIs. Larger SMIs (especially in urban areas) have access to resources such as the Internet where they can learn about market trends, product pricing, sales promotion and advertising. The lack of access to such information is an inhibiting factor in SMI development.

Another reason why small-scale industrialists do not gain the utmost use of their loans is due to a lack of awareness and information as to what is available to them. For instance, after so many years of SMI activity, it has been found that most of the entrepreneurs with project proposals are not aware of the services they can obtain from the PCIs and from the large number of supporting institutions[14] that could provide technical, financial and other advice (National Development Bank, 1989:106).

[14] Examples of such supporting institutions include the IDB, EDB, Sri Lanka Standards Institute, Clothing Industry Training Institute, Ceylon Institute of Scientific and Industrial Research, National Institute of Business Management and Sri Lanka Business Development Centre.

4.2.6 Exogenous Constraints

Adequate macromanagement is a prerequisite to a facilitating environment for SMIs and any other industrial activity for that matter. For instance, it is difficult for firms to expand and accumulate capital easily during periods of declining per capita income, foreign exchange shortages, inflation and negative net investment. Hence, improvements in macro management will go far to increase incomes of SMIs and hence their ability to foster industrialization. Industrial activity needs to gain momentum in the country in order to provide SMIs with the needed competitive pressures for expansion.

Firms are also affected by market fluctuations due to an uncertain economic environment as a result of socio-politcal instability. The ethnic conflict in the Northern and Eastern provinces has effectively cut off markets for some firms thus depressing demand for SMI products. The upheavals in these provinces have also meant that enterprise development has been limited or non-existent in these areas.

The topic of law and order is often overlooked in the literature on SMIs. However, it was found that it is very relevant when discussing what constitutes an enabling environment for SMIs to grow. For instance, the lack of law enforcement in some localities is often an obstacle to the efficient running of factories. *Lanka Printing & Packaging Co.* had to move their factory and office from Kolonnawa to Boralesgamuwa because of thuggery and intimidation. The local gang fights impeded the day-to-day running of the factory and eventually stopped employees from attending work. Moreover, the enterprise got no support from local government authorities to remedy the situation.

4.3 Regulatory Constraints

4.3.1 Tax Regulations

The World Bank survey found that tax levels and tax regulations were one of the most important obstacles to expansion faced by firms (World Bank 1997:55). However, taxes do not necessarily affect all firms irrespective of size. Levy's field research suggests that as Sri Lankan companies grow, they become vulnerable to large increases in tax and to other regulatory strictures implying that there is a definite correlation between firm size and tax burden (Levy 1993:75). Often, the smaller firms do not have to pay taxes or are more able to evade tax payments. Levy refers to the threshold burden which is a discontinuity in the structure of costs that results when a fiscal burden is imposed only on firms above a minimum size. Consequently, he finds that many entrepreneurs

rationally limit expansion of their enterprises because if they grow (or shift to limited liability status), they have to pay more and higher taxes which in turn increases their cost of production (Levy 1993: 75). Often the result of this is that firms resort to different forms of creative accounting and entrepreneurs are quick to admit that they `cook their books' in order to avoid taxation. Levy finds that in practice, entrepreneurs conceded that their tax payments were substantially below the formally mandated levels.

The crux of the matter here lies with weak tax administration. Entrepreneurs accept that firms have to pay certain taxes, but they protest about the inequitable implementation of tax regulations. They find it unfair that they have to compete with those firms that evade taxes because such firms then have the advantage of offering lower prices.

4.3.2 Labour Regulations

Levy finds once again that labour regulations affect firms once they have crossed a threshold size (Levy 1993:75). Generally, the larger firms cannot evade labour regulations as easily as small ones. One of the advantages of being small is that such firms are not covered by hire/fire rules, working conditions etc. The larger firms, on the other hand, are compelled to follow these rules and often have to incur higher costs as a result of increased wages and increased contributions to employee benefit schemes. The result is that smaller firms tend to resist expansion in order to avoid the added cost of adhering to labour regulations.

Restrictive labour regulations also affect the capacity utilization of firms. Entrepreneurs claim that they cannot hire and dismiss inefficient workers with ease. Such restrictions often prevent firms from employing as many workers as they would like, thus constraining efforts at expansion.[15]

Employers also claim that such regulations have a negative impact on labour productivity which in turn hinders firm growth. Job security regulations allow workers to idle at work as there is little chance of dismissal, prevents firms from making on-the-job evaluations of workers and encourages the use of temporary workers who acquire fewer firm-specific skills (Gunatilaka et al. 1996).

[15] The Termination of Employment of Workmen Act (TEWA) stipulates that an employer should obtain the written consent of an employee or the prior written approval of the Commissioner of Labour, before terminating employment of a worker who has worked not less than 180 days in the preceding 12-month period. Industrial units with less than 15 workers do not come under this Act (Gunatilaka et al, 1996).

Labour regulations also affect the employment of women in SMIs, specially in blue-collar jobs. Regulations such as those that restrict women from working overtime are reasons for employers being reluctant to hire female workers.

4.4 Cost Constraints

4.4.1 Cost of Materials (Input Costs)

A large number of industrialists complain about the high cost of raw materials. However, Lakshman et al. (1994b:104) interpret this as an indication of the nature of the financial environment in which these firms are operating. With heavy competition among themselves, these firms (especially the small ones) have virtually no control over prices they are able to charge for their products. The demand for these products emanate largely from the surrounding areas and is not all that buoyant. The complaint of "high cost" of raw materials appears to be basically a reflection of this general financial environment in which these industrialists are forced to operate. On the other hand, larger firms do not appear to find the high cost of raw materials as constraining and in fact claim that liberalization has ensured the free availability of intermediate inputs which is of benefit to those SMIs that depend on imported raw materials and finished products.

On the issue of liberalization, however, one should note that although raw materials are freely available, not all small-scale industries have access to them. Often, the larger and more established firms buy most of the supplies. There is also the case of BOI status creating a distortion for small industrialists. Due to their priviledge, BOI companies can offer a better price for inputs than ordinary SMIs. This priviledge, in turn, becomes a disadvantage to the small-scale industrialist.

Furthermore, liberalization does not automatically imply lower cost of inputs either. The liberalized imports of raw materials and capital equipment has benefited primarily the larger enterprises because the smaller ones had to depend on the mediation of traders for their supply of raw materials and thus ended up paying higher prices than their large competitors who could afford to import on their own (Islam et al. 1988:56).

4.5 Conclusion

This chapter has sought to identify underlying problems that require special focus in support of small and medium scale firms. They were also small industrialists' perceptions of their problems. The analysis made clear that the constraints to expansion of SMIs are not only financial. SMIs

need monetary support but they also need an adequate institutional and regulatory environment within which to operate efficiently.

The forgoing analysis also brought to light the fact that most of the perceived problems are clearly general problems that confront virtually all firms in the industrial sector, small and large. The message for policy makers then is clear in terms of what the approach should be to support SMIs. The appropriate policy response is to provide SMIs with a supportive environment that enables them to have equal opportunities to succeed. This means neutralizing the incentive structure with respect to taxation, labour laws, access to infrastructure services and integrating markets through communications and transport development. Once this has been provided, it is up to those industries that have a genuine comparative advantage to survive.

Chapter 5: Future Directions in Financing SMIs

This chapter offers *some* reflections on the possible policy direction for the future. The paper thus far has attempted to indicate what needs to be rectified in programmes designed to promote the development of SMIs. It also indicates that such an incentive structure should be compatible with the overall development policy of achieving private-sector led, market oriented industrial growth that stimulates regional dispersion and diversification. Furthermore, it should not encourage non-viable production by encouraging distortive resource transfers through protective measures. Having made this clear, the rest of the chapter will discuss two specific issues in terms of providing guidelines for policy makers in the future. The first will be on SMI finance and the second will centre around the issue of size and what that implies for SMIs.

5.1 Financing SMIs

5.1.1 Venture Capital

Credit guarantee schemes to the SMI sector may also have reached a level of maturity where they need to look beyond refinancing to becoming a form of venture capital lending. The discussion in this paper makes clear that loans must not only be given, they must also be recovered. The units set up must be viable and robust and be able to withstand competition and the vagaries of the market. Venture capital financing can play an important role in providing financial assistance to entrepreneurs, particularly where the entrepreneur lacks adequate collateral to secure conventional credit facilities from banks. It is commonly regarded as equity investment for a pre-determined time period in small businesses with high growth potential. Such forms of financing benefit both lender and borrower. There are three main characteristics of venture capital financing:

- it involves equity or equity-related participation in the form of a direct purchase of shares, or through warrants, options or convertible securities.
- venture capitalists add value to investments by developing an active on-going involvement in the strategic and operational management of the investee companies, often through working representation on the Board of Directors.
- venture capital financing is a long-term investment discipline that often requires a period of 7 - 10 years before receiving any significant return on investment.

Here, the participating credit institution would be more involved in guiding entrepreneurs in their business ventures. This sees to the fact that lending institutions are properly involved in their clients' business activities from the stage of loan application to the stage of using funds.

5.2 Reducing Vulnerabilities that Arise Due to Size

The overall conclusion from this study is that larger SMIs had a bigger impact on employment creation and earnings than smaller SMIs and most importantly were longer-lasting. Cost conditions and market prospects that factor in on sustainability differ for small and medium industries. Medium level SMIs seem to have less difficulty in continuing their operations and the likelihood of their becoming large is greater than that of a small or micro enterprise. Smaller SMIs on the other hand, with all that size implies for economies of scale, access to finance capital and the scope for technological improvement, find it harder to lower their input costs and find it difficult to deal with competition from more sophisticated products from regional, national and foreign manufactures. What are the suitable options for small firms to minimize the cost of being small?

5.2.1 Clustering

A way in which micro-enterprises can be made more viable and productive is through a system of clustering (Schmitz 1995). A group of producers making the same or similar things in close vicinity to each other constitute a cluster. Clustering opens up efficiency gains which individual producers rarely attain. Firms can share knowledge of new products or processes, labour availability, reliability of suppliers and traders, specialization, and can lend each other tools and machinery. This method of 'clustering' can be used together with the development of industrial estates for SMIs.

5.2.2 Sub-Contracting

Since Sri Lanka is a small country, its internal market for the wide range of products needed by the local consumers is limited. In addition, the country has the most 'open' economic policies. This implies that the smaller scale manufacturing sector cannot expect much economies of scale although they have to be competitive with imported products, both in quality and price. This suggests that the scope for producing end products for the consumer is limited. Therefore, the tendency in the small-scale manufacturing sector should be in the direction of sub-contracting activities and the service sector rather than manufacturing of finished products.

Sub-contracting arrangements provide a mechanism by which the deficiencies or gaps in skills related to the marketing function in a small industrialist is remedied by a main contractor, who carries out such tasks on his behalf. In 1980 the government established *The Sub-Contracting Exchange* (Osmani 1987:191). Its duties included assisting SMIs to gain knowledge of potential public procurement or private orders, communicating to large enterprises the production

capabilities of potential SMI sub-contractors and assisting SMIs in meeting required quality standards and delivery schedules. However, the Exchange did not prove to be very effective in executing its functions. The large buyers preferred to deal directly with known and trusted suppliers rather than go through the Exchange. The information supplied by the buyers to the Exchange often fell short of the full specifications required by a potential supplier (Osmani 1987:192).

Sub-contracting enables SMIs to join larger manufacturers as sources for components/final products and thus take advantage of management, technical and marketing expertise available to them. Tendler advocates demand-driven support provided by large customers such as firms, traders and government agencies, rather than the usual supply-driven methods which provide standardized assistance on a variety of subjects to the largest number of firms possible. The demand-driven approach centres around large customers providing small firms with a market, technical help and often finance. Hence, such an approach tackles one of the major problems facing struggling small firms - that of finding a reliable customer and thereby having sufficient assurance about the future so as to focus on improving productivity (Tendler 1996:410).

5.3 Conclusions

There have been significant improvements to the management of SMI loan schemes in recent years. These schemes have supported a significant number of enterprises and helped generate a considerable number of employment opportunities for mainly low-skilled labour. Even so, there is considerable room for improving on current credit practices in participating credit institutions, and programme sustainability remains questionable if multilateral lenders withdraw funding while liquidity constraints continue to hamper the domestic financial market. Furthermore, one should not forget the objectives of programmes such as these that are targeted to enhance the growth of the SMI sector. They are intended to give opportunities to all firms, irrespective of size, to succeed. SMI development is chosen especially because it has the capacity to encompass most income groups which is not what happens with an undifferentiating industrial strategy. Hence, financial institutions and policy makers should not only focus on the urban, larger, and more credit-worthy SMIs because this defeats the purpose of promoting rural industrialisation. Finally, it should be reiterated that improving accessibility to credit alone is not enough to encourage the growth of the sector. Providing a conducive macroeconomic environment is key to success, while eliminating infrastructure bottlenecks and other institutional barriers that inhibit the expansion of the sector.

ANNEX I: SMI I-IV

The World Bank/Asian Development Bank - sponsored SMI lending scheme became operational in Sri Lanka in 1979. To date, Sri Lanka has obtained credit under 4 successive lines of credit. The number of loans under each scheme and the value of each line of credit is given in Table 1, in Chapter 1.

Objectives of Loan Schemes

The SMI strategy had 3 major objectives:

- It sought to engage the government of Sri Lanka in a dialogue about the efficacy of economic policies regarding trade, and the appropriate roles of the public and private sectors.
- It sought to make the Government restructure the financial sector from one that serviced a centrally-planned industrial economy, which favoured large enterprises, into one that responded to the demands placed on it by entrepreneurs.
- It sought to generate jobs so that Sri Lanka's unemployment problem could be addressed on a cost-effective basis.

Eligibility Criteria

Projects qualified for lending only if their fixed assets were below the maximum allowed. Table 2 gives these limits.

Table 1: Size of Enterprise to Qualify for SMI Funding

	Total investment in fixed assets at original book value on completion of project
SMI I	Rs. 2 mn excluding land & buildings (leased or owned)
SMI II	Rs. 4 mn excluding land & buildings (leased or owned)
SMI III	Rs. 8 mn excluding land & buildings (leased or owned)
SMI IV	Rs. 16 mn excluding land & buildings (leased or owned)

Source: National Development Bank.

Projects eligible for credit had to fall into the following sectors:

Manufacturing
Mining
Construction contracting
Agricultural industries
Fish processing
Industrial services
Horticulture
Commercial transport of goods
Animal husbandry

Table 2 gives a breakdown of the number and value of loans granted under these activities.

Table 2: Loans Granted under SMI Loan Schemes to Different Industries

Products	SMI I, II, III & IV (1979 - 1996)	
	No.	Rs. Mn
Food Processing	3,549	2,212
Other Agro-Industries	305	140
Rubber Products	314	328
Metal Products	1,568	748
Construction Materials	1,243	629
Construction Contracting	278	523
Wood Products	990	872
Garments	963	760
Textiles	301	307
Repair Works	558	329
Others (a)	6,573	5,188
Total	16,642	12,036

(a) Includes passenger & commercial transport, leather, animal husbandry, chemical, fishing, restaurants, fibre glass, electronics, ceramic and polythene.

Source: Central Bank of Sri Lanka.

Table 3: Gross Approvals by Sector - SMI Refinance

Food, Beverages & Tobacco	17.59%
Construction Materials	3.97%
Agriculture, Agro-Business & Fisheries	10.83%
Textiles & Wearing Apparel	4.94%
Wood & Paper Products	8.36%
Rubber & Leather Products	2.93%
Metals & Chemicals	9.14%
Services	35.28%
Others	6.83%

Source: NDB

Debt-Equity Ratio: The overall minimum equity contribution is normally 25 per cent on completion of any sub-project.

Security: Sub-project viability and adherence to eligibility criteria formed the basis of credit institutions' lending decision rather than the collateral provided by the sponsor. In most cases the appraisal of the project viability combined with the security provided by the assets of the projects itself and the cover under the Central Bank Credit Guarantee Scheme was considered adequate security for the sub-loan.

Disbursement of Funds

The NDB and DFCC have been involved in the disbursement of funds. Commercial banks too have given loans for the development of SMIs, but the resources for these have come from the NDB in the form of refinance. The NDB provided refinance upto an extent of 70% of the sub-loans granted by private financial institutions.

Table 4: SMI Scheme Refinance Approvals by PCIs as at March 27, 1998 (Rs. Million)

PCI	SMI I			SMI II			SMI III			SMI IV			TOTAL			
	No.	Amount	%	No.	Amount	%.	No.	Amount	%	No.	Amount	%	No.	%	Amount	%
Bank of Ceylon	658	86.1	37.5	1310	458.3	43.3	728	288.7	25.9	2442	1155.6	22.8	5138	33.1	1988.7	26.6
People's Bank	896	91.4	39.8	722	254.1	24.0	932	305.8	27.5	2338	936.8	18.5	4888	31.5	1588.1	21.3
Commercial Bank	115	29.5	12.8	90	49.2	4.6	87	68.8	6.2	399	367.7	7.2	691	4.5	515.2	6.9
Hatton National Bank	65	21.7	9.5	76	38.2	3.6	203	82.1	7.3	994	749.1	14.8	1338	8.6	891.1	11.9
DFCC	7	0.8	0.4	293	258.8	24.5	264	256.1	23.0	1277	1338.1	26.4	1841	11.9	1853.8	24.8
Sampath Bank Ltd.	-	-	-	-	-	-	160	105.3	9.5	232	172.9	3.4	392	2.5	278.2	3.7
Seylan Bank	-	-	-	-	-	-	2	4.6	0.4	248	280.4	5.5	250	1.6	285.0	3.8
RRDB – Kurunegala	-	-	-	-	-	-	63	2.6	0.2	560	41.8	0.8	623	4.0	44.4	0.6
RRDB – Kegalle	-	-	-	-	-	-	-	-	-	114	18.0	0.3	114	0.7	18.0	0.2
RRDB – Kandy	-	-	-	-	-	-	-	-	-	236	13.7	0.3	236	1.6	13.7	0.2
Total	1741	229.5	100.0	2491	1058.6	100.0	2439	1114.0	100.0	8840	5074.1	100	15511	100.0	7476.2	100.0

Source: NDB.

ANNEX II: OTHER SMI LOAN SCHEMES

SOME OF THE OTHER EXISTING CREDIT SCHEMES FOR THE SMALL ENTERPRISE SECTOR

(1) Central Bank Schemes

This is a scheme launched in 1980 for the small enterprise sector operated by the Central Bank of Ceylon through its regional offices located in Matara, Anuradhapura and Matale.

Maximum Loan	-	upto Rs. 75,000
Interest	-	15% to 18%
Security	-	Personal guarantors and assets of enterprise
Repayment	-	3 to 5 years
Grade Period	-	3 to 6 months

(b) Regional Rural Development Banks Scheme

A scheme sponsored by the Ministry of Finance and Planning and the Central Bank essentially to cater to the credit requirements of the rural farmer and the rural entrepreneur. This scheme first established in Kalutara and Matara District in the year 1985 has gradually been expanded to cover 9 other districts as well, namely Kurunegala, Anuradhapura, Hambantota, Kegalle, Puttalam, Galle, Kandy, Nuwara-Eliya and Moneragala.

Maximum loan	-	Rs. 75,000
Interest	-	18%
Security	-	Relaxed collateral and simple guarantors
Repayment	-	3 to 5 years
Grace period	-	3 to 6 months

(c) **Special Schemes**

Over the years the Central Bank has been instrumental in sponsoring credit schemes for various sub-sectors with refinance facilities and on comparably easy terms and conditions. Most of the schemes have been launched through the two state banks namely Bank of Ceylon and Peoples Bank to gear to the credit needs of small scale entrepreneurs in the respective sub-sectors. The most significant among such schemes are

- Fisheries Sector-Bank Financing Scheme – 1979
- Credit Schemes of Fisheries Cooperatives – 1980
- Youth Self Employment Schemes for Matara District 1981
- Youth Self Employment Schemes for Anuradhapura District – 1982
- Schemes for financing self employment projects in Kandy, Matale and Nuwara-Eliya and Kegalle District of 1986
- Schemes for financing self employment projects in Kalutara & Kurunegala Districts – 1986
- Kegalle District, I.R.V.P. Industrial Credit Schemes – 1987

2. COMMERCIAL BANKS SPONSORED SCHEMES

(a) **New Enterprise Schemes for Self Employment**

This is the latest scheme for small enterprise development launched by the Bank of Ceylon. Under this scheme unemployed individuals, groups, external institutions desirous of relending to members could seek assistance.

Eligibility	-	Projects where the total investments does not exceed Rs,25,000
Maximum loan	-	upto 80% of Project cost subject to a maximum of Rs. 25,000
Interest	-	19%
Security	-	Guarantee of 2 others in the scheme or guarantee of 2 adult family members. In addition to above, mortgage of assets or any other security offered.
Repayments	-	5 years
Grace Period	-	12 months

(b) Venture Capital Scheme

This is the latest scheme sponsored by the Peoples Bank to assist the small scale entrepreneur to purchase his machinery and equipment and meet his working capital requirements.

Eligibility	-	i. School leavers between the age group of 18 to 35 who have acquired some technical skills. ii. Individuals who are not engaged in any other business. iii. Those who have never borrowed money from a Financial Institution before.
Maximum loan	-	Rs. 30,000
Interest	-	18% (3% rebate is allowed for timely repayment of instalments)
Security	-	Upto Rs.10,000 guarantee of parents or employed family members. Over Rs.10,000. In addition to above assets of the applicant.
Repayment	-	5 to 7 years
Grace period	-	3 months
Borrowers Contribution	-	Only for loans over Rs.10,000

(c) Praja Naya Niyamaka Scheme (P.N.N.)

The P.N.N. Scheme was launched both by the Peoples Bank as well as Bank of Ceylon this year to save the tin sector entrepreneur from the clutches of the money lenders, who levy interests as high as 30% per mensum. This is a bold attempt to penetrate into the informal money market and the success will depend on the persons selected as 'Niyamakas'.

		Peoples Bank	Bank of Ceylon
Maximum loan to Niyamaka	-	Rs.100,000/-	Rs.200,000/-
Rate of Interest	-	18% per annum	18% per annum
Lending rate to Borrower	-	2.5% per mensum	2.5 per mensum
Repayment period	-	10 years	10 years
Grace period	-	2 years	2 years
Maximum loan to the Borrower	-	Rs.5,000/-	Rs.3,000/-

3. COOPERATE SECTOR SPONSORED SCHEMES

(a) National Youth Service Council – NYSCO Scheme

This is a scheme launched by NYSCO (National Youth Service Cooperative island-wide through their cooperatives to meet the credit needs of their members. Youths who are inclined to start small scale enterprises are first subjected to training in entrepreneurship development and are required to possess at least 1 share in the Cooperative Society organised at Grama Seva Division level. Maximum loan 30 times the share capital. Subject to a maximum of Rs.10,000.

Interest	-	16%
Security	-	Interest guarantee of 2 members
Repayment	-	3 to 5 years
Grace period	-	6 months to 1 year

(b) Craft Council Credit Scheme

The National Craft Council in cooperation with the Bank of Ceylon launched a scheme in 1988 to assist small Artisans and Craftsmen to obtain credit on easy terms

Maximum loan	-	Rs.10,000/-
Interest	-	17%

Security	-	Interest guarantee
Repayment	-	in 4 years
Grace Period	-	6 months to 1 year

Source: National Seminar on Small Enterprises Development Opportunities in Sri Lanka under the UNDP/ILO Project SRL/87/035 Integrated Entrepreneurship Development Programme – 20 – 22, 1989.

ANNEX III - Recent Trends in Lending to SMIs

(Lending outside the SMAP and SMILE loan schemes by DFCC and NDB are not considered in this note)

Lending to SMIs which was at a very low level in 1997 picked up in 1998 due to the SMAP loan scheme which was started in September 1997. SMI lending further expanded in 1999 due to the SMILE loan scheme which was launched in June 1998.

Table 1: Loan Disbursements to SMIs

	1997	1998	1999 Jan - April
No. of Loans	323	2834	1953
Value of Loan (in Rs. Mn.)	395.3	3365.9	1705.5

Source: Central Bank of Sri Lanka.

Loan distribution by administrative districts indicates that Colombo and Gampaha Districts continue to receive the largest amount of loans followed by Matara and Kandy Districts.

Loans by Purpose

Loan distribution by purpose indicates that about 65% of the loans have been granted for the expansion of existing projects.

Table 2: Loans by Purpose (percentage distribution)

Purpose	1997	1998	1999 Jan - April
New Projects	33.2	35.9	32.3
Expansion	67.8	64.1	68.7
Total	**100.0**	**100.0**	**100.0**

Source: Central Bank of Sri Lanka.

Interest Rates

Interest rates charged for loans have declined in 1999 particularly in respect of small loans granted under the SMILE loan scheme.

Table 3: Interest Rates

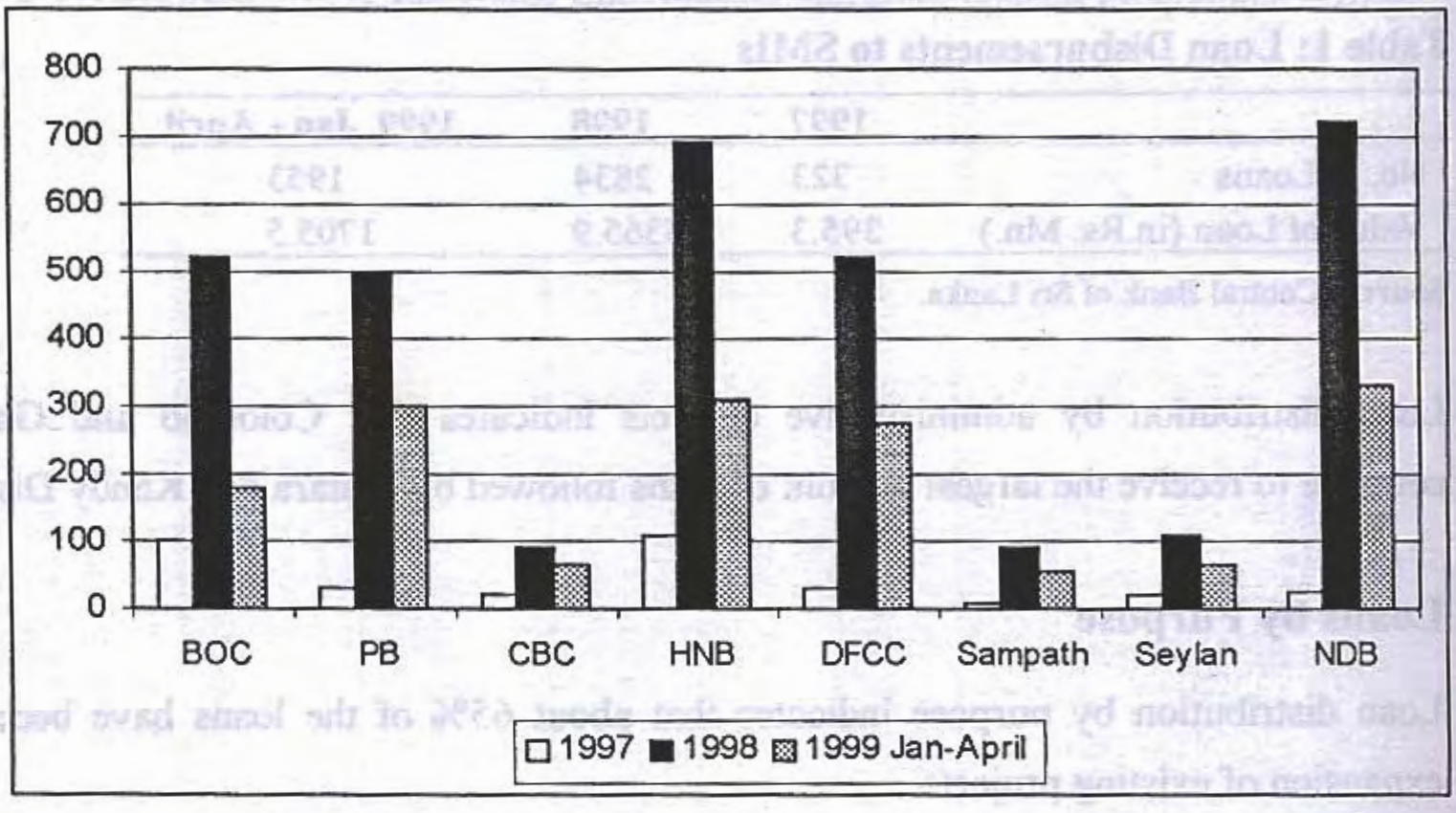
Interest	1998	1999 (Jan - April)
Average Interest Rate of Loans	16 - 17.5%	15 - 16.5%
Interest Rate for Small Loans	-	12 - 14%

Source: Central Bank of Sri Lanka.

Lending to SMIs by PCIs

Of the two development banks, NDB has provided the most amount of loans to small scale enterprises. Among the commercial banks, Hatton National Bank has been the most prominent lender. One significant feature to note is the declining role of the Bank of Ceylon in lending to SMIs.

Figure 1: SME Lendings by Main PCIs



Source: Central Bank of Sri Lanka.

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INSTITUTE OF POLICY STUDIES

99 St Michael's Road
Colombo 3, SRI LANKA

Telephone: 94 1 431 368

Facsimile: 94 1 431 395

email: ips@sri.lanka.net

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